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Federal Regulation of Municipal Securities: Disclosure Requirements and Dual Sovereignty

New York City's financial crisis in 1975 prompted investor demands for more extensive disclosure by municipal issuers.¹ The long-standing exemption of municipal securities from federal disclosure regulation²

1. The terms "municipal debt" and "municipal securities" generally refer to the obligations of states as well as their political subdivisions. Therefore, all references in this Note to municipal obligations should also be taken to embrace state obligations.


2. Section 3(a)(2) of the Securities Act of 1933, 15 U.S.C. § 77(c)(a)(2) (1970), expressly exempts from the registration and reporting requirements of the statute "[a]ny security issued or guaranteed . . . by any State of the United States, or by any political subdivision of a State or territory, or by any public instrumentality of one or more States or territories . . . or any security which is an industrial development bond." Section 3(a)(12) of the Securities Exchange Act of 1934, 15 U.S.C. § 78(c)(a)(12) (Supp. V 1975), exempts "municipal securities" from the requirements of that Act. Section 3(a)(29) of the 1934 Act, id. § 78(c)(a)(29), defines municipal securities as "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 a State or any political subdivision thereof, or any municipal corporate instrumentality of one or more States, or any security which is an industrial development bond." An "industrial development bond" is defined by reference to I.R.C. § 103(c)(2).

came under attack as investors, suddenly aware of New York's success in concealing its true financial condition, questioned the efficacy of current regulation under the vague antifraud provisions of the securities laws. Investors' demands for adequate disclosure regarding municipal securities are frustrated by the absence under the present securities laws of clear legal standards specifying the information to be disclosed or assigning liability for nondisclosure. The resultant uncertainty about the legal duty to disclose and the lack of investor confidence are particularly troublesome since a healthy municipal securities market is essential to both overall economic stability and the financing of local government.

Current proposals for reform would not remedy this situation. They leave materiality and liability standards undefined. Further, they fail to accommodate the Tenth Amendment limitations on federal regulation of state and municipal governments enunciated by the Supreme Court.
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Court in National League of Cities v. Usery. This Note proposes a regulatory scheme that relies on clear statutory standards for disclosure, enforced by underwriter liability. Such a system, it is argued, should ensure adequate disclosure while satisfying the limitations imposed by Usery.

I. Inadequacies of the Present Regulatory Structure

A. The Need for Disclosure

The purpose of disclosure regulation is to generate a flow of information to investors that promotes efficiency in capital markets and protects investors from fraud and misrepresentation. Disclosure regulation promotes capital market efficiency by facilitating investment decisions based on accurate predictions of future returns from the

8. The Note's argument thus differs from those analyses that attempt to refute the traditional justifications for the exemption: lack of abuses, investor sophistication, and the costs that regulation would impose on municipalities. See Hearings, supra note 1, at 165; House Hearings, supra note 6, at 1-2 (statement of Rep. Murphy); cf. Stock Exchange Practices: Hearings on S. Res. 84 (72d Cong.), 56 and 97 (73d Cong.) Before the Senate Comm. on Banking and Currency, 73d Cong., 1st Sess., pt. 16, at 7441-52 (1933) [hereinafter cited as Stock Exchange Hearings] (George B. Gibbons, municipal bond dealer) (setting forth the traditional reasons for exemption). For example, in introducing S. 2969 Senator Williams argued that two of these justifications—investor sophistication and costs to municipalities—were no longer valid. Senator Williams asserted that the reduced share of commercial banks in the new issue market meant that individual, and hence less sophisticated, investors were purchasing a larger proportion of municipal debt. 122 Cong. Rec. S1632 (daily ed. Feb. 17, 1976). He also maintained that an “erosion of investor confidence” after the New York City crisis led to higher costs, and thus that disclosure costs would be offset by the lower interest rates that would result from increased investor confidence. See id. at S1632-33.

The Senator's initial premise, however, is questionable. It is difficult to predict the future role of individual investors in the municipal securities market. Although individual investors have held increasing dollar amounts of municipal securities, and have increased their share of total municipal securities holdings from 1972 to 1974, their share of municipal securities outstanding in 1974 was only 29.1%, which is substantially lower than their 35.2% average share of holdings in the middle 1960s. Board of Governors of the Federal Reserve, Flow of Funds, Assets and Liabilities Outstanding 1974, at 10 (1975) [hereinafter cited as 1974 Accounts]; see note 14 infra. Furthermore, disclosure will not necessarily lead to lower yields.

security, thereby encouraging issuers of securities to undertake those capital projects likely to be most profitable. Disclosure protects investors by subjecting the fiscal actions of the issuer to public scrutiny.

Municipal securities, however, are sufficiently different from corporate securities to warrant a separate regulatory framework. Municipal securities are issued to finance public rather than private projects, and are generally safer investments than corporate bonds. Moreover,

10. A socially efficient allocation of resources is one in which all resources are employed in the activities in which their social returns are highest. The most efficient allocation of resources by capital markets would require disclosure of all information necessary to yield the best predictions of future returns. See Securities & Exchange Comm'n, Disclosure to Investors: A Reappraisal of Federal Administrative Policies Under the '33 and '34 Acts (The Wheat Report) 60-61 (1969) [hereinafter cited as Wheat Report]; Hearings, supra note 1, at 115 (remarks of Jackson Phillips, exec. vice pres., Moody's Investor Service, Inc.). Some economists have defined an "efficient" capital market as one in which prices fully reflect available information. See Fama, Efficient Capital Markets: A Review of Theory and Empirical Work, 25 J. Finance 383, 383 (1970). Other economists have recognized that information is itself produced at a cost and is subject to the forces of supply and demand. Gonedes, The Capital Market, the Market for Information, and External Accounting, 31 J. Finance 611, 612-15 (1976).

There is some dispute whether compelled disclosure produces information of sufficient utility to investors to justify the costs of regulation. Compare R. Posner, Economic Analysis of Law 198-99 (1972); Bentson, The Effectiveness and Effects of the SEC's Accounting Disclosure Requirements, in Economic Policy and the Regulation of Corporate Securities 23, 72-76 (H. Manne ed. 1969); and Stigler, Public Regulation of the Securities Markets, 19 Bus. Law. 721, 730 (1964) with Gonedes, Evidence on the Information Content of Accounting Numbers: Accounting-based and Market-based Estimates of Systematic Risk, 8 J. Financial & Quantitative Analysis 407, 433-36 (1974). See also J. Keynes, The General Theory of Employment, Interest and Money 147-63 (1933) (predominant activity of developed securities markets is forecasting psychology of market rather than prospective yield of assets). Resolution of this controversy is beyond the scope of this Note. The disclosure standards proposed here are designed to facilitate accurate appraisals of investment risk for each type of municipal security, and thus attempt to meet the major criticism of securities regulation—that the information disclosed has little economic significance. See pp. 946-51 infra.

11. Protection of investors was a central concern of the drafters of the 1933 and 1934 Acts. See H.R. Rep. No. 1383, 73d Cong., 2d Sess. 11-13 (1934); S. Rep. No. 47, 73d Cong., 1st Sess. 1 (1933); H.R. Rep. No. 85, 73d Cong., 1st Sess. 7 (1933). Commentators have noted several ways that disclosure protects investors. See, e.g., L. Brandeis, Other People's Money and How the Bankers Use It 92-99 (rev. ed. 1932) (publicity most effective means of encouraging bankers' adherence to fiduciary duties); Schoenbaum, The Relationship Between Corporate Disclosure and Corporate Responsibility, 40 Fordham L. Rev. 563, 577-78 (1972) (disclosure encourages corporate managers to adhere to higher standards of conduct). It has also been suggested that the opportunity for fraud increases as the amount of information decreases because the security's price becomes less representative of its true economic value. Knauss, A Reappraisal of the Role of Disclosure, 62 Mich. L. Rev. 607, 610 (1964).

12. During the period 1948-1965, permanent losses of interest and principal on municipal bonds amounted to less than $10 million, or .01% of the municipal debt outstanding. G. Hempel, The Postwar Quality of State and Local Debt 28 (1971); Twentieth Century Fund, Building a Broader Market 115 (1976). Of the $500 million of municipal bonds that were in default during 1945-1974, $334 million were revenue bonds financed by three toll roads. Id. In comparison, in the 1970s alone an estimated $1.6 billion in corporate long-term and short-term debt was defaulted. Id.
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since interest on municipal securities is exempt from federal income taxation, the market is probably composed of investors subject to the highest tax rates. High-income and institutional investors are likely to be financially sophisticated; municipal securities would therefore seem to warrant less pervasive regulation than corporate securities.

The information necessary to protect investors and enable them to assess risk accurately varies with the type of municipal security. Debt

First, commercial banks, which are subject to Federal Reserve regulation, can underwrite general obligation municipal securities but not corporate securities. 12 U.S.C. § 24 (1970 & Supp. V 1975). Second, competitive bidding requirements for general obligation bonds eliminate the private placement option open to corporations. This difference is significant, since corporations have increasingly resorted to private placements to avoid the costs of registered offerings. See Benton, supra note 10, at 67-70 (private placements 3% of total offerings during 1900-1934, 46% during 1935-1965). Competitive bidding also reduces the incentive for an underwriter to research an issue thoroughly because the effort will be for naught if the bid proves unsuccessful. Trading in Municipal Securities: Hearings on S. 1933 and S. 2474 Before the Subcomm. on Securities of the House Comm. on Banking, Housing and Urban Affairs, 93d Cong., 2d Sess. 154, 158-61 (1974) (statement of Securities Industry Ass'n).

Proposals before Congress to subject municipal bonds to the same regulation as corporate securities overlook these distinctions. As a result the proposals received no support in Senate hearings. See Hearings, supra note 1, at 41, 141-42.


14. As indicated in 1974 figures, the municipal securities market is dominated by three groups—commercial banks (48.8%), households (29.1%), and fire and casualty insurance companies (15.5%). 1974 Accounts, supra note 8, at 10. The "household" category is residual and includes holdings of private trusts. If investors are rational and consider the tax exemption, it is likely that "holdings of tax-exempts [by individuals] are highly bunched at the upper end of the marginal tax scale." Galper & Petersen, The Equity Effects of a Taxable Municipal Bond Subsidy, 26 Nat'l Tax J. 611, 617 (1973). Commercial banks and fire and casualty insurance companies invest in municipal securities largely because these institutions are subject to stricter tax treatment than other financial intermediaries and thus place greater value on tax-free income. See Clark, The Federal Income Taxation of Financial Intermediaries, 84 Yale L.J. 1603, 1629-31, 1664-66 (1975); cf. R. Robinson, Postwar Market for State and Local Government Securities 84-88 (1960) (tax exemption, varied coupon dates, and desire to participate in underwriting account for bank holdings).

Future composition of the market is difficult to predict. Tax considerations, bank demands for loanable funds, and losses incurred by fire and casualty insurers are major factors. See Wall St. J., Sept. 20, 1976, at 20, col. 2. Recently commercial bank participation in the market has decreased: banks absorbed 61.3% of the increase in municipal securities outstanding from 1960 to 1974, but only 18.7% in 1974 and 1975. 1976 Accounts, supra note 5, at 3; Board of Governors of the Federal Reserve, Flow of Funds Accounts 1945-1968, at 74-75 (1970); 1974 Accounts, supra note 8, at 10; Board of Governors of the Federal Reserve, Assets and Liabilities of Commercial Banks, Dec. 31, 1975, at 1 (1976); id., Dec. 31, 1973, at 1 (1974). Whether this decline is a temporary or long-term trend, and whether individuals (rather than other institutions) have increased their share of the market, are uncertain.

15. The preponderance of sophisticated investors was a major reason for the original exemption of municipal securities from federal regulation. Stock Exchange Hearings, supra note 8, at 7450 (statement of George Gibbons, municipal bond dealer).

16. Securities Industry Ass'n, Fundamentals of Municipal Bonds 3-4 (9th ed. 1973) [hereinafter cited as SIA]; Rosenzweig, supra note 2, at 136. Recent commentators have
service for general obligation bonds, which are issued directly by the city, is paid from general tax revenues. The riskiness of these bonds is thus a function of the city's debt structure, public service obligations, and ability to collect taxes or otherwise obtain revenues. Revenue and industrial development bonds are issued by separate municipal entities, and the city usually does not promise to repay these debts out of its general revenues. Rather, debt service on revenue bonds is paid from the revenues of the public project (e.g., a toll bridge or highway). The riskiness of these bonds depends on the ability of the project to generate revenues sufficient to cover payments on principal and interest. Industrial development bonds are not focused on the important differences between the types of municipal securities and the consequences of these differences for disclosure regulation. See, e.g., Proposals, supra note 2, at 1054-58; Federal Regulation, supra note 2, at 595 (stating only that distinctions should be made).

17. Municipalities also issue short-term notes, which are a form of general obligation debt. In 1974 the amount of short-term debt (12 months or less) issued ($29.1 billion) exceeded the amount of long-term debt issued ($22.8 billion). Hearings, supra note 1, at 124. However, in 1974 short-term securities comprised only 8.7% of total state and local securities outstanding. 1974 ACCOUNTS, supra note 8, at 10.

18. See A. RABINOWITZ, MUNICIPAL BOND FINANCE AND ADMINISTRATION 136-40 (1969); Indirect Regulation, supra note 2, at 614. Losses of principal and interest on general obligation bonds have been rare, G. HEMPEL, supra note 12, at 15-32, but there are indications that the quality of municipal debt has decreased. Id. at 7. In particular, central cities in the Northeast and Midwest are experiencing serious declines in their tax bases, thus increasing the likelihood that those cities will be unable to meet their service and debt obligations. See JEC, supra note 1, at 11-18. The possibility of default increases the significance of the uncertainties surrounding the measure of creditor compensation under the Municipal Bankruptcy Act, 11 U.S.C.A. §§ 401-418 (West Supp. 1977), i.e., determining the "going concern value" of a city or dividing anticipated revenues between essential services and debt service. See Note, Reform of Creditor Participation Procedures in Municipal Bankruptcy, 85 YALE L.J. 423, 439 & n.94 (1976).

19. Twentieth Century Fund, supra note 10, at 37. Indeed, cities have increasingly set up independent projects and public authorities to limit municipal liability for desirable, but perhaps nonessential, undertakings. Id. at 45-53. To increase the attractiveness of revenue bonds to investors municipalities have sometimes issued "moral obligation bonds," which are revenue bonds backed by a moral (nonlegal) obligation of the municipality to meet debt service payments if the project's revenues prove inadequate. Id. at 53; J. PETERSEN, CHANGING CONDITIONS IN THE MARKET FOR STATE AND LOCAL GOVERNMENT DEBT 10-12 (Jt. Econ. Comm. Print 1976).

20. Cities also issue special obligation bonds, the revenues of which are derived from a specific tax source. Rosenzweig, supra note 2, at 136. These can be classified as either general obligation or revenue bonds, depending upon the degree to which the tax source exhausts the city's potential tax base. See G. HEMPEL, supra note 12, at 97.

21. Speer, What Every Lawyer Should Know About... Municipal Bonds, 44 ILL. B.J. 146, 146-47 (1955). Revenue bonds are not necessarily riskier than general obligation bonds. Hearings on S. 1933 and S. 2474, supra note 12, at 126-27 (Wayne Anderson, Nat'l League of Cities). However, 91% of the dollar value of all municipal debt in default (or principal backing interest in default) from 1945 to 1963 involved 27 municipal units, all but six of which defaulted on revenue bonds. G. HEMPEL, supra note 12, at 27. The riskiness of revenue bonds is increased insofar as political pressures cause officials managing a project to attempt to offer as many services as possible at the lowest cost
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serviced by the rents that a private firm pays to a public authority whose sole purpose is to issue bonds, build an industrial plant, and collect rent to pay off the debt. Investors in such bonds must be aware of all factors that affect the financial health of the tenant industrial firm.

For each type of bond there are persuasive indications that disclosed information is inadequate under the existing regulatory scheme. Current disclosure neither promotes capital market efficiency nor protects investors. Municipalities frequently provide immaterial information and use dissimilar accounting methods that prevent meaningful comparisons between cities.

The timing and frequency of disclosure possible. For example, the Port Authority of New York and New Jersey invested additional funds in mass transit despite restrictions in its revenue bond contracts prohibiting such use because revenues were not sufficiently above costs. See United States Trust Co. v. New Jersey, 97 S. Ct. 1505 (1977) (rev'g 69 N.J. 258, 333 A.2d 514 (1976)) (Supreme Court held that state legislatures' unilateral abrogation of revenue bond provisions that precluded use of revenues for mass transit violated the contract clause).

That revenue bonds are generally perceived as riskier investments than general obligation bonds is evidenced by the higher interest rates (2.5 to 1.50 percentage points) of the former. Swensen, The Cyclical Behavior of the Net Interest Cost Differential Between General Obligation Bonds and Revenue Bonds, 27 NAT'L TAX J. 123, 123 (1974).

Critics have charged that industrial development bonds are merely a means of financing private ventures with debt carrying tax-free interest, to the detriment of the federal treasury. Spiegel, Financing Private Ventures With Tax-Exempt Bonds: A Developing "Truchhole" in the Tax Law, 17 STAN. L. REV. 224, 232 (1965); Note, The Proliferation of Industrial Revenue Bond Financing: Ban the Bond?, 41 TEMP. L.Q. 289, 309 (1968).

Congress responded to these criticisms by revising § 103 of the Internal Revenue Code, narrowing the definition of industrial development bonds that are given the federal income tax exemption. H.R. Conf. Rep. No. 1533, 90th Cong., 2d Sess. 32-42, reprinted in [1968] U.S. CODE CONG. & AD. NEWS 2373, 2379; see I.R.C. § 103(c)(2). Although these reforms virtually eliminated the traditional industrial development bond (which financed an industrial plant), the exceptions provided (especially that for pollution control facilities, id. § 103(c)(4)(F)), have allowed issuance of huge amounts of industrial development bonds ($5 billion in 1975).

Among the questionable practices uncovered were failures to use accrual accounting and to disclose accrued pension and employee benefits and details of leases. Id. at 26-29. Another of the "Big Eight" accounting firms made similar criticisms. ARTHUR ANDERSON & Co., SOUND FINANCIAL REPORTING IN THE PUBLIC SECTOR (1975). Further, a representative of an in-
has failed to take into account the differences between types of municipal securities. Evaluations by private rating agencies, the most influential sources of market information, have frequently been challenged as inaccurate and tainted by political considerations. Even the most sophisticated participants in the municipal securities market, underwriters and institutional investors, have only recently begun to undertake independent evaluations of municipal securities. Their success will depend on the incentives for disclosure created by the regulatory scheme.

Municipal disclosure is also influenced by political considerations. Politicians, who control the information to be disclosed, have incentives to conceal important fiscal decisions from voters and investors.
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alike; there are obvious advantages to manipulating budgets to avoid both cuts in municipal services and tax increases in an election year. There are obvious advantages to manipulating budgets to avoid both cuts in municipal services and tax increases in an election year.29 Political pressures may also cause excessive use of revenue bonds and separate fiscal entities, because these financing devices not only circumvent debt limits and voter referenda requirements but may conceal or obscure governmental actions from investors.30

B. Failure of Existing Regulation to Compel Disclosure

Even as strengthened by the 1975 Securities Acts Amendments,31 current regulation has failed to ensure adequate disclosure. Municipal issuers still are subject only to the antifraud provisions of the 1933 and 1934 Acts.32 Since the 1975 Amendments do not clarify the nature of the Securities and Exchange Commission’s (SEC’s) power to enjoin municipalities,33 regulation of municipal issuers may only be possible

29. See Haider & Elmore, supra note 3, at 5-8. Revenue estimates and allocation of costs between fiscal years can be used to “hide” funds in order to balance the election year budget while cutting taxes and increasing services. Id. at 7. If an insufficient “cushion” has been created for an election year, officials may resort to questionable accounting practices to achieve these results. Wall St. J., Mar. 30, 1976, at 24, col. 4.

New York City’s ability to conceal a huge budget deficit is the frequently cited, though perhaps somewhat atypical, example of creative budgeting. The city had “an antiquated and crazy-quilt accounting system” that was barely comprehensible. Wall St. J., Mar. 9, 1976, at 17, col. 1; see Municipal Accounting: A Better Blueprint Via IFMS, J. Accountancy, Dec. 1976, at 42; Official Statement Relating to the Issuance of $125,000,000 General Obligation Serial Bonds of the City of New York, at 3 (July 1, 1976) (on file with Yale Law Journal). Accounting gimmicks can only balance the city’s books; they cannot provide the cash to offset current deficits. The city must obtain this cash through borrowing. New York was no exception. The amount of short-term debt which New York City had to renew (“roll-over”) was far larger than any other city’s. JEC, supra note 1, at 4-5. At the height of the crisis the city was rolling-over $6 billion in short-term notes annually—30% of all short-term notes issued by all states, counties, and local authorities in the country. Weisman, supra note 1, at 72.


Operating accounts outside of the executive budget (the budget before independent agencies and funds are accounted for), pushed New York State’s spending from $10.8 to $16.7 billion in fiscal 1977. Wall St. J., Mar. 30, 1976, at 24, col. 4. The $16.7 billion figure still excluded the budgets of 42 independent agencies. Id.


33. The 1933 and 1934 Acts authorize the SEC to seek injunctions against municipalities. Section 20(b) of the 1933 Act empowers the Commission to seek an injunction against any person who is violating (or is about to violate) a provision of the Act. 15 U.S.C. § 77t(b) (1970). Section 2(2) of the 1933 Act defines “person” to include “government or political subdivision”, and the antifraud provision of the Act, § 17, applies to municipalities. Id. §§ 77b(2), 77q(c). Similarly, § 21(e) of the 1934 Act, 15 U.S.C. § 78u(d) (Supp. V 1975), provides for injunctive relief and is applicable to municipalities (“persons” under § 3(a)(9), id. § 78c(a)(9)) which violate the antifraud provision, § 10(b), 15 U.S.C. § 78j(b) (1970). But the SEC did not bring a municipal issuer to court until 1976. See SEC v. Reclamation Dist. No. 2990, Civ. No. C76-1251-SAW (N.D. Cal., filed June 17,
through damage actions brought under the antifraud provisions. But
the incentive that the threat of damage actions creates to disclose in-
formation is weakened by the failure of the antifraud provisions to
clarify liability standards, and to specify who is liable for nondisclo-
sure of information—the city, its officers, the underwriters, or the
brokers. Moreover, there are no clear standards regarding the duty of
underwriters to conduct independent investigations of information
voluntarily provided by municipalities.

The confusion in this area is heightened by the uncertainty sur-
rounding constitutional limitations on liability. The Eleventh Amend-
ment, for example, may bar private damage actions against states, 34

1976) (first SEC suit against municipal issuer and its officers); Hearings, supra note 1, at 323 (statement of Robert Doty, Assoc. Prof. of Law, Creighton Univ.). An informal search of SEC files revealed only 2 other actions brought by the Commission against issuers of municipal securities. Telephone Interview with Glenn Mays, staff attorney, office of the General Counsel, SEC (May 4, 1977) (notes on file with *Yale Law Journal*). Moreover, the city of Philadelphia has challenged the constitutionality of the Commission’s power to seek injunctive relief against municipalities under the 1933 and 1934 Acts. City of Philadelphia Complaint, City of Philadelphia v. SEC, No. 76-2396 (E.D. Pa., filed July 29, 1976).

34. Well-defined liability standards are a means of encouraging certain voluntary behavior. See generally G. Calabresi, *The Costs of Accidents* 68-94 (1970). Individuals who are risk-neutral will avoid performing acts that lead to liability if the perceived probability of liability times its cost exceeds the cost of avoidance. See R. Posner, supra note 10, at 72. To compel disclosure, liability standards must set out clearly the information to be provided, and then must place liability for failure to provide information on the party who can most cheaply ensure disclosure. See note 87 infra.

In the corporate context, the standards of liability are often ambiguous. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 & n.12 (1976) (under § 10(b), 15 U.S.C. § 78j(b) (1970), “scienter” required for damage actions; no decision whether “scienter” required for injunctive relief); see Rosenzweig, supra note 2, at 150.

35. Investigation of disclosed information is necessary to ensure accuracy. Lack of clear liability standards for failure to investigate has been a major criticism of existing regulation. See Doty, supra note 2, at 411-17; Hearings, supra note 1, at 124-27 (statement of Richard Kezer, Pres., Dealer Bank Ass’n).


The court has held that states may waive immunity merely by participating in an
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and even the SEC's authority to investigate possible antifraud violations has been challenged as an intrusion on state prerogatives.37 Doubts as to which parties are responsible for ensuring full and accurate disclosure may lead to situations in which each party to an underwriting independently verifies the information or in which no party does so.38

Compounding the failure of the statute and case law to specify who is liable for nondisclosure is the failure to stipulate what information must be disclosed. Standards of materiality remain ill-defined. In the absence of such standards, underwriters fearing liability may well be overzealous in insisting on disclosure by the city or in refusing to bid on an issue.39 As a result the information they extract may be


38. When liability standards are clear, only those parties on whom liability is placed need balance the risk and potential costs of liability for misinformation against the costs of verification. As liability standards become less certain, the perceived risk of liability decreases for those who formerly were certain that they were liable and increases for parties previously certain that they were not. Thus, depending on the costs of investigation and the degree of uncertainty surrounding liability standards, many parties (or no party) may find the costs of verification less expensive than the expected liability for misinformation.

39. Underwriters or dealers can demand disclosure as a condition of bidding on an issue of securities, even though they can obtain and subsequently disclose only information that the city chooses to provide. Hearings, supra note 1, at 128 (remarks of Richard Kezer, Pres., Dealer Bank Ass'n). After passage of the 1975 Amendments, some underwriters refused to bid on issues because of uncertainty as to the type of disclosure required. Proposals, supra note 2, at 1024-26; Hearings, supra note 1, at 128; Wall St. J., Jan. 6, 1976, at 1, col. 6. The yield which a municipality must pay on its debt generally increases as the number of bids decreases. Kessel, A Study of the Effects of Competition in the Tax-Exempt Bond Market, 79 J. Political Econ. 706, 707 (1971); Swensen, supra note 21, at 132; West, Determinants of Underwriters' Spreads on Tax-Exempt Bond Issues, 2 J. Finance & Quantitative Analysis 241 (1967). This bid-yield relationship creates pressure for a municipality to provide information in order to reduce borrowing costs.
irrelevant, and the costs they impose substantial. Indeed, underwriters have forced the state of New York to engage in largely purposeless disclosure.40

Aside from preserving the minimal antifraud regulation of municipal issuers, the 1975 Amendments directly regulate municipal brokers and dealers, requiring these brokers and dealers to register with the SEC, creating an organization for their self-regulation (the Municipal Securities Rulemaking Board (MSRB)), and prohibiting fraudulent or manipulative devices as well as any breach of the MSRB’s rules.41 The MSRB may provide for periodic examination of brokers and dealers,42 and the SEC may censure, limit the activities of, or suspend or revoke the registration of any municipal securities dealer.43 This regulatory structure, however, does not resolve the problems of vagueness. The statute specifically prohibits the Board from directly or indirectly prescribing requirements that force disclosure by municipal issuers.44 Any attempt by the MSRB to specify liability or materiality standards would seem to contravene that prohibition, because it would cause—indeed require—brokers and dealers to demand specific information. The 1975 Amendments were designed only to cope with abuses by brokers and dealers in the marketing of securities.45

II. Inadequacies of Proposed Legislation

H.R. 2724, introduced in the current session of Congress and identical to House and Senate bills considered in the last Congress, is

40. In order to sell $3.66 billion in short-term notes, New York State had to issue a 74-page prospectus, aptly described as fit “for Talmudic scholars.” Wall St. J., Mar. 30, 1976, at 24, col. 4; see Casey & Smith, supra note 2, at 645 (N.Y. State, Nassau County, N.Y., and Baltimore, Md., required to prepare extensive disclosure documents). Controller Levitt of New York State claimed that lawyers for underwriters were overemphasizing protection of their clients to the point where information was stated so conservatively that it became “misinformation.” Wall St. J., May 20, 1976, at 27, col. 3. The Municipal Securities Rulemaking Board noted in a statement to a congressional subcommittee that throughout the municipal securities market costly negotiations between issuers and underwriters had led to disclosure of “possibly non-material items.” Hearings, supra note 1, at 389.
43. Id. § 78o-4(c)(2).
44. Id. § 78o-4(d)(1), (2). The Board’s power is limited to requiring disclosure by brokers and dealers of information generally available from a source other than the issuer. Id. § 78o-4(d)(2).
the most comprehensive reform yet proposed. The proposed legislation has received careful consideration in hearings before both Houses of Congress and is likely to provide the basis for future legislative proposals. Municipalities would be required to meet disclosure guidelines set by the SEC under a broad statutory mandate. Unlike previous proposals, the bill attempts to accommodate the distinctions between municipal and corporate securities and to create a separate regulatory structure for municipal securities. The bill apparently relies on the 1934 Act’s antifraud provisions to enforce its disclosure requirements.

H.R. 2724 outlines general categories of information to be disclosed, but delegates considerable power to the SEC to set the specifics and extent of disclosure. Cities with over $50 million in securities outstanding are required to file an annual report containing descriptions of debt, tax and revenue sources, and public service obligations. The annual report must also include audited financial statements as prescribed by the SEC. The bill provides further that issues of over $5 million be accompanied by a distribution statement describing the issue and the intended use of the funds. The SEC is authorized to

46. H.R. 2724, 95th Cong., 1st Sess. (1977); see S. 2969, 94th Cong., 2d Sess. (1976), reprinted in Hearings, supra note 1, at 5-13; H.R. 15205, 94th Cong., 2d Sess. (1976), reprinted in House Hearings, supra note 6, at 4-12. This Note will refer only to H.R. 2724.

47. See Hearings, supra note 1; House Hearings, supra note 6.

Both the SEC and the Department of the Treasury supported the general approach taken by H.R. 2724, 95th Cong., 1st Sess. (1977). Hearings, supra note 1, at 18-42; House Hearings, supra note 6, at 19, 29. Aside from full regulation under the 1933 and 1934 Acts, an approach that has received little support, the only significant alternative regulatory scheme proposed is that of the Municipal Securities Rulemaking Board, discussed at note 88 infra.

48. See Proposals, supra note 2, at 1040-42. H.R. 2724 would add a new § 13A to the 1934 Act, dealing with municipal securities. H.R. 2724, 95th Cong., 1st Sess. (1977). Hereinafter citations to H.R. 2724 will be to the subsections of the proposed § 13A, which are printed in the bill.

49. See note 12 supra.


51. Specifically, the annual report would contain: an identification and description of the issuer and its securities outstanding; a delineation of legal limits on the issuer’s debt and taxing power; descriptions of the issuer’s debt, including short-term notes, contingent liabilities, and defaults within the last 20 years; a description of the issuer’s major taxpayers and public services; actual tax experience over the last 5 years; and specification of governmental units with overlapping jurisdictions, and of federal and other assistance programs available to the issuer. H.R. 2724, § 13A(a)(2)(A)-(I). Some of these provisions would seem to be applicable only to general obligation bonds, but the bill does not differentiate among the various types of municipal securities.

52. Id. § 13A(a)(2)(J).

53. The bill requires the following information: a description of the offering, including underwriting arrangements; a detailing of the security and redemption provisions; for revenue or special assessment bonds, the project or enterprise to be financed; a
require that the distribution statement include any information set forth in the annual report. The bill also gives the SEC authority to require that annual reports and distribution statements include "similar and specific information . . . necessary or appropriate in the public interest or for the protection of investors." Under this statute, then, the Commission could require municipalities to file distribution statements as detailed as the prospectuses required by the 1933 Act and annual reports as exhaustive as those required by the 1934 Act. In contrast to its powers in the corporate field, however, the SEC would not have power to conduct a pre-offering review of these reports or to require more frequent disclosure.

A. Lack of Clear Liability Rules

Although H.R.2724 may ameliorate the materiality problem by delegating to the SEC the power to set disclosure rules, it fails to clarify liability standards. It remains unclear who is liable and for what penalty, who can bring suit, and what defenses are available to the parties if disclosure of all material information has not been made. Since the bill relies solely on the antifraud provisions of the 1934 Act to enforce disclosure rules, the failure to clarify liability

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54. Id. § 13A(b)(2). When the annual report and distribution statements are combined they comprise statutory disclosure guidelines similar to the prospectus requirements of the 1933 Act, 15 U.S.C. § 77j(a) (1970).
56. For instance, corporate annual reports must include detailed descriptions of properties, legal proceedings, corporate officers and directors, and changes in competitive factors. 3 FED. SEC. L. REP. (CCH) ¶¶ 31,101-08 (form 10-K). For a city this could entail, among other things, elaborate predictions of the future economic health of the region and detailed descriptions of schools, parks and the like. The SEC could institute such requirements under its power to set the "form and detail" of financial statements. H.R. 2724, § 13A(a)(2)(J), (b)(2).
58. The elements in the cause of action, the available defenses, and the damage formula used after actionable conduct has been proven all enter into the calculation of a party's expected loss for failure to disclose. H.R. 2724 fails to clarify any of these standards, except that underwriter liability is limited to the total price at which the issue was sold to the public. H.R. 2724, § 13A(g); cf. 15 U.S.C. § 77k(e) (1970) (same provision). The 1933 Act, by comparison, outlines specific liability standards for omissions or misstatements in registration statements. Id. § 77k. This Note proposes codified liability standards. See pp. 939-46 infra.
standards discourages voluntary compliance and thus undermines the effectiveness of the statute.

B. Disclosure and the Problems of Delegation

In setting disclosure standards H.R. 2724 generally does not distinguish between different types of municipal bonds. The proper amount of disclosure, however, depends on the type of municipal security. Under H.R. 2724 the SEC could ensure adequate disclosure by setting disclosure requirements for each type of bond, tailored to the special risks of that type. Indeed this delegation of power to the SEC is essential to the efficacy of regulation under the bill. Yet, it may run afoul of the newly pronounced judicial solicitude for the prerogatives of local government.

In *National League of Cities v. Usery* the Supreme Court limited Congress's power under the commerce clause to enact legislation affecting state governments. In his opinion for the Court, Justice Rehnquist found, in either the Tenth Amendment or general principles of federalism, a constitutional mandate that Congress should not impair certain attributes of state sovereignty. The Court then held that the commerce clause did not give Congress authority to extend the minimum wage and hour provisions of the Fair Labor Standards Act to employees of states and municipalities. Protection of state "'functions essential to separate and independent existence,'" the Court held, was a constitutional mandate that could not

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60. The only provision applying specifically to "revenue or special assessment" securities requires that the distribution statement include a description of the project or enterprise to be financed and any financial or engineering feasibility studies available. H.R. 2724, § 13A(b)(2)(C).
61. See pp. 923-75 supra.
62. In order to enhance the usefulness of corporate prospectuses, the SEC has created specialized disclosure forms tailored to the disclosure needs of different categories of issuers and offerings. WnEAT REPORT, supra note 10, at 68-77. Disclosure requirements for municipal securities would also have to accommodate diverse issuers and offerings.
64. The exact constitutional basis for the Court's holding is a matter for speculation. Justice Rehnquist noted that in Fry v. United States, 421 U.S. 542 (1975), the Court had recognized that the Tenth Amendment was an express limitation on federal power over states. 426 U.S. at 842; see id. at 861-63 (Brennan, J., dissenting). The Court also seemed to rely on the general notion of "the essential role of the States in our federal system of government." Id. at 844. The Court did not identify a specific constitutional provision for its limitation of federal power over states, but this Note assumes that the primary doctrinal foundation was the Tenth Amendment.
65. 426 U.S. at 852 (holding unconstitutional 29 U.S.C. § 203(s)(5) (Supp. V 1975) ("public agencies" are employers for the purposes of the Act) and id. § 203(x) (state and local governments are "public agencies"). Usery held that because local governmental units derive their authority and power from the states, they too are covered by the Tenth Amendment. 426 U.S. at 855 n.20.
66. 426 U.S. at 845 (quoting Lane County v. Oregon, 74 U.S. (7 Wall.) 71, 76 (1869)).
be abrogated merely by invocation of an "affirmative grant of legislative authority." \(^{67}\) Legislation that imposed costs sufficient to displace state policies \(^{68}\) or that interfered with functions essential to sovereignty \(^{69}\) was impermissible, unless, perhaps, it was necessary to achieve an important congressional goal. \(^{70}\)

Although it is clear that the Court meant to depart from the rather indifferent view it had taken of the Tenth Amendment over the last 40 years, \(^{71}\) the extent of that departure is unclear. \(Usery\) provides no workable guidelines for determination of the limits on commerce clause legislation. Indeed, the Court sets out eight different constitutional tests without explicating, or perhaps even recognizing, the distinctions among them. \(^{72}\) Moreover, the Court’s failure to articulate its

\[\text{Notes and Sources:}\]

- \(^{67}\) Id. at 845.
- \(^{68}\) Justice Rehnquist argued that regulation may displace state policies by raising the costs of a state activity to a point where the state must fundamentally alter its activities. See id. at 846-48.
- \(^{69}\) Id. at 845.
- \(^{70}\) Some indication of a balancing rationale appears in the plurality’s treatment of \(Fry v. United States, 421 U.S. 542 (1975)\). Justice Rehnquist argued that the federal legislation upheld in \(Fry\) was temporary, reasonable in light of the emergency involved, and carefully drafted to avoid displacing state policy choices. Thus the majority found \(Fry\) consistent with \(Usery\)’s invalidation of the minimum wage legislation. 426 U.S. at 852-53; see note 79 infra. But see Note, \(Municipal Bankruptcy, the Tenth Amendment and the New Federalism, 89 Harv. L. Rev. 1871, 1883-84 (1976)\) (no indication of balancing approach in Court’s holding).

Justice Blackmun seized on this language to emphasize that the majority was in fact balancing constitutional provisions. 426 U.S. at 856 (Blackmun, J., concurring). Since Justice Blackmun was the swing vote in a 5-4 decision, his opinion is significant, particularly in light of the position of three dissenters that the Tenth Amendment merely confines the federal government to its enumerated powers, see id. at 862 (Brennan, J., dissenting), and the contention of Justice Stevens that activities of a “State qua State” can be regulated, id. at 880-81 (Stevens, J., dissenting). Justice Blackmun did not attempt to elaborate on the balancing test he proposed, but he did suggest that the importance of the federal interest and the necessity of including the state in the regulatory scheme should be taken into account. \(\text{id. at 856.}\)

- \(^{71}\) \(Usery\) proffers at least eight possible, albeit overlapping, tests of the constitutionality of legislation: (1) impairment of attributes of state sovereignty, 426 U.S. at 845; (2) abrogation of functions essential to separate and independent existence, \text{id. at 845}; (3) forced relinquishment of important governmental activities, \text{id. at 847}; (4) displacement of state policies regarding the manner of delivery of governmental services, \text{id. at 847};
conception of the federal system deprives notions of “sovereignty” or “essential state functions” of any analytical content. The Court provides no guidelines to aid in determining whether legislation represents a “substantial” infringement on the states. The holding is further muddled by the suggestion that the test under the Tenth Amendment is in fact a balancing test sensitive to federal legislative goals.

It seems clear that the scheme proposed in H.R. 2724 for regulation of municipal securities is not as burdensome as the provisions invalidated in Usery. Nonetheless, it is sufficiently analogous to those provisions to implicate Tenth Amendment limitations. The borrowing function, it would appear, is essential to the separate existence of municipal governments. Municipalities must have access to credit (5) interference with traditional aspects of state sovereignty, id. at 849; (6) substantial restructuring of the traditional ways in which local governments have arranged their affairs, id. at 849; (7) direct displacement of the states’ freedom to structure integral operations in areas of traditional governmental functions, id. at 852; and (8) significant impact on municipalities because of monetary cost, id. at 846. These tests admit of substantial variations in the activity or right protected and the amount of federal interference allowed. In particular, there are substantial differences between traditional and essential functions, and between impairment and abrogation. Justice Brennan found no meaning in any of the standards, id. at 872-80 (Brennan, J., dissenting), and one commentator has agreed, Note, supra note 70, at 1881-84. But see Note, supra note 71, at 1006 (arguing that majority opinion implicitly provides workable test).

73. Justice Brennan derided the “conceptually unworkable essential function test.” 426 U.S. at 880 (Brennan, J., dissenting). As Justice Brennan realized, to apply the Usery tests the Court must develop a conception of the federal system, see id. at 875-76, because determination of what is “essential” or “sovereign” depends on the duties and powers of the governmental unit to which a function is allegedly “essential” or “an attribute of sovereignty.” See Note, supra note 70, at 1886-88. The diversity of possible state functions and the lack of consensus on the role of states in the federal system suggest that the boundary for intergovernmental immunity will be a fragmented and case-oriented one. But cf. Fry v. United States, 421 U.S. 542, 558 n.2 (1975) (Rehnquist, J., dissenting) (distinguishing “governmental” from “proprietary” activities); Note, supra note 71, at 1002-03 (stating that Court protected “traditional state services”).

74. The method by which the determination of substantiality is to be made is muddled by the Court’s somewhat misleading statement that there was no need to ascertain the “actual impact” of the wage and hour provision, 426 U.S. at 851, since even according to the Government’s assessments the impact of the provisions was significant. Id.

75. Justice Blackmun’s opinion and Justice Rehnquist’s treatment of Fry suggest such an approach. See note 70 supra; Note, supra note 71, at 1004-05.

76. At the House hearings on H.R. 15205, the applicability of Usery was vigorously debated. Compare House Hearings, supra note 6, at 19, 41, 91-93 with id. at 35-36, 49. The Treasury Department was particularly concerned about excessive delegation of rulemaking power to the SEC. Id. at 35-36 (statement of Robert Gerrard, Ass’t Sec’y of Treasury).

77. Any uncertainty over the constitutional status of the borrowing function arises only because the Usery opinion is unclear as to which state functions are to be accorded constitutional protection against federal regulation. The power to set wages and hours was included as a protected function on the bare assertion that it was “[o]ne undoubted attribute of state sovereignty.” 426 U.S. at 845. Just as the power to set wages and hours
markets to balance the uneven flows of expenses and revenues and to spread the costs of large capital projects over time.\textsuperscript{78}

In \textit{Usery} the Court was particularly concerned with federal regulation that imposed burdensome costs on municipalities.\textsuperscript{79} Since the collection, compilation, verification, and distribution of information are expensive, disclosure requirements will increase the distribution costs involved in issuing municipal securities, thereby reducing the fraction of borrowed funds that can actually be used to provide services.\textsuperscript{80} Furthermore, by granting the SEC authority to determine the size of the issue or the amount of outstanding debt that triggers disclosure requirements,\textsuperscript{81} H.R. 2724 delegates power to the SEC ef-

\textsuperscript{78} See, e.g., R. ROBINSON, supra note 14, at 57-39; JEC, supra note 1, at 3-4.

\textsuperscript{79} Monetary costs alone could have "a significant impact on the functioning of the governmental bodies involved," even if municipal policies are not reordered. 426 U.S. at 846. The constitutional significance of the costs imposed by regulation is particularly clear in Justice Rehnquist's discussion of \textit{Fry} v. United States, 421 U.S. 542 (1975). 426 U.S. at 852-53. \textit{Fry} involved a suit by the United States to enjoin Ohio from paying state employees more than the seven percent wage increase deemed reasonable by the Emergency Price Control Board under the Economic Stabilization Act of 1970, Pub. L. No. 91-379, 84 Stat. 799 (expired April 30, 1974). Justice Rehnquist emphasized that not only was the legislation in \textit{Fry} temporary, but it also reduced pressure on state budgets while merely maintaining past state wage policies. 426 U.S. at 853.

Justice Brennan, however, argued that the majority did not rely on the cost argument. \textit{Id.} at 876 (Brennan, J., dissenting). He described questions of cost as matters of policy and not as constitutional issues. \textit{Id.} One commentator has agreed that the cost argument is "not critical." Note, supra note 71, at 1006 n.187. But, in fact, the Court itself did not make clear what factors were critical.

\textsuperscript{80} The cost of disclosure is part of the expense of floating securities. Corporations can pass on at least a portion of these costs to their customers by charging a higher price for their products. And, to minimize disclosure costs, corporations can rely on retained earnings or private placement of debt. See V. BRUDNEY & M. CHIRESTEIN, CASES AND MATERIALS ON CORPORATE FINANCE 423-24, 751-58 (1972). These options generally are not available to municipalities. See note 12 supra. Further, municipalities would find it difficult to accumulate cash reserves because of political pressures to reduce taxes and increase services and because of the substantial burden it would place on current taxpayers. Municipalities, unlike corporations, do not have customers to whom they can pass on some of the costs of disclosure.

\textsuperscript{81} H.R. 2724, § 13A(d).
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Effectively to block the entry of small issuers into the bond market. In addition, the increased costs of raising capital due to disclosure will displace some policy choices by making projects requiring large capital outlays more expensive. Federal regulation of municipal securities under the commerce clause is thus likely to receive Tenth Amendment scrutiny.

That scrutiny, or the consequences of it, may well hinder the attempt at regulation. The delegation essential to the efficacy of the statute will invite frequent Tenth Amendment challenges that could undermine the regulatory scheme. Every extension of disclosure requirements by the SEC will impose costs and will thus become suspect under at least one of Usery's many standards. If the Court refines Usery to require a balancing test, constitutionality may be resolved only on a case-by-case basis. The elements of the balance—the need

82. Costs of flotation for corporate offerings are significantly higher for smaller issues. Hearings, supra note 1, at 320; see SEC, COST OF FLOTATION OF REGISTERED ISSUES 1971-72, at 29 (1974) (approximately $10 per thousand for issues of over $100 million, compared to $140 for those under $500,000).

83. Costs of projects requiring large cash outlays, such as bridges or mass transit facilities, would rise significantly if interest rates increased, since such projects are usually financed with long-term debt. See JEC, supra note 1, at 3.

84. One commentator has argued that S. 2969 (the predecessor of H.R. 2724) is likely to pass Usery's test of constitutionality because it imposes minimal costs on municipalities and does not expand SEC enforcement powers. Note, supra note 71, at 1016-20. This conclusion is overly optimistic. First, the SEC's ability to use its enforcement powers, even though limited to violations of the antifraud provisions, is significantly expanded by H.R. 2724's broad delegation of power to the SEC regarding the definition of fraudulent disclosure. Second, the costs of disclosure will not be known until the SEC sets specific standards. Most importantly, Usery does not provide guidelines as to which of its numerous formulations of the constitutional test should be relied on in a given case. See note 72 supra. Any prediction of Usery's application must be made cautiously.

85. Usery already has prompted litigation concerning the SEC's existing powers under the antifraud provisions of the 1933 and 1934 Acts. See note 37 supra. Federal courts have wrestled with the various Usery standards in other contexts. In Christenson v. Iowa, 417 F. Supp. 423, 424-25 (N.D. Iowa 1976), the court upheld the equal work—equal pay provisions of the Age Discrimination in Employment Act, 29 U.S.C. §§ 621-634 (1970 & Supp. V 1975), as applied to states, holding that Usery must be limited to its facts. Usery v. Board of Educ., 421 F. Supp. 718 (D. Utah 1976), also upheld these equal pay provisions, but attempted to apply the Usery standard. In doing so the court offered three alternative rationales. The court first balanced state and federal interests, then held that the provision did not "directly" displace a state's freedom to structure integral state functions, and for good measure noted that legislation pursuant to the equal protection clause is less susceptible to Tenth Amendment challenge than legislation under the commerce clause. Id. at 720-21; see Usery v. Bettendorf Community School Dist., 423 F. Supp. 637 (S.D. Iowa 1976) (equal pay provisions of Fair Labor Standards Act, 29 U.S.C. § 206(d) (1970), upheld as a minimal intrusion on states, or, alternatively, power to pay discriminatory wages is not attribute of sovereignty).

86. An administrative agency granted broad powers to regulate municipal securities may, according to its own balancing of state and federal interests, choose not to exercise all of these powers. Since a law delegating powers to an administrative agency is not, on its face, ripe for adjudication unless the specific powers challenged are likely
for regulation and its intrusiveness on state prerogatives—will probably vary in relative weight according to the type of security regulated, the size of the city covered, and the sort of disclosure mandated. Prior cases would usually be distinguishable and litigation would likely proliferate. As a result the bounds of regulation might be determined more by the fear of litigation than by the need for disclosure. Moreover, fragmentation of the statute by inconsistent judicial decisions could hamper the SEC's regulatory efforts.

Even apart from the threat of adverse or inconsistent judicial decisions, Congress should recognize its responsibility in a federal system to limit direct federal regulation of states. When a less intrusive means of accomplishing federal goals exists, it should be preferred as a matter of policy. Moreover, congressional action affecting states may well be accorded a greater presumption of constitutionality than similar actions by an administrative agency. The next section presents

to be exercised by the agency, see Buckley v. Valeo, 424 U.S. 1, 113-18 (1976), municipalities must defend their rights on a case-by-case basis. Clear standards would avoid the uncertainty and litigation costs that accompany delegation.

87. Even if the Supreme Court clarifies the Usery standards, lower courts may be in conflict over specific actions taken by the SEC under H.R. 2724. Among the SEC's powers, those particularly likely to provoke litigation include the authority to enlarge the class of municipalities covered, H.R. 2724, § 13A(d), to prescribe the manner in which the audit is taken, id. § 13A(a)(2)(f), to specify the forms that the reports and distribution statements must take, id. § 13A(e), and to require the disclosure of additional information, id. § 13A(a)(2), (b)(2)(C).

88. To avoid the problems arising out of delegation of power to the SEC, the MSRB has proposed that a committee composed of an equal number of representatives of municipal issuers, underwriters, and the public set disclosure guidelines within a broad statutory mandate. Hearings, supra note 1, at 395-96. Under the MSRB's proposal compliance with the guidelines would be "voluntary," but only to the extent that compliance is not essential to the "accuracy and completeness" of information disclosed. See id. at 390-91, 393; Proposals, supra note 2, at 1054-56. Liability would be based on an express cause of action for damages, similar to § 11 of the 1933 Act, 15 U.S.C. § 77k (1970). Hearings, supra note 1, at 400-02.

The major changes that the Board would make in H.R. 2724 are questionable as a matter of policy. The Board's proposal gives two-thirds of the voting strength in the committee to groups with the incentive to impose the strictest possible standards on municipalities. Materiality standards that are set by a committee dominated by underwriters and "the public" (predominantly investors and bond counsel) would seem more intrusive on state interests than delegation of those powers to the SEC. See id. at 326-27 (statement of Robert Doty, Assoc. Prof. of Law, Creighton Univ.) ("inequitable" to subject issuers to regulation by those private parties with whom they must bargain). Underwriters and investors could well require cities to provide information even though the costs to the municipality of providing it far outweigh the value of the information to underwriters and investors.


90. Congressional action is normally accorded a presumption of constitutionality. P. Brest, Processes of Constitutional Decisionmaking 1004-10 (1975). Although Justice Brennan's argument in Usery that the Court should not engage in Tenth Amendment review because the States are protected by their representation in Congress, 426 U.S. at
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a proposal which, it is argued, accomplishes the same goals as H.R. 2724 with less intrusion on state functions and better-defined liability standards.

III. A Proposal: Liability and Disclosure Standards

Specific statutory disclosure requirements and liability standards would avoid the problem of extended constitutional litigation. A workable statutory framework, however, must set clear disclosure and liability standards for each type of municipal security. The Note proposes such a statutory framework and argues that it is likely to meet the tests of Usery.91

A. Liability Standards

If there are well-defined liability standards, direct SEC regulation of disclosure is unnecessary.92 An individual faced by possible damage actions will act to avoid them if avoidance is less costly than the likely liability.93 Hence, to ensure disclosure at least cost, liability should be placed on the party who can most cheaply avoid it by disclosing the relevant information.94 This principle affords the following guide-

876-77 (Brennan, J., dissenting), was rejected by the majority, id. at 841 n.12, it may still have enough force to afford congressional regulation of the states a presumption of constitutionality. See Note, supra note 70, at 1888-90. Certainly "the Court is on weakest ground when it opposes its interpretation of the Constitution to that of Congress in the interest of the states, whose representatives control the legislative process and, by hypothesis, have broadly acquiesced in sanctioning the challenged Act of Congress." Wechsler, The Political Safeguards of Federalism: The Role of the States in the Composition and Selection of the National Government, 54 COLUM. L. REV. 543, 559 (1954).

Administrative determinations enjoy a less weighty presumption. Lower courts, for example, have rejected the Environmental Protection Agency's interpretation of the Clean Air Act, 42 U.S.C. §§ 1857-1857l (1970 & Supp. V 1975), largely on the grounds that severe intrusions on state prerogatives require an "unequivocal" congressional intent. Brown v. EPA, 521 F.2d 827, 839 (9th Cir. 1975), cert. granted, 426 U.S. 904 (1976); see District of Columbia v. Train, 521 F.2d 971, 983-85 (D.C. Cir. 1975), cert. granted, 426 U.S. 904 (1976). A broad delegation of power that may or may not involve intrusion on state prerogatives would not seem to evince such clear intent. "[C]ourts play a larger role in reviewing administrative legislation than they customarily assume when the actions of legislators themselves are challenged." J. MASHAW & R. MERRIL, INTRODUCTION TO THE AMERICAN PUBLIC LAW SYSTEM 233 (1975).

91. This Note's approach is similar to that advocated by the Treasury Department, which called for statutory standards to avoid delegation to the SEC. House Hearings, supra note 6, at 35-36, 39.

92. For a general discussion of the SEC's administration of the securities laws, see I L. Loss, supra note 22, at 263-316.

93. See note 38 supra.

94. If the parties agreed on the probability of future liability, and if there were zero transactions costs, the parties would contract so that the party who could most efficiently reduce liability costs would do so. Coase, The Problem of Social Cost, 3 J.L. & ECON. 1, 1-15 (1960). But transactions costs include all costs "which inhibit competitive
lines: Underwriters should be subject to stringent liability standards for failure to disclose since they can most cheaply ensure disclosure. Public officials should be liable only for "willful or reckless disregard" of the truth. Municipal issuers should be exempt from liability altogether. Furthermore, these specific standards should appear in the statute, since reliance on antifraud enforcement creates an unnecessary degree of uncertainty.  

1. Underwriter Liability

Underwriters are usually the most knowledgeable participants in an offering. Their business demands familiarity with the securities laws and the information needs of investors, as well as knowledge of the municipality whose securities they are selling. Clear underwriter liability for nondisclosure of material information, in conjunction with municipal officer liability for fraud, would provide adequate disclosure at least cost by ensuring that underwriters specifically re-

markets from working." Polinsky, *Economic Analysis as a Potentially Defective Product: A Buyer's Guide to Posner's Economic Analysis of Law*, 87 Harv. L. Rev. 1655, 1667 (1974). Therefore, the assumption of zero transactions costs requires that the parties have perfect information and the ability to enter into agreements without cost. *Id.* That assumption is untenable where the purpose of negotiations is to determine which party will verify the adequacy of available information. It has been suggested that when transactions costs are taken into account liability should be placed on the party who can avoid liability at the least cost. Calabresi & Melamed, *Property Rules, Liability Rules, and Inalienability: One View of the Cathedral*, 85 Harv. L. Rev. 1089, 1096 (1972).

95. A major criticism of H.R. 2724, which relies on enforcement through the antifraud provisions, is that it fails to clarify liability standards. See, e.g., *Hearings*, supra note 1, at 124, 223, 243; *House Hearings*, supra note 6, at 86, 45-46, 49. A similar criticism can be made of proposals advocating regulation of municipal securities through voluntary disclosure guidelines enforced by the antifraud provisions. See Borge, *Municipal Securities Offerings and the Need for Voluntary and Responsible Disclosure*, 43 Current Municipal Probs. 146 (1976); Doty & Petersen, *supra* note 2, at 288-90, 377-400; *Hearings*, *supra* note 1, at 310-27 (statement of Robert Doty, Assoc. Prof. of Law, Creighton Univ.). Reliance on the antifraud provisions would require courts to establish special liability standards for the various participants in municipal offerings. See Doty & Petersen, *supra* note 2, at 377-400. Such an approach is inappropriate. The courts may fail to develop a comprehensive and consistent system of regulation for municipal securities and may not recognize the important differences between corporate and municipal securities. Moreover, standards set by the courts under the antifraud provisions can evolve only after considerable litigation. Statutory liability standards, as proposed by this Note, afford much greater certainty.

96. Since municipal officials have the easiest access to information, presumably they can most cheaply collect it. But the underwriters can most cheaply determine what information should be collected. Thus, if underwriters fail to require the municipality to disclose material information, they are liable. Municipal officials are liable only if they fraudulently disclose material information. The potential lacuna in this system—negligence by municipal officials in collecting the information requested by underwriters—is dealt with by requirements that underwriters perform independent verification of information they receive. See pp. 941-43 *infra*. For general obligation bonds the reasonable reliance defense for underwriters leaves a necessary gap in investor protection that is justified by the safety of the bonds and the importance of the functions they finance.
quest and receive material disclosures from municipal officials. Moreover, underwriter liability would spread the risk of misconduct among many municipal issuers. Underwriters would increase the costs of floating all municipal securities in order to cover the expected costs of liability.

The defenses available to underwriters would vary with the type of security issued. This variation in treatment is justified by differences in the importance of these types of debt to the municipality, the possibility of default or significant changes in the likelihood of repayment, and the amount and type of information needed to assess the risk of the bond. In all cases, however, underwriters would be responsible for prescribing the type and form of disclosure to be prepared by municipal officers.

Since general obligation bonds are the primary source of credit for municipal governments, the costs of regulating the issuance of these bonds should be minimized to mitigate the burden that regulation imposes on the credit market activities of cities and thus to avoid Tenth Amendment problems. These bonds are also a relatively risk-free investment, and the information needed to make a rough estimate of their quality—such as debt per capita, general wealth of the community, and tax rate per $1000 assessed valuation—is generally public. Hence, the benefits of imposing strict liability standards on underwriters are probably outweighed by the increased underwriting costs that would result—costs that would be borne at least in

97. Any statutory provision that decreases the likelihood of recovery by potential plaintiffs will reduce the incentives for underwriters to ensure the truth and completeness of disclosure. Section 11 of the 1933 Act, 15 U.S.C. § 77k (1970), provides the best example of a statutory provision designed to encourage different levels of investigation by participants in an offering. Separate defenses are provided in § 11(b) for experts, nonexperts, and persons relying on statements of public officials or documents. Id. § 77k (b)(3); see Escott v. BarChris, 283 F. Supp. 643 (S.D.N.Y. 1968); R. Jennings & H. Marsh, supra note 57, at 825-35. Arguably these gradations of liability were meant to assure complete, but not duplicative, investigation of disclosures.

98. General obligation bonds represent almost 60% of municipal debt. Hearings, supra note 1, at 149 (statement of Securities Indus. Ass'n). Revenue bonds are usually a secondary source of funds for public projects inasmuch as they are often relied on only when a general obligation debt limit is reached. See L. Ecker-Racz, The Politics and Economics of State-Local Finance 124-25 (1970); A. Heins, supra note 30, at 83.


100. See id. at 47. Hempel notes that these variables, plus a variable for tax delinquency, could explain up to 50% of the variation in observed defaults. Id. at 46. He notes that the tax delinquency rate reflects a community's willingness to pay, id., which an investor could also gauge through newspaper reports. Moreover, extra information seemed to add little to the explanatory power of his model. Id. The interest rates paid by a municipality might decrease if extra information is disclosed. If the municipality can predict a reduction in interest charges greater than the cost of added disclosure, however, it would presumably disclose the information voluntarily. See Bentson, supra note 10, at 24-25.
part by municipal issuers. One means of reducing these costs might be to allow underwriters a defense such as reasonable reliance on the statements of municipal officials. Costs may be further reduced by designating as the statutory standard of materiality information that a reasonable investor would consider important. Institutional investors, who demand more detailed information than is required by this standard, are able to fend for themselves by applying pressure through the market for the information they need.

101. Total costs of flotation of municipal offerings are significantly less than for corporate offerings. Hearings, supra note 1, at 520 (statement of Robert Doty, Assoc. Prof. of Law, Creighton Univ.). Presumably at least part of the differential is due to the absence of strict liability for municipal security underwriters. If such liability were imposed, underwriters would demand disclosure as a condition of bidding for a municipal issue in order to avoid liability. See Casey & Smith, supra note 2, at 645, 653-54. They presumably would also demand a premium to build up a fund to protect against possible future liability. At the hearings on municipal disclosure, underwriters claimed that underwriter liability would increase costs to municipalities because of increased underwriting costs and fewer bids. Hearings, supra note 1, at 130 (remarks of Richard Kezer, Pres., Dealer Bank Ass'n); cf. Kessel, supra note 39, at 707 (issuer costs decrease as number of bids increases).

102. At present, in order to avoid liability underwriters must satisfy a standard of due diligence in investigating the veracity of data in corporate registration statements. The due diligence standard requires reasonable investigation of the issuer as well as reasonable grounds to believe that statements are true and not misleading. See 15 U.S.C. § 77k(b)(3)(A), (B) (1970). The due diligence standard necessitates a considerable effort by underwriters and cooperation from issuers. See Escott v. BarChris, 283 F. Supp. 643, 686-97 (S.D.N.Y. 1968); Doty, supra note 2, at 417-22; Comment, BarChris: Due Diligence Refined, 68 COLUM. L. REV. 1411, 1415-22 (1968).

The reasonable reliance standard only requires reasonable grounds to believe that the information provided is accurate and complete. See 15 U.S.C. § 77k(b)(3)(C), (D) (1970). Although the "reasonable reliance" standard dictates less investigation than the due diligence standard, there is no reason that it should become, as Senator Williams intimated, "an invitation [to an underwriter] to protect himself by putting blinders on and earmuffs, too." Hearings, supra note 1, at 133. Under any standard the courts must determine whether, in a particular situation, the underwriter's actions were reasonable. The reasonable reliance standard does not permit the underwriter to request less information; it merely reduces the need for independent verification of data.


104. See R. Posner, supra note 10, at 198-99. Individual investors spend little time evaluating investment information, see Lease, Lewellen & Schlarbaum, The Individual Investor: Attributes and Attitudes, 29 J. FINANCE 413, 427 (1974), and hence detailed (i.e., expensive) information is unlikely to be material to them.
The underwriter would face more stringent liability standards for revenue and industrial development bonds. These forms of debt play a subsidiary role to general obligation bonds in municipal financing.¹⁰⁵ Since these bonds present risks similar to those of corporate bonds,¹⁰⁶ underwriters should be held to the standards of liability applicable to underwriters of corporate securities¹⁰⁷ and thus would be accorded only a due diligence defense against challenges to their procedures for verification of information supplied by the municipality. Regulation would provide underwriters with stronger incentives to force disclosure and to investigate the veracity of the information disclosed for revenue and industrial development bonds than for general obligation bonds.

2. Liability of Municipal Officials

The civil liability of municipal officials should be limited to liability for fraud. Although municipal officers will generally know if their statements are plainly false, they usually do not have the necessary knowledge either of the securities laws or of accounting to determine when statements may be inadequate or misleading to investors. Underwriters can make these determinations at a lower cost.¹⁰⁸ Moreover, the threat of personal loss posed by failure to disclose would deter some prospective officeholders from serving, a primary con-

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¹⁰⁵ Since revenue bonds sell at higher interest rates than general obligation bonds, A. HEINS, supra note 30, at 36; Swensen, supra note 21, at 123, revenue bonds would not be an economical alternative to general obligation bonds for most projects. Revenue bonds are economical only when the extra costs of borrowing are outweighed by the advantages of not pledging the city’s credit. A. HEINS, supra note 30, at 85.

¹⁰⁶ See notes 21 & 22 supra.

¹⁰⁷ Section 11 of the 1933 Act, 15 U.S.C. § 77k (1970), sets up strict civil liability for false registration statements. Since underwriters are covered by § 11, id. § 77k(a), they are strictly liable for misstatements unless they sustain the burden of proving an affirmative defense, such as a due diligence investigation. Id. § 77k(b). See generally 3 L. Loss, supra note 22, at 1683-1746 (1961).

¹⁰⁸ L. ECKER-RAČ, supra note 98, at 123-24; see Federal Regulation, supra note 2, at 594 n.167. Only the largest cities are likely to have house counsel or financial advisors who can provide the needed expertise. L. ECKER-RAČ, supra note 98, at 123. Moreover, underwriters have constant contact with the market and are able to determine the needs of investors at little cost.
sideration weighed by the Supreme Court in strengthening the "good faith" defense for public officials charged with violating an individual's civil rights. Finally, fear of personal liability for official acts may cause decisionmakers to use the municipality's resources to protect themselves rather than to further the interests of the city. Hence, fraud in this context may best be narrowly defined, requiring, for example, "willful or reckless disregard" of the truth.

3. Issuer Liability

a. General Obligation Bonds

Despite almost universal support for some sort of municipal issuer liability, there has been little public discussion of the purposes or consequences of such liability. Placing liability on municipal issuers will produce useful disclosure only if the possibility of future claims against the municipality provides an incentive for public officials or voters to ensure that disclosure. However, an official's desire for reelection will often prevail over any sensitivity to the possibility of municipal liability. Nor is issuer liability likely to induce voters to

109. "The most capable candidates for school board positions might be deterred from seeking office if heavy burdens upon their private resources from monetary liability were a likely prospect during their tenure." Wood v. Strickland, 420 U.S. 308, 320 (1975) (liability under 42 U.S.C. § 1983 (1970)) (footnote omitted).

110. When the public and private incentives of decisionmakers diverge, there is a danger that decisions optimal from the social perspective will not be made. See Tullock, Public Decisions as Public Goods, 79 J. POLITICAL ECON. 913 (1971). Liability for reasonable mistakes "would undoubtedly deter even the most conscientious school decisionmaker from exercising his judgment independently, forcefully, and in a manner best serving the long-term interest of the school and the students." Wood v. Strickland, 420 U.S. at 319-20. Municipal officer liability stricter than that imposed by the antifraud sections would create a heavy personal responsibility to investors. Federal Regulation, supra note 2, at 592. Such liability would significantly reduce the responsiveness of elected officials to the electorate. Underwriter liability avoids these problems while still protecting investors.


112. See, e.g., Proposals, supra note 2, at 1054-55; Hearings, supra note 1, at 393 (statement of MSRB).

113. A. Downs, AN ECONOMIC THEORY OF DEMOCRACY 174-75 (1957). The danger of politically expedient nondisclosure is greatest when the city's economic condition and citizens' expectations make it difficult to balance the budget while satisfying the electorate's desires for increased services and lower taxes. Unfortunately, these are exactly the situations in which default is possible and therefore disclosure is most needed. Budgets are inevitably a product of political processes, and even in noncrisis situations, administrators of government agencies attempt to conceal their true performance from the public. S. Howard, CHANGING STATE BUDGETING 11-14, 49-51, 102-07 (1973). Labor negotiations offer many examples of municipal officials sacrificing the best interests of the city to political experience—here, to satisfy politically powerful unions. See H. Wellington & R. Winter, THE UNIONS AND THE CITIES 121-28 (1971).
exert pressure on public officials for disclosure. The liability is far too contingent and the problem far too complex to incite a reaction at the polls. Municipal issuer liability would provide few effective incentives for more complete and accurate disclosure. Hence, municipalities should not be liable for violations of disclosure requirements in connection with issuance of general obligation bonds.

Placing liability primarily on underwriters and exempting municipal issuers from liability could, however, have a negative impact on investor confidence in general obligation bonds. Investors might fear that underwriters alone would be unable to compensate them for losses caused by nondisclosure. Although investor reactions are often unpredictable and irrational, the infrequency of defaults on municipal bonds and the secure financial position of underwriters should dampen any adverse reaction. A greater danger is that underwriters will refuse to bid or will demand exorbitant compensation. Given the defenses provided underwriters of general obligation bonds an underwriter should have no difficulty meeting its statutory responsibilities.

b. Revenue Bonds

Revenue bonds are issued by an entity created to manage a revenue-producing project. Because they do not have to seek reelection, project officials have much less incentive than municipal officials to sacrifice the long-run health of the project to win votes. Furthermore, although revenue project officials are not required to maximize the profitability of the project, it is likely that they will attempt to minimize conflicts with and criticisms from the public and bondholders. Officials can be expected to provide adequate disclosure to avoid disruptive civil damage actions. Hence, an express civil damage action against revenue projects should be created. The standards applicable to corporations under the 1933 Act, including strict liability of the

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114. Furthermore, since voters are unlikely to have access to more information than investors, they would not be able to make informed judgments as to whether the costs of further borrowing outweigh the benefits of the programs to be financed, or whether the costs of further disclosure outweigh the reduction in potential liability.

115. Like members of public utility commissions, revenue project officials are under no obligation to maximize profit, but are subject to pressures from consumers of the public service, bondholders, and other special interest groups. Since officials can be expected to maximize their own job satisfaction and security, it would appear to be in their interest to ensure the continued operation of the project and to placate the demands of all interest groups. See Joskow, Inflation and Environmental Concern: Structural Change in the Process of Public Utility Price Regulation, 17 J.L. & Econ. 291, 297-98 (1974).
The issuer, should apply.\textsuperscript{116} If the municipality considers the services provided by the project to be so vital that the project should not be liable in the same manner as a corporation, it can finance the services with general obligation debt.

c. \textit{Industrial Development Bonds}

The issuer of an industrial development bond is, in substance, the industrial firm that rents the plant.\textsuperscript{117} Other than the terms of the lease, all information material to investors in industrial development bonds relates to this firm.\textsuperscript{116} These bonds should therefore be considered obligations of the industrial firm, as they would if the firm had issued its own securities to finance the industrial plant. The firm should be liable as if the securities were its own.

B. \textit{Disclosure Standards}

A disclosure policy should ensure that underwriters, rating agencies, and professional investors have enough information to evaluate a security, and that their evaluations reach individual investors.\textsuperscript{110} Moreover, the requirements should be the minimum necessary to ensure investor protection.\textsuperscript{120} That minimum varies for each type of security, and therefore separate disclosure requirements are needed for general obligation, revenue, and industrial development bonds. It is necessary to consider the need for distribution statements and annual reports for each type of bond.

Distribution statements should be required for all new issues of municipal securities that exceed a statutorily-specified amount.\textsuperscript{121} For

\textsuperscript{116} Strict liability for misrepresentations in registration statements is provided for in § 11 of the 1933 Act, 15 U.S.C. § 77k (1970). The Act also gives the SEC power to investigate or seek an injunction against any issuer suspected of violating any provision of the Act. \textit{Id.} §§ 77s(b), 77t. \textit{See generally} 3 L. Loss, \textit{supra} note 22, at 1683-1746.

\textsuperscript{117} \textit{See} Spiegel, \textit{supra} note 22, at 232.

\textsuperscript{118} The terms of the lease are vitally significant and should be disclosed in addition to the corporate data.

\textsuperscript{119} Regulation of brokers and dealers by the MSRB ensures that their evaluations reach individual investors. \textit{See} p. 930 \textit{supra}. The goal of regulation should not be to ensure that issuers directly inform all holders of municipal securities, since investors receive disclosed information through secondary sources. \textit{See} Knauss, \textit{supra} note 11, at 618-19; Kripke, \textit{The SEC, the Accountants, Some Myths and Some Realities}, 45 N.Y.U. L. Rev. 1151, 1164-70 (1970).

\textsuperscript{120} \textit{See} note 11 \textit{supra}.

\textsuperscript{121} Statutory standards avoid delegation to the SEC of power to change the scope of legislation. \textit{See} Hearings, \textit{supra} note 1, at 54 (Edwin Yeo, Under Sec'y of Treasury) (suggesting that to avoid Tenth Amendment problems, SEC only be allowed to raise
general obligation bonds, H.R. 2724's provisions are of adequate specificity, except that the contents of financial statements must be outlined in the statute. Distribution statements for revenue bonds should provide the same type of information disclosed for general obligation bonds as well as descriptions of the project to be funded, including revenue estimates and descriptions of the legal powers and obligations of the officials who manage the project. Industrial development bond distribution statements should include descriptions of the plant and the uses for which it is designed, plus the information about the firm renting the plant that would be included in a 1933 Act registration statement. The proposed distribution requirements should provide information adequate to assess the risk of each type of security. In recognition of the costs of disclosure, the proposal attempts to do no more.

The need for annual reports depends on the amount of trading in the bond and the degree to which current data have an effect on market price. If there is minimal trading in a security, the costs of disclosure

“issue size” and “debt level” thresholds which determine whether a municipality is subject to disclosure requirements; House Hearings, supra note 6, at 55-59 (Robert Gerard, Ass't Sec'y of Treasury) (urging statutory standards rather than delegation to the SEC).

122. See notes 51 & 52 supra. The financial statements should contain consolidated balance sheets and income statements, and estimates of unfunded pension liabilities. See Coopers & Lybrand, supra note 25, at 13-14. The most important disclosure may well be that of short-term debt. While accounting gimmicks may balance books, a city generally can obtain cash only through taxes, transfers from other governmental units, and borrowing. New York City could not have accumulated such a large deficit if it had not obtained short-term credit in such enormous amounts. JEC, supra note 1, at 24-25; see note 29 supra.

123. See p. 924 & note 21 supra. Although some revenue projects are entirely independent of municipal government, many are not. The difficulty of drawing a line separating projects that are affected by the city's financial health from those that are not dictates a blanket rule that information about a city be disclosed.

124. See note 22 supra; 15 U.S.C. § 77aa (1970). Information about the municipality would not be required, since typically the municipality does not back the bonds with its taxing power. See 4 L. Loss, supra note 22, at 2588.

125. All of the above statements would be filed at a central repository and at the issuer's main office. See H.R. 2724, § 13A(f)(5). Copies would be made available by the issuer at a price reflecting the costs of copying, mailing, and handling. There would be no prospectus requirement, because prospectuses do not provide much information that is useful to either the individual investor or specialist. See Kripke, The Myth of the Informed Layman, 28 Bus. Law. 651, 652-56 (1973). Underwriters could choose to issue prospectuses in order to increase investor confidence, and, concomitantly, bond prices.

126. In general there is little need for annual reports. The large dollar size (usually $5,000 face value) and lack of fungibility of municipal securities restrict the market to investors with large resources and segment the market among different maturity dates and interest rates, raising significantly the costs of trading. See Doty & Petersen, supra note 2, at 317-19. Furthermore, most individual investors buy municipal securities to hold until maturity. N.Y. Times, Oct. 19, 1975, § 1, at 48, col. 2. As a result, the secondary market for municipal securities is small. Indirect Regulation, supra note 2, at
would probably outweigh its benefits because economic efficiency would not be seriously affected if the market value deviates from the underlying economic value.  

Similarly, if those characteristics of the issuer that affect the bond's market price are stable, current data are not necessary even though the market price of the bond may fluctuate due to other factors. For general obligation bonds, the market price should depend on the market rate of interest, the coupon rate of the bond (which is constant), and the ability of the city to collect revenues sufficient to pay its debt service. The latter factor changes so slowly that for a city with enough bonds outstanding to generate substantial trading, the distribution statements required when it reenters the market should provide adequate current disclosure. Thus, annual reports are unnecessary for general obligation bonds.

Revenue bonds usually provide the initial capital needed to finance a public project and are repaid over long periods of time. Revenue bond issues tend to be much larger than general obligation issues,


127. To satisfy economic efficiency criteria the price an investor pays for a bond should correspond to the probable returns from the bond—namely the interest and principal weighted by the possibility of default. This requirement is applicable to purchases in the secondary market as well as initial offerings. See V. BRUDNEY & M. CHIRELSTEIN, supra note 80, at 980-83. Adequate information allows investors to choose the portfolio they prefer on the basis of their risk-return preferences. Lintner, A Model of a Perfectly Functioning Securities Market, in ECONOMIC POLICY AND THE REGULATION OF CORPORATE SECURITIES 143, 160-63 (H. Manne ed. 1969). When the information needed to assess probabilities is unavailable, rational decisionmaking, and hence efficient economic choice, becomes very difficult. See Dorfman, Decision Rules under Uncertainty, in COST-BENEFIT ANALYSIS 560, 591-92 (R. Layard ed. 1972). But where trading is minimal the costs of disclosure can not be justified by the gains resulting from more informed portfolio selection.

128. The primary determinant of the price of fixed income securities is the market rate of interest, since that interest rate determines the return that an investor can obtain on alternative investments. The municipal bond market also experiences highly volatile prices caused by the instability of large investors' demand for tax-free income. See TWENTIETH CENTURY FUND, supra note 12, at 103. None of the information the municipality could disclose would help predict the trends of these exogenous factors.

129. For large cities, significant changes in the tax base, the ultimate source of security for general obligation bondholders, are unlikely to occur over a period shorter than several years.

130. Usually only the obligations of large and well-known governmental units are traded on national markets. R. ROBINSON, supra note 14, at 149. Larger governmental units are likely to enter the new issue market frequently, and information obtained from this process can be supplemented by the national and financial media.


132. TWENTIETH CENTURY FUND, supra note 12, at 92 (72.6% of general obligation issues were less than $2.5 million par value, compared with 49.9% for revenue bond issues).
and there are often restrictions on refundings. Since issues are large and infrequent, and since there can be substantial trading in the larger issues, there is a need for current disclosure when a project's outstanding debt surpasses a statutory minimum, perhaps H.R. 2724's $50-million level. The need for current disclosure is reinforced by the likelihood of fluctuations in project revenues, the detailed analysis needed to assess credit risk, and the incentives for project officials to color disclosures to avoid bondholder unrest.

The market price of industrial development bonds is sensitive to the same factors that affect the market price of securities of the firm renting the industrial plant being financed. Annual reports similar to those issued by corporations should be issued for those bonds.

Because the default risk of revenue and industrial development

133. SIA, supra note 16, at 55-56. Some revenue bond indentures restrict the issuance of additional bonds to those needed to complete the facility. Id. at 56. Of course a large and diversified public authority, such as the Port Authority of New York, is likely to issue bonds more frequently, and is usually subject to an "open end" indenture that restricts additional debt by placing conditions on the required ratio of revenues to debt service. See id.; note 21 supra. Issues are still likely to be infrequent because of their large dollar size.

134. See R. Robinson & D. Wrightsman, supra note 126, at 272.

135. H.R. 2724, § 13A(a)(1).

136. The likelihood of fluctuations in revenues is usually greater for revenue than for general obligation bonds, although certain types of revenue bonds (such as those financing sewer districts) have extremely stable revenues. R. Robinson & D. Wrightsman, supra note 126, at 271-72. Fluctuations in revenues assume major importance for investors in revenue bonds because the public projects are often financed totally by debt. See A. Heins, supra note 30, at 26; Twentieth Century Fund, supra note 12, at 52-53. Fluctuations in revenues combined with a large fixed debt obligation increase the likelihood of a default on interest payments.

137. Credit analysis is far more complex for revenue than for general obligation debt. A. Rabinowitz, supra note 18, at 42. Revenue bonds can assume a bewildering number of legal forms, each of which necessitates its own peculiar types of credit analysis and investment information. See Twentieth Century Fund, supra note 12, at 44-53.

138. If bondholders do not press revenue project officials for information, the officials may not disclose unfavorable information in order to avoid bondholder criticism. See Joskow, supra note 115, at 297-99.

139. For instance, the Commission may require that annual reports disclose material contracts as well as remuneration of directors, officers and underwriters. 15 U.S.C. §§ 78l (b)(1)(D), (l)(1), (3) (1970). To avoid claims of interference with local policy decisions, the SEC should not have the power to require a pre-offering review of these reports. In the corporate field, the Commission has acquired considerable power by conditioning acceleration of its pre-offering review on the issuer's compliance with substantive requirements. I L. Loss, supra note 22, at 277-85 (1961); Schneider, Reform of the Federal Securities Laws, 115 U. Pa. L. Rev. 1023, 1027, 1030 n.41 (1967).

The need for annual reports should not be determined simply by the amount of trading in the industrial development bonds. Since under the proposed regulatory scheme these bonds are to be regarded as liabilities of the corporation, annual reports should be required if any of the corporation's securities are traded on a national exchange, 15 U.S.C. § 78a (1970), or if the corporation has assets of over $1 million and more than 500 holders of a class of equity securities, id. § 78g(1). The proposal thus refers to the congressional scheme for corporate securities regulation.
bonds is sensitive to such market forces as costs and sales, which are reflected in financial statements, the statute would require an independent audit for these types of bonds. Audits would not be required for general obligation bonds. In some cases, however, an underwriter might require an audit to satisfy its duty of investigation. Although uniform accounting standards and mandatory independent audits would simplify financial analysis and possibly bolster investor confidence in municipal securities, the costs of such requirements, coupled with the necessity of delegating power to set standards in order to accommodate the diverse nature of municipal entities, far outweigh the benefits. These benefits might well be obtained through voluntary compliance with industry-wide standards, reinforced by underwriter pressure.

Municipal securities should not be exempt from disclosure requirements if they are subject to state disclosure regulation. While states could regulate municipal securities more extensively than could federal authorities confined by the Tenth Amendment, the standards proposed ensure that certain minimum requirements are imposed.

Exemption of insured municipal issues would be appropriate if Congress authorized the SEC to certify insurers of municipal securities. Insurance would provide additional security for investors and

141. H.R. 2724 delegates power to set accounting standards to the SEC. Id. § 13A(c).
142. Although creation of uniform disclosure and accounting standards at the state level has been proposed, Bus. Week, Oct. 11, 1976, at 56, the North Carolina Local Government Commission, which attempted to set uniform standards as a part of its role as the marketing agency for local debt, found that it had to permit variations for individual communities. Hearings, supra note 1, at 117. For instance, the methods by which inventories or capital assets are valued differ as a product of local laws and diverse governmental structures and functions. See L. Moak & A. Hillhouse, supra note 77, at 332-37.
143. See Petersen, Doty, Forbes & Borque, Searching for Standards: Disclosure in the Municipal Securities Market, 1976 Duke L.J. 1177, 1196 (level of voluntary disclosure increased dramatically in year ending in Spring 1976). Accounting guidelines have been developed by the Municipal Finance Officers Association (MFOA). MFOA, Disclosure Guidelines for Offerings of Securities by State and Local Governments (1976). Underwriter pressure for compliance with these guidelines can accommodate the diverse legal requirements and functions of municipal units.
144. H.R. 2724 provides for a state regulation exemption from the annual report, but not the distribution statement requirements. H.R. 2724, § 13A(c)(1).
145. Constitutional restrictions on federal regulation are discussed at pp. 933-39 supra. States already have mechanisms for regulating local finance. Proposals, supra note 2, at 1055-57.
146. Insured issuers need not publicly disclose any information because, barring failure of the insurance company, investors are assured interest and return of principal. Insurance companies would presumably only insure municipal issues that they deem to
Federal Regulation of Municipal Securities

would ensure a thorough examination of a city's creditworthiness. Through certification the SEC could guarantee that insurers of municipal securities have sufficient financial resources and adequate procedures for evaluating investment quality.\textsuperscript{147}

Conclusion

The federal government has a substantial interest in stabilizing the municipal bond market because of its importance in national capital markets and because of the number of investors involved.\textsuperscript{148} The \textit{Usery} decision seems to require that federal regulation impinging on essential state functions manifest a congressional recognition and accommodation of state interests.\textsuperscript{149} Specifically, \textit{Usery} appears to require that in regulating states Congress use the most limited approach available.\textsuperscript{150} This Note's proposal is a limited and carefully drafted reaction to the unstable conditions existing in the municipal bond market. The specific provisions evince a solicitude for state interests; they carefully limit the liability of issuers and their officers, set disclosure for each type of bond at minimum levels consistent with investor protection, and exempt small issues and bonds covered by insurance. In fact, municipalities may well be a major beneficiary of regulation because a properly functioning municipal securities market should reduce their cost of borrowing.

have a low default risk. To assure the financial health of approved insurance companies, the SEC should be given power to supervise their operating methods and financial status. Insurers of municipal securities would also be subject to state regulation of insurance companies. \textit{Hearings}, \textit{supra} note 1, at 381 (statement of Municipal Issuers Service Corp., managers of Municipal Bond Insurance Ass'n), Senator William Proxmire, Chairman of the Senate Committee on Banking, Housing and Urban Affairs, has expressed interest in a federal insurance scheme for municipal securities, coupled with budget and reporting requirements. \textit{N.Y. Times}, Dec. 21, 1976, at 7, col. 1.

Even without an exemption from disclosure regulation, many municipalities would find insurance an economical choice. The tightening market for municipal securities following New York City's financial crisis prompted insurers to sell policies that guaranteed the interest and principal on municipal securities. \textit{Wall St. J.}, Jan. 12, 1976, at 16, col. 3. Issuers hoped to recoup the insurance costs through lower interest rates. \textit{Id}. From May 1974 through July 1976 the Municipal Bond Insurance Association insured $1 billion in principal amount of tax-exempt bonds. \textit{Id.}, July 21, 1976, at 23, col. 4.

147. In approving an insurer the Commission would consider the quality of the insurer's evaluation—for instance, the number of analysts, the extent of independent investigation, and the process by which evaluations of individual analysts are reviewed.
148. See note 4 supra.
149. See Note, \textit{supra} note 70, at 1888-91. The attempt to accommodate state interests should be apparent from the statutory language, since legislative history is a less reliable indicator that serious consideration was given to these interests. \textit{Id.} at 1888 n.125.
150. See \textit{id.} at 1889 (suggesting that \textit{Usery} requires Congress to choose the least intrusive alternative).
Under a reasonable construction of the rather murky *Usery* decision, the Note's proposal appears to meet the constitutional tests and certainly seems more likely to pass muster than current legislative alternatives. By combining clear statutory disclosure standards and enforcement through specific liability provisions, this Note's proposal avoids the dual dangers of uncertainty and excessive delegation, albeit at the expense of flexibility. The municipal securities market can function much more smoothly if participants are aware of their responsibilities in the disclosure process. Statutory standards, if they achieve the same congressional goals as delegation of power to set standards, are a less intrusive means of regulation because the extent of the intrusion on state prerogatives is clear and subject to expansion only by further legislation.\(^{151}\)

151. *See* pp. 937-38 *supra.*