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# As Municipal Securities Market Grows, Increased Regulation Is Needed

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THE SECURITIES and Exchange Commission (SEC) is reviewing the disclosure requirements applicable to municipal securities in the midst of tremendous uncertainty about the economic health of federal, state and local governments, as well as heightened investor concern about the transparency of the municipal securities market, including the lack of uniform disclosure by municipal issuers of their unfunded pension obligations.

But is the current review by the SEC of the existing framework enough? Do municipal issuers provide adequate financial disclosure to their massive retail investor base? The answer to both questions appears to be "no."

In recent years, the market for municipal securities[1] has grown at a torrid pace, reaching nearly $3 trillion in outstanding securities by the end of 2010. In 2010 alone, more than $400 billion in municipal securities sold on the primary market. In contrast, in 1975, which was the first year that the municipal securities market was federally regulated to any meaningful degree, there was barely $49 billion in outstanding securities. Today, municipal securities are issued by more than 90,000 state and local government issuers and are comprised not only of traditional, relatively straightforward fixed-rate debt instruments, but also of vastly complex structured transactions. Most importantly, nearly two-thirds of this debt is held, directly or indirectly, by individual investors, which sets the municipal securities market apart

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from other securities markets.

The regulation of the municipal securities market has not kept pace with its growth in volume or the complexity of the securities traded. For a variety of reasons,[2] regulation of municipal securities remains modest by comparison to that of other securities issued, publicly and privately, via the U.S. capital markets. As enacted, both the 1933 Act and the 1934 Act exempted, with the important exception of their antifraud provisions, municipal issuers from their purview.[3] Even today, those exemptions remain largely intact. For reasons discussed herein, unlike the disclosure-based regulation imposed on corporate issuers, regulation of the municipal market focuses on the municipal securities dealers and, more recently, municipal advisers.

This unique aspect of the municipal securities market, which is often incorrectly attributed to constitutional concerns on the part of Congress in crafting the 1933 Act and 1934 Act, actually flows from the perception that federal intervention is not needed in municipal securities regulation. When the 1933 Act and 1934 Act were amended in 1975 to provide for a modicum of federal regulation of the municipal securities market, Texas representative John Tower proposed a set of amendments designed to further protect municipal issuers from direct regulation. These amendments, referred to collectively as the "Tower Amendment," prohibit the SEC and the Municipal Securities Rulemaking Board (MSRB) from requiring "any issuer of municipal securities…to file with the Commission or the Board…any application, report, or document in connection with the issuance, sale, or distribution of such securities." In addition, the Tower Amendment prohibits the MSRB (but not the SEC) from requiring "any issuer of municipal securities…to furnish the Board or to a purchaser or a prospective purchaser of such securities any application, report, document, or information with respect to such issuer." As a result, disclosure in connection with municipal securities offerings is only indirectly regulated through underwriters of municipal securities.

The events of the fiscal crisis of 2008 have called into question the efficacy of the ratings assigned by the credit ratings agencies to several classes of securities, including municipal securities. The bond insurance industry has all but evaporated, with only one insurer continuing to write business. The mainstream press is awash with dire predictions for municipalities and the securities issued by them. To calm investor fears and allow the market to continue functioning smoothly, regulators should impose standard, fulsome and continuing disclosure obligations directly on municipal issuers, and stand prepared to devote resources to enforcing such disclosure obligations and aggressively pursuing fraud and related failures of disclosure in the municipal securities markets.

## Existing Regulation

Like most securities regulation in the United States, much of municipal securities regulation is the product of congressional response to one

municipal financial disaster or another, although it remains modest by comparison to regulation of other securities issued, publicly and privately, via the U.S. capital markets.

As mentioned above, the original incarnations of both the 1933 Act and the 1934 Act essentially ignored the municipal securities market. Although issuers of municipal securities were subject to liability of the antifraud provisions of the 1933 Act and the 1934 Act, prior to the 1970s, "disclosure" was often limited to a notice of sale of the securities. This was the result of a confluence of factors, including the fact that most municipal securities issued during this period were plain vanilla "general obligation" bonds backed by the full faith and credit of the issuing state, and that most buyers were sophisticated institutional investors.

More than 40 years passed after the enactment of the 1933 Act and 1934 Act before any meaningful effort was made to regulate the market. In reaction to the New York City bond crisis, in 1975 Congress enacted a series of amendments designed to improve the oversight of the market for municipal securities. Among other things, these amendments established the MSRB, a self-regulatory body charged with establishing rules governing the activities of the underwriters and dealers of municipal securities. However, the MSRB has no enforcement power. Instead, the rules of the MSRB, which themselves are subject to SEC approval, are enforced, to the extent possible, by the SEC, the Financial Regulatory Authority (FINRA) and various banking regulators.

The 1975 amendments were limited by the Tower Amendment, which prohibits both the MSRB and the SEC from requiring that any issuer of municipal securities provide the type of detailed presale disclosure expected of corporate issuers subject to the 1934 Act. As a result of the Tower Amendment and the varied, indirect regulation of municipal securities it requires, investors have limited access to information relating to both the securities they are buying and the municipalities issuing them.

Following the 1984 default by the Washington Public Power Supply System on its bonds, the SEC, mindful of the Tower Amendment, crafted a regulatory scheme that regulated municipal issuers indirectly. Specifically, the SEC adopted Rule 15c2-12 in 1989, which required any municipal securities underwriter participating in a primary offering of at least $1 million to obtain and review the issuer's "Official Statement," and to distribute a copy of that Official Statement to potential investors who request a copy. The Official Statement, similar to a prospectus distributed in connection with an offering of corporate securities, describes, among other things, the financing, the means by which the debt will be repaid, potential risks and the tax attributes of the bonds.[4] However, the obligation to review and distribute the Official Statement falls on the underwriter and not the municipality. Indeed, unlike corporate issuers, municipal issuers are not obligated to follow any particular form or disclosure or accounting standards in preparing their Official Statements, and therefore any substantive review of the Official Statement by an underwriter is necessarily a limited exercise.

A 2008 study indicated that **more than 50 percent of the municipal securities** sold during the period from 1996 to 2005 had one or more years of **deficient (late or non-existent) disclosure**.

Rule 15c2-12 provided investors with a level of primary market disclosure but did not mandate continuing, post-issuance disclosure of relevant information. In 1994, partially in response to the bankruptcy of Orange County, Calif., the SEC amended Rule 15c2-12 to address that oversight, requiring underwriters to determine whether an issuer of municipal securities has entered into a "continuing disclosure agreement" with investors prior to underwriting any issuance by that issuer, pursuant to which the issuer agrees to file annual, audited[5] financial statements and notices of material events with the MSRB or one of four designated data repositories. Under amended Rule 15c2-12, an underwriter must ensure that the Official Statement contains a description of the issuer's continuing disclosure obligation for the securities being offered and that it discloses any previous failures by the issuer to comply with prior continuing disclosure agreements. However, this continuing disclosure framework was intended to be enforced (and effected) by the underwriter, and neither the MSRB nor the SEC has the authority, under Rule 15c2-12 or otherwise, to *compel* disclosure by the issuer.[6]

Not surprisingly, the 1994 amendments failed to resolve many of the issues with regulation of the municipal securities market. A 2008 study indicated that more than 50 percent of the municipal securities sold during the period from 1996 to 2005 had one or more years of deficient (late or non-existent) disclosure.[7] Unlike private issuers of securities, there remained no central repository for disclosure until June 2009, when a centralized, electronic EDGAR-like database for the municipal securities market was unveiled. The Electronic Municipal Market Access System (EMMA) was designed to provide investors with detailed, timely information about the municipal securities they were buying. However, unlike EDGAR, all reporting is voluntary, and there are no ramifications for deficient disclosure. Indeed, the SEC has acknowledged the lack of consequences for an issuer's failure to provide secondary market disclosure, stating that there is nothing that would "prohibit Participating Underwriters from underwriting an Offering of municipal securities if an issuer or obligated person has failed to comply with previous undertakings to provide secondary market disclosure."[8]

By the mid-2009, a municipality that sought to issue bonds was required, indirectly, to make disclosure both at the time of the initial offering and on a continuing basis thereafter. But, as noted above, no federal or state governmental agency has any enforcement authority, the municipal issuers view these obligations as contractual in nature, and the SEC is aware that these contractual obligations are frequently breached. There is no penalty to a municipal issuer for non-compliance; the only remedy is for a bondholder to sue the issuer for breach of the continuing disclosure agreement. As a practical matter, this rarely happens.[9] Even a violation by a municipal issuer of the anti-fraud provisions of the 1933 Act and 1934 Act rarely results in an enforcement action. To date, the SEC has brought only one enforcement action against a state issuer for violations of the federal securities laws, asserting in late 2010 that the state of New Jersey violated the securities laws by failing to disclose that it was underfunding the state's two largest pension funds. Similarly, in 2010 the SEC secured financial penalties against individual public officials in a municipal bond fraud case for the first time, this time in connection with the failure by the City of San Diego to disclose that it was underfunding its pension fund. Other investigations, including one related to bond offerings by the state of Rhode Island, are ongoing.

**Regulation After Dodd-Frank**

The Dodd-Frank Wall Street Reform and Consumer Protection Act (Dodd-Frank),[10] passed by Congress in reaction to the 2008 financial crisis, was meant to represent the most sweeping reform of financial regulation since the Great Depression. As it relates to municipal securities, §§975 through 979 of Title IX of Dodd-Frank became effective on Oct. 1, 2010 and were intended to make several changes to the oversight of the municipal market.

In crafting §975, Congress again avoided direct

regulation of municipal issuers, this time by requiring the registration of municipal advisors with the SEC[11] and empowering the MSRB to regulate them, thus bifurcating examining and rulemaking responsibilities between the two entities. Municipal advisors are also required to register with the MSRB. In addition to this registration requirement, Dodd-Frank modified §15(B)(c)(1) of the 1934 Act to provide that municipal advisors have a fiduciary duty to their municipal clients. In late 2010, the SEC published a proposed municipal advisor registration rule interpreting §975 of Title IX of Dodd-Frank, but following a maelstrom of letters in protest of the proposed rule, to date the final rule has not been issued.

An "Office of Municipal Securities" within the SEC is established by §979. The Office of Municipal Securities is intended to administer SEC rules relating to municipal securities brokers, dealers, issuers, investors and advisors and to serve as a liaison between the SEC and the MSRB. To date, the rule remains unimplemented, and no such office exists within the SEC.

Dodd-Frank modifies the MSRB board of directors by requiring that at least eight members of the 15-member board be "independent" of municipal securities dealers, municipal advisors, brokers and dealers. The MSRB was originally conceived in 1975 as a self-regulatory organization, and as such at least two-thirds of its board was required to consist of municipal securities dealers and other bank representatives. Effective Oct. 1, 2010, the MSRB was temporarily expanded to 21 members, 11 of whom are "independent," with three of the remaining 10 seats filled by municipal adviser representatives.

Perhaps the most important provision of Dodd-Frank relating to municipal securities is §978, which requires that the Government Accountability Office compare municipal and corporate disclosure and evaluate the costs and benefits of repealing the Tower Amendment. Such a repeal could subject issuers of municipal securities to some form of registration, a result that would have significant cost implications in terms of both time and money to such issuers.

Following the passage of Dodd-Frank, the SEC has taken several actions to increase oversight of municipal securities. In May 2010, the SEC approved rules (effective Dec. 1, 2010) designed to improve the quality and timeliness of municipal securities disclosure. Specifically, these rules expand Rule 15c2-12 to (i) include variable rate demand obligations, (ii) include disclosure of events that could adversely affect a bond's tax exemption, (iii) eliminate the need for a "materiality" determination in respect of certain events (which themselves are expanded by the new rules) subject to the continuing disclosure requirement, and (iv) provide specific filing deadlines for continuing disclosure. In an August 2011 letter to the SEC, the MSRB urged the SEC to further amend Rule 15c2-12 as necessary to (finally) impose consequences to municipal issuers for failure to comply with their continuing disclosure requirements.[12]

Notwithstanding the expansion of the MSRB, the new registration requirements applicable to municipal advisers and the passage of the recent disclosure rules by the SEC, the regulatory landscape for the municipal market remains largely unchanged more than a year after the passage of Dodd-Frank. The resulting lack of meaningful disclosure, coupled with continuing fiscal distress at both the federal and municipal level, contributes to the unease amongst municipal investors and the general weakness that has recently typified municipal securities market. It is troubling that post-2008 regulation of the municipal securities market has focused on registration and regulation of the underwriters, brokers and advisers, while essentially ignoring an obvious fix to the underlying issue: robust regulations requiring enhanced availability and accuracy of disclosure from the issuer.

### The Need for More Disclosure

The corporate securities laws were designed to protect the unsophisticated retail investor from fraud, to improve investor confidence in the securities markets and to promote an efficient market by enhancing the quality and quantity of publicly available information. Today, it is difficult to argue that such goals are not as relevant in the market for municipal securities as they are in the market for corporate securities. By the same token, it is easy to understand how standardized disclosure requirements, and a means to enforce compliance therewith, might help assuage investor uncertainty and minimize fraudulent practices.

The reasons that justified exempting municipal securities at the time of the 1933 and 1934 Act are no longer relevant: Today, the market for municipal securities is enormous, complex and dominated by retail investors. Without direct regulation of the issuers of municipal securities by repeal of the Tower Amendment and removal of the exemptions from the 1933 and 1934 Acts, efforts to meaningfully regulate the municipal market will continue to be met with resistance and indifference. The time is ripe for the SEC to push for repeal of the Tower Amendment and for direct regulation of municipal issuers.

1. In this article, we use the term "municipal securities" to mean securities issued by the states and their political subdivisions. Christopher Cox, Chairman, U.S. Sec. & Exch. Comm'n, Speech by SEC Chairman: Integrity in the Municipal Market (July 18, 2007) [hereinafter Cox Speech], available at http://www.sec.gov/news/speech/2007/spch071807cc.htm.

2. For example, federal regulation of municipal fundraising efforts may violate the Tenth Amendment. See Cox Speech. In addition, the sheer volume of securities issued annually by municipalities would likely overwhelm current regulatory systems—and budgets.

3. While often attributed to constitutional concerns, in fact, the reasons for excluding municipal securities were (i) the local nature of municipal securities markets, (ii) the lack of demonstrated abuses and (iii) the sophistication of the participants in the municipal securities markets.

4. 17 C.F.R. §240.15c2-12(f)(3).

5. Note that municipal issuers are not subject to any uniform accounting standards.

6. Studies have indicated that municipal issuers avail themselves of this fact: More than half of the municipal bonds sold between 1996 and 2005 had deficient disclosure. Andrew Ackerman, "Delinquent Disclosure; Report Finds Fault With Secondary System," The Bond Buyer, Sept. 3, 2008, at 1.

7. Id.

8. SEC Release No. 34-34961.

9. Ackerman, "Delinquent Disclosure," supra note 6.

10. The Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub.L. 111-203, H.R. 4173).

11. In general terms, a "municipal advisor" is anyone that (a) provides advice to or on behalf of a municipal entity or obligated person with respect to municipal financial products or the issuance of municipal securities or (b) undertakes a solicitation of a municipal entity with respect to municipal financial products, investment advisory services or the issuance of municipal securities.

12. Joan Quigley, "MSRB to SEC: Issuers Should Be Penalized for Not Complying With Disclosure Agreements," The Bond Buyer, Aug. 9, 2011.

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