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Municipal Bonds and the Federal Securities Laws: The Results of Forty Years of Indirect Regulation

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Table of Contents

I. INTRODUCTION

Recent abuses occurring in the municipal bond markets have threatened investor confidence and caused Congress to reevaluate its original decision to exempt these securities from the Securities Act of 1933 and the Securities Exchange Act of 1934. This Note will analyze in some depth the securities regulation aspects of the municipal securities markets. First, because an understanding of the unique nature of municipal securities and their markets is essential, a description will be made of the characteristics of municipal bonds and municipal bond purchasers, the participants in the municipal securities industry, and the new issue and trading markets for municipal bonds. The discussion will emphasize the facets of the securities markets unique to the municipal sector. Next, the current method of regulating the municipal securities industry will be discussed. In this section, the system of municipal securities regulation will be distinguished from securities regulation in general, and an analysis of the pertinent legislative history will be undertaken. The widespread market abuses that have recently occurred will then be discussed in the context of the relevant case law, administrative proceedings and litigation releases. Throughout this section the role of the current regulatory framework in facilitating the abuses will be examined. Finally, after a discussion of the current legislative proposals for reform, some conclusions will be drawn about the optimal method of achieving the goals of securities regulation in the municipal securities industry.

II. Characteristics of Municipal Securities and Municipal Investors

A. *The Nature of Municipal Securities*

Municipal securities are exempted to varying degrees from the ambit of the substantive provisions of both the Securities Act of 1933 (1933 Act)[1] and the Securities Exchange Act of 1934 (1934 Act).[2] Because the terms "municipal security" and its synonym, "municipal bond" encompass a wide variety of debt instruments issued by various governmental units, it is useful at the outset to describe the basic characteristics of the various types of municipal securities. One method of characterizing these securities is by type of issuer. Thus, the 1933 Act and 1934 Act exemptions, in defining municipal securities as "exempt securities," have created a class of securities encompassing generally those debt securities issued or guaranteed by states or territories, their political subdivisions, agencies and instrumentalities, and any security issued by a governmental issuer that is an industrial development bond as described by section 103 of the Internal Revenue Code of 1954.[3]

1. Securities Act of 1933 § 3(a)(2), 15 U.S.C. § 77c(a)(2) (1970).
2. Securities Exchange Act of 1934 § 3(a)(12), 15 U.S.C. § 78c(a)(12) (1970).
3. The Securities Act of 1933 § 3, 15 U.S.C. § 77c (1970) provides:

Section 3. *Exempted Securities*

(a) Except as hereinafter expressly provided, the provisions of this subchapter shall not apply to any of the following classes of securities:

. . . .

(2) Any security issued or guaranteed by the United States or any territory thereof, . . . or 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 by any person controlled or supervised by and acting as an instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States;

In addition, it is important to classify municipal securities according to the type of resources used to pay debt service charges. Municipal bonds generally fall into one of four classifications of this type. A "general obligation" bond is secured by the issuer's pledge of its full faith, credit, and taxing power.[4] Issuance of this class of securities requires authorization of the voters of the municipality and involves the actual levy or agreement to levy general taxes against all taxable property within the boundaries of the issuer municipality to the extent necessary to meet the maturing interest, principal and other obligations of the issue.[5]

In contrast with the general obligation bond, a "revenue bond" is payable only from the revenues of a specific municipally-owned project,[6] and the bondholder normally has no right to look to any other source for payment.[7] These distinctions can be crucial to a potential investor. Further, unlike the general obligation bond, no voter authorization is usually required to issue a revenue bond.[8]

A third type of municipal bond is the "special obligation bond,"

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or any certificate of deposit for any of the foregoing; . . . or any security which is an industrial development hond (as defined in section 103(c)(2) of Title 26) the interest on which is excludable from gross income under section 103(a)(1) of Title 26 if, by reason of the application of paragraph (4) or (6) of section 103(c) of Title 26 (determined as if paragraphs (4)(a), (5), and (7) were not included in such section 103(c)), paragraph (1) of such section 103(c) does not apply to such security; . . . .

The Securities Exchange Act of 1934 § 3(a)(12), 15 U.S.C. § 78c(a)(12) (1970) provides: *Section 3(a)(12).* The term "exempted security" or "exempted securities" includes securities which are direct obligations of or obligations guaranteed as to principal or interest by the United States; such securities issued or guaranteed by corporations in which the United States has a direct or indirect interest as sball be designated for exemption by the Secretary of the Treasury as necessary or appropriate in the public interest or for the protection of investors; securities which are direct obligations of or obligations guaranteed as to principal or interest by 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 (as defined in section 103(c)(2) of Title 26) the interest on which is excludable from gross income under section 103(a)(1) of Title 26 if, by reason of the application of paragraph (4) or (6) of section 103(c) of Title 26 (determined as if paragraphs (4)(a), (5), and (7) were not included in such section 103(c)), paragraph (1) of such section 103(c) does not apply to such security . . . .

4. INVESTMENT BANKERS ASSOC. OF AMERICA, FUNDAMENTALS OF MUNICIPAL BONDS 3 (G. Calvert ed. 1965). [Hereinafter cited as FUNDAMENTALS].

5. Speer, *What Every Lawyer Should Know About Municipal Bonds*, 44 ILL. BAR J. 146 (1955). [Hereinafter cited as Speer]. In some instances, a state may limit the rate of tax that may be levied against a particular assessed valuation. *Id.* Nevertheless, the bonds are still general obligation bonds, but fall into the subclass of "limited tax bonds." FUNDAMENTALS, *supra* note 4, at 3.

6. These revenues generally consist of tolls or rent charges paid by those who use the facilities constructed with the proceeds of the bond issue. FUNDAMENTALS, *supra* note 4, at 3.

7. Speer, *supra* note 5, at 147.

8. L. CHERMAK, THE LAW OF REVENUE BONDS 65 (1954). For more detailed discussions of the various facets of revenue bonds and revenue bond financing *see, e.g., id.*; L. KNAPPEN, REVENUE BONDS AND THE INVESTOR (1939).

which is payable only from the proceeds of a special and usually limited source of taxation or other income of the municipality.[9] Moreover, if the bond is not additionally secured by the full faith and credit of the municipality, it is sometimes classified in the generic category of revenue bonds because it is payable only from a special fund.

The fourth type of municipal bond, the "industrial development bond," is actually a form of revenue bond.[10] Under this method of financing, a municipality constructs an industrial facility with the proceeds from the bond issue. The facility is then leased to a business concern whose rental payments are used to pay off the bonds. This type of instrument has proven highly successful in municipal efforts to attract new industry, but has limited usefulness because of dollar-amount limitations imposed by the Internal Revenue Code.[11] The holder of an industrial development bond must depend upon the lessee corporation to generate revenues sufficient to meet the periodically maturing principal and interest payments.

B. *Municipal Investors and Their Objectives*

The primary objectives of municipal investors are twofold. First, they desire to take advantage of the tax exempt status of municipal securities.[12] The interest received by holders of most municipal securities is exempted from federal income tax, the tax exemption corresponding generally with the securities acts exemptions.[13] Indeed, the tax exempt status serves as another way to identify municipal securities, because many persons equate the generic term "municipal bond" with a security whose interest payments are not subject to federal income taxation. Because this tax benefit is of more value to taxpayers in higher marginal tax brackets, financial institutions and wealthy individuals dominated the municipal mar-

9. FUNDAMENTALS, *supra* note 4, at 3; Speer, *supra* note 5, at 147. Some examples of income sources used to pay special obligation bonds include highway bonds payable from gasoline taxes, proceeds from the sale of a specific piece of municipal property, or contingent income of the municipality.

10. For an excellent, detailed discussion of the aspects of industrial development bonds see Abbey, *Municipal Industrial Development Bonds*, 19 VAND. L. REV. 25 (1965).

11. INT. REV. CODE OF 1954 § 103 (c).

12. *Municipal Bonds: Not Only For Millionaires*, 139 FINANCIAL WORLD, Jan. 24, 1973, at 10; *Hearings on S. 1933 and S. 2474 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs*, 93d Cong., 2d Sess. at 49. [Hereinafter cited as *Hearings*].

13. H. SOWARDS, FEDERAL SECURITIES ACT § 3.03 (1974). By making the 2 definitions correspond, Congress intended to avoid any constitutional difficulties that might have arisen by including state and municipal obligations. H.R. REP. No. 85, 73d Cong., 1st Sess. 14 (1933). It should be noted that federal government securities are not exempt from taxation.

ket in the first half of this century. With the rise of income tax rates in the last thirty years, however, persons with more moderate incomes have begun to benefit substantially from investments in municipal securities.[14] Indeed, from 1960 to 1973, investments by households in municipal securities rose from $30.8 billion to $47.5 billion.[15] During this same period, however, the total amount of municipal securities outstanding rose from $70.8 billion to $181.7 billion,[16] reducing the percentage of total ownership by households from forty-four percent in 1960 to twenty-six percent in 1973. Despite the fact that holdings of nonhousehold investors comprise almost seventy-five percent of total municipal bond holdings, the large absolute amount of household holdings and the trend toward investment by nonaffluent, relatively unsophisticated[17] investors increases the potential for fraud and abuse in the municipal securities market far above the level existing when Congress originally created the municipal bond exemptions of the 1933 and 1934 Acts.

The second major factor in an investor's decision to purchase municipal bonds concerns the high degree of investment security normally associated with these instruments.[18] Municipal bonds often are characterized as second only to federal government securities in terms of safety of interest and principal.[19] Nevertheless, as pointed out above, an investor must be careful to distinguish between general obligation and revenue bonds because of the disparity of issuer obligations under each type of instrument. Further, an evaluation of issuer financial conditions is pertinent to any investment decision. During the 1960's, the overall quality of rated municipal debt deteriorated slightly.[20] Moreover, the rating agencies in making quality assessments during this period mitigated the effect of weakened instrument and borrower characteristics by favorable projections of general economic conditions.[21] These projections, however, are subject to some doubt in light of current overall economic conditions. For example, the State of New York's Urban Development Corporation, the nation's largest public housing developer, recently defaulted on $135 million of "moral obligation" notes.[22] An additional $1.1 billion of revenue bonds will be placed

14. *Hearings, supra* note 12, at 49.
15. *Id.* at 48.
16. *Id.*
17. *Id.* at 49.
18. Speer, *supra* note 5, at 147.
19. *Id.*
20. *See* G. Hempel, The Postwar Quality of State and Local Debt 113 (1971).
21. *Id.* at 124.
22. Wall Street J., March 3, 1975, at 13, col. 2. The moral obligation note is an instrument created to circumvent the public vote required in New York for public-housing financ-

in jeopardy if that agency enters bankruptcy proceedings. Because of alleged fiscal mismanagement by the agency, New York banks have refused to underwrite additional Urban Development Corporation bond issues.[23] Moreover, several days after this refusal, bank syndicates forced the city of New York to cancel $260 million of tax-anticipation notes when city officials were not able to show satisfactorily that the additional financing was within a state statutory provision requiring that outstanding tax-anticipation notes cannot exceed the amount of estimated real estate tax revenue over a certain period.[24] Thus, as evidenced by these examples, without the benefit of favorable economic conditions to offset the effect of unfavorable instrument and borrower characteristics the assumption that all municipal bonds are highly sound investments is open to significant questioning.

III. Firms Comprising the Municipal Securities Industry

The municipal securities industry comprises approximately 202 dealer banks and 748 securities firms engaged in the process of buying and selling municipal bonds.[25] These businesses can be divided into three categories—securities firms acting as dealers that buy and sell for their own account, separate departments or divisions of commercial banks that purchase and sell for their own trading account rather than as fiduciaries for trust department clients, and bond brokers that act only as agents for buyers and sellers[26] and do not purchase and sell for their own account. Of the 748 securities firms, 484 are members of the National Association of Securities Dealers (NASD) and 264 are not. In addition, the total of 748 securities firms can be further reduced to 341 NASD members and 172 nonNASD members who can be considered "active" dealers.[27] As to the 202 dealer-banks, only 130 are members of the Dealer Bank Association, a trade association composed of active dealer banks; the remaining banks apparently maintain municipal bond

ing. Under the terms of the instrument, if the reserve fund set up to meet the debt service on the bonds proves insufficient, the governor must ask the legislature to make up the difference. The legislature, however, is not legally obligated to comply with the request. These securities have been used by about 30 states to build housing, schools and other special projects. Wall Street J., Feb. 28, 1975, at 26, col. 1.

23. *Id.*

24. Wall Street J., Mar. 3, 1975, at 13, col. 2. The request by the banks for recent data proving compliance with the statutory provision is itself an indication that fiscal mismanagement by the city has weakened its credibility in the financial markets. *Id.*

25. S. Rep. No. 93-1145, 93d Cong., 2d Sess. 2-3 (1974) [hereinafter cited as S. Rep.]; *Hearings, supra* note 12, at 62.

26. *Hearings, supra* note 12, at 158.

27. *Id.*

departments only for the purposes of bidding on local issues or buying for their respective bank portfolios at dealer prices.[28] While the municipal securities industry is significant in size, it does not approach the magnitude of the corporate securities industry, which includes, for example, 569 New York Stock Exchange member firms and 3700 members of the NASD, none of which are banks.[29]

In addition to the substantial number of firms comprising it, the municipal securities industry accounts for a large dollar volume of new investment each year. While in 1950 the total amount of new municipal bonds issued was only 5 billion dollars, by 1973 state and local governments were issuing approximately 23 billion dollars of new debt instruments annually.[30] Both this large dollar amount and the large number of participants in the industry indicate the presence of a substantial public interest in determining the appropriate method of preventing abuses in the markets for municipal securities.

IV. The Municipal Underwriting Process

The process of underwriting municipal securities generally is determined as a matter of state law.[31] Unlike corporate securities, most states require the sale of all general obligation bonds by competitive bid.[32] Revenue Bonds, in contrast, normally are free from any competitive bidding requirement.[33] Nevertheless, even when not required by state law, the issuer may employ competitive bidding if it believes it can obtain a more favorable price.[34] As in the distribution of corporate securities, the underwriting profit is the difference between the price at which the bonds are sold to the public and the price at which the underwriter or underwriting syndicate purchases from the municipality.[35]

While a detailed exposition of the process by which municipal

28. S. Rep., *supra* note 25, at 2-3.

29. *Hearings, supra* note 12, at 158.

30. For a more complete breakdown of the amounts of new municipal debt issued annually and the purposes for which that debt was used see *Hearings, supra* note 12, at 213-17.

31. Fundamentals, *supra* note 4, at 71-78; S. Rep. note 25 *supra*, at 3.

32. S. Rep. *supra* note 25, at 3.

33. *Id.*

34. Fundamentals, *supra* note 4, at 71.

35. S. Rep. *supra* note 25, at 3. If the bond is sold by a dealer who is not a member of the underwriting syndicate, the nonmember will buy the bond from the syndicate member at the public offering price less a predetermined dealer's concession, and resell it to the public at the offering price. Accordingly, the syndicate member's gross profit will be reduced by the amount of this dealer's concession. Fundamentals, *supra* note 4, at 76.

bonds are distributed to the public is beyond the scope of this note,[36] any discussion of the various proposed methods of regulating the municipal securities industry would be incomplete if it did not examine the key differences between the processes by which corporate and municipal securities are distributed to the public. Only in light of such an examination can an effective evaluation be made of the possible regulatory approaches.

An important practical distinction between the processes currently used in distributing corporate and municipal securities concerns the cost of the initial underwriting. Because corporate securities generally are subject to the registration requirements of section 5 of the 1933 Act[37] unless an exemption is available, any corporate issuer will incur the drafting, investigation, printing, accounting, and legal expenses associated with the preparation and use of registration statements. Conversely, municipal securities are expressly exempted[38] from the registration requirements of section 5, and the activities undertaken and documents prepared in readying a new municipal issue for distribution are largely matters of state law and industry custom,[39] involving less rigorous standards and fewer expenses than those associated with a 1933 Act registration statement. The total cost of an initial corporate securities underwriting often reaches eight to ten percent of the total offering price, while a comparative municipal securities issue sold by an issuer who frequently enters the market for funds generally costs only two to three percent.[40] Unfortunately, cost data for "blue chip" corporate issuers who often enter the capital markets are not available. Nevertheless, once a corporate issuer distributes its initial public offering, the expenses incurred in complying with the registration requirements of the 1933 Act can be expected to decline drastically, perhaps even approaching those required to float a municipal offering.

A second major distinction concerns the role played by banks in the underwriting of general obligation municipal bonds. While banks are largely excluded from the securities business by the National Banking Act of 1933,[41] the exclusion does not apply to general

36. More extensive discussions of the municipal underwriting process are available in FUNDAMENTALS, *supra* note 4, at 29-39, 71-78; L. CHERMAK, THE LAW OF REVENUE BONDS 188-92 (1954); L. KNAPPEN, REVENUE BONDS AND THE INVESTOR 94-102 (1939).

37. Securities Act of 1933 § 5, 15 U.S.C. § 77*e* (1970).

38. Securities Act of 1933 § 3(a)(2), 15 U.S.C. § 77c(a)(2) (1970).

39. FUNDAMENTALS, *supra* note 4, at 77-78; L. KNAPPEN, REVENUE BONDS AND THE INVESTOR 99-101 (1939).

40. Interview with Clarence Haley, Vice-President of J.C. Bradford & Co., in Nashville, Tenn., Nov. 14, 1974.

41. Glass Steagall Act of 1933, 12 U.S.C. § 24 (1970).

obligation municipal securities, although it does apply to revenue bonds.[42] As a result, banks underwrite more than fifty percent of all new general obligation municipal bonds and approximately fifty percent of all municipal securities issued annually.[43] Further, the 1934 Act[44] excludes banks from the definitions of the terms "broker" and "dealer" contained therein, making banks subject only to the antifraud provisions of that Act. Consequently, banks remain closely regulated only by traditional bank regulatory agencies. The particular agency having this regulatory responsibility will vary with each individual bank. Thus, the Comptroller of the Currency is charged with regulating national banks, banks operating under the District of Columbia Code of Law and any wholly owned subsidiary, department, or division thereof; the Federal Reserve Board with regulating state member banks, their subsidiaries, departments, divisions or bank holding companies and bank subsidiaries; and the Federal Deposit Insurance Corporation with regulating non-Federal Reserve member banks insured by the FDIC and their wholly owned subsidiaries or departments or divisions thereof.[45] Unfortunately, these agencies traditionally have exhibited little concern for investor protection, while emphasizing depositor confidence and bank solvency considerations through discreet enforcement policies.[46]

A third distinction concerns the mechanics of the underwriting process. As stated above, municipalities often sell their securities through the use of a public bidding procedure. A dealer wishing to bid on a particular issue often forms a syndicate with other dealers or banks for bidding purposes.[47] Bids are generally sealed and must be accompanied by a "good faith" check for a stated percentage amount of the bid price (usually one to five percent), which is for-

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42. *Hearings, supra* note 12 at 50. Under a proposed bill, S. 1933, the National Banking Act would be amended to allow national banks to underwrite revenue bonds. This development likely would result in an increase in the percentage of municipal securities underwritten by these institutions.

43. *Hearings, supra* note 12, at 63.

44. Securities Exchange Act of 1934 § 3(a)(6), 15 U.S.C. § 78c(a)(6) (1970).

45. S. REP. note 25 *supra*, at 19.

46. Moreover, the regulation of bank dealings in municipal securities is to some degree outside the "mainstream" of bank regulation which has been traditionally oriented toward the regulation of banks in their capacity as depositories for savings and as a principal source of credit for American business, industry and for the public generally. This orientation has naturally produced a significant difference in regnlatory approach between bank regulatory authorities and the Commission, particularly in the area of enforcement, where bank regulators have great concern that enforcement action be taken discreetly to ensure public confidence in banks from adverse depositor reaction.

Hearings, supra note 12, at 51 (testimony of SEC Commissioner Evans).

47. FUNDAMENTALS, *supra* note 4, at 72.

feited in the event the bid is accepted but the bidder breaches his contract by failing to take up and pay for the bonds once they are ready for delivery.[48] After a bid is accepted, liabilities of syndicate members are determined by contract. If the members have agreed to an *Eastern* or *Undivided* account, each member has pro rata liability as long as any bonds remain unsold. In a *Western* or *Divided* account, a syndicate member's liability ceases once he has sold his allotted portion of the issue.[49]

Municipal bonds usually are sold in serial maturities so that no two bonds of the same issue may be exactly alike.[50] Because the securities are not fungible, either the bonds are allocated on a first-come, first-served basis, or various maturities are pro rated among the members of the syndicate in advance.[51] Once a dealer specifies a particular maturity, he takes the bond at the offering price less a discount called the take-down, from which is subtracted any dealer's concession paid to a nonsyndicate member. Any net profit above the take-down received by syndicate members goes into the general syndicate account and is allocated among all syndicate members.[52]

A fourth important difference between the underwriting of corporate and municipal securities concerns the amount of disclosure accompanying the new issue. Corporate underwritings are highly regulated by the SEC in terms of offers and sales,[53] permissible advertising,[54] and registration statement content.[55] Transactions in municipal securities, on the other hand, are subject only to the antifraud provisions of the 1933 and 1934 Acts, and their sale is not directly regulated by the SEC.[56] New issues of municipal securities generally are accompanied by various sale documents, which usually include an announcement of sale in the form of an official advertisement, or an offering circular or prospectus, or both.[57] The

48. *Id.* at 75. In some instances the good faith check may be kept as liquidated damages in the event of a breach by the successful bidder.

49. *Id.* at 73. In a *Western* account, a dealer can still sell unsold bonds in excess of his allotment and he is often paid an extra selling commission for doing so.

50. *Id.* at 73.

51. *Id.*

52. *Id.* at 76. Dealers' concessions are paid only to dealers or banks with bona fide bond departments.

53. Under section 5(a), no offers to sell any security can be made until a registration statement has been filed. 15 U.S.C. § 77*e*(a) (1970).

54. Rules 134-39, 17 C.F.R. §§ 230.134-.139 (1974).

55. *E.g.*, Guides for Preparation and Filing of Registration Statements, Securities Act Release No. 4936 (1968).

56. *See* text accompanying notes 81-89 *infra*.

57. S. REP., *supra* note 25, at 10.

contents of the offering circular will vary, although the Investment Bankers Association of America has set forth guidelines for both general obligation and revenue bonds.[58] The distinction between general obligation and revenue bonds is important in this area because with the former an investor is concerned primarily with the validity of his obligation and the municipality's ability to levy sufficient taxes to meet required payments,[59] whereas with the latter he not only must investigate the validity of his obligation, but also must make a business judgment whether the revenue producing project will generate sufficient income to satisfy his debt.[60] Thus, since the prospective revenue bond investor needs detailed information about both the community and the particular project to make an informed investment decision, his position is closely akin to that of a corporate securities investor. The Investment Bankers Association guidelines recognize these considerations; thus it is customary to use much more extensive circulars accompanying revenue bonds than general obligation bonds, which frequently are accompanied only by a short synopsis of the issue and municipality.

Another important element distinguishing the underwriting of corporate securities from municipal securities is the method of assessing the financial condition of the municipality in determining the selling price of the issue. The primary method of assessing the financial condition of municipalities is the use of ratings published by a municipal bond investment advisory service.[61] One of these rating services, Moody's Investors Service, has rated since World War II approximately two thirds of all outstanding municipal debt.[62]

58. FUNDAMENTALS, *supra* note 4, at 84-90.

59. Speer, *supra* note 5, at 146.

60. *Id.* at 147. The amount of disclosure will also vary with the opinions of counsel and the type of entities involved. Thus, it is not uncommon for a corporate issuer, who is ahout to participate in an industrial development hond issue and is familiar with the 1933 and 1934 Act disclosure requirements, to set forth the full disclosure that would have been required hy a 1933 Act registration statement, even though that Act is not applicable. The intent behind this type of activity is to avoid any possibility of antifraud liability for material misstatements or omissions under the 1933 or 1934 Acts. Interview with Clarence Haley, Vice-President of J. C. Bradford & Co., in Nashville, Tenn., Nov. 14, 1974. For discussions of the type of investigation and disclosure that should accompany a revenue bond issue see L. CHERMAK, THE LAW OF REVENUE BONDS 188-92 (1954); L. KNAPPEN, REVENUE BONDS AND THE INVESTOR 97-102 (1939).

61. For an extensive discussion of bond ratings, their validity and usefulness, and the methods by which they are made, see, e.g., G. HEMPEL, THE POSTWAR QUALITY OF STATE AND LOCAL DEBT 101-24 (1971); West, *Bond Ratings, Bond Yields and Financial Regulation: Some Findings*, 16 J.L. & ECON. 159 (1973).

62. G. HEMPEL, *supra* note 61, at 103-04. The Moody's service "rates bonds of issuers which have $600,000 or more of debt, except basis of educational institutions, projects under construction, enterprises without established earnings records and situations where current financial data are lacking." FUNDAMENTALS, *supra* note 4, at 21. Thus, those "speculative"

The rating services group municipalities into general classes of quality after an evaluation of various pertinent characteristics.[63] The position of an issuer within these classes will affect its cost of borrowing from the public.

In rating the bonds of a municipal issuer, the bond rating agencies engage in a two-step process. First, all of the pertinent characteristics about the project being financed are gathered and investigated by an experienced bond analyst.[64] Next, a rating committee considers the data collected by the analyst and reaches a consensus on the appropriate rating. The committee does not use formal standards or weights for particular characteristics, but makes a careful study of the characteristics of each issue, including both a weighing of environmental factors and an application of the experience possessed by the bond analysts.[65]

Examinations of the effectiveness of municipal bond rating agencies are difficult, because while statistics on default are available,[66] defaults are rare, and, in any event, such data does not reflect the accuracy of quality ratings for issues not in danger of default. One important problem with the ratings is that the bond analysts do not have sufficient time and resources to make a comprehensive

issues for which a potential investor may need the most information likely will not be rated by a rating service.

63. The rating classes used by Moody's are as follows:

Aaa	Best quality, carrying the smallest degree of investment risk.
Aa	High quality (together with Aaa comprise "high-grade bonds").
A	Higher medium grade, many favorable investment attributes.
Baa	Lower medium grade, neither highly protected nor poorly secured.
Ba	Have speculative elements.
B	Generally lack characteristics of the desirable investment.
Caa	Poor standing.
Ca	Speculative in big degree.
C	Lowest rated class.

FUNDAMENTALS, *supra* note 4, at 25.

64. Most analysts specialize in a specific geographic area or particular types of revenue producing projects. G. HEMPEL, *supra* note 61, at 106.

65. *Id.* at 105-06.

66. *Id.* at 108-13. Hempel notes that of the 264 municipal issues constituting over three-fourths of the total defaults during the 1929 depression period, 78% were rated Aa or above. After that experience, however, the rating agencies made substantial changes in their rating procedures. Subsequent default statistics indicate that since the depression period, only 6 rated issues have defaulted. Three were rated only after the default and of the other 3, the ratings did forecast low quality prior to the default. *Id.* at 108. Professor Hempel concludes:

> The most favorable conclusion one can derive from the past payment performance of rated state and local issues is that the new and more sophisticated rating processes started in the mid-1930's . . . are largely untested as an indicator of prospective quality. In spite of the lack of historical proof, the consensus opinions of groups of sophisticated bond analysts (i.e., agency ratings) are analyzed as meaningful indicators of prospective quality.

Id. at 113.

evaluation of the more than 10,000 municipal issues outstanding. Furthermore, once a rating has been made, it is extremely difficult for an agency to update its rating processes to consider and evaluate all contemporaneous improvements or deteriorations in the financial condition of a municipal issuer.[67] Nonetheless, bond ratings remain a widely accepted gauge of quality, affecting the interest rate paid by the issuer and even the eligibility of bonds for purchase by certain types of investors.

The role of counsel in the issuance of a municipal securities offering in comparison with a corporate securities underwriting provides a final basis for distinction. Because many municipal bonds distributed to the public during the late 19th century were illegally issued, resulting in financial loss to the purchasers, the practice arose among municipal bond dealers of engaging reputable laywers to render an opinion on the validity of the bonds prior to sale.[68] The investing public accepted this practice, and suspicion and unwillingness to purchase municipal securities soon abated. Today the municipal issuer employs bond counsel who serves as legal advisor to the ultimate investor and renders an opinion that the bonds have been issued in compliance with all pertinent state laws.[69] This task requires extensive scrutiny of the instruments, the requisite proceedings and the pertinent state law.[70]

As in the corporate securities situation, bond counsel clearly is a pivotal figure in the underwriting process who performs a myriad of functions beyond examining the validity of the bonds.[71] Moreover, bond counsel generally is the sole legal representative employed in connection with a municipal securities offering. Conversely, in the corporate securities area separate counsel customarily represent the underwriter and issuer. This situation creates a quasi-adversary setting under which counsel engage in extensive due diligence efforts to investigate and independently verify the truth of information supplied by management about the corporation.[72] Bond counsel, however, does not act in this quasi-adversary, independent-examiner capacity to the same degree as corporate securities counsel. Rather, he is principally concerned with assuring that the bonds are

67. Interview with Clarence Haley, Vice-President of J. C. Bradford & Co., in Nashville, Tenn., Nov. 14, 1974. Mr. Haley noted that once a municipality receives a particular bond rating, it is difficult to get that rating reviewed and changed.

68. FUNDAMENTALS, *supra* note 4, at 53.

69. *Id.* at 54.

70. *Id.* at 56-59.

71. *Id.* at 60; L. CHERMAK, THE LAW OF REVENUE BONDS 63 (1954).

72. *See, e.g.*, Escott v. BarChris Construction Corp., 283 F. Supp. 643 (S.D.N.Y. 1968); W. PRIFTI, SECURITIES: PUBLIC AND PRIVATE OFFERINGS §§ 91-96 (1974).

issued in conformity with state law requirements.[73] Thus, the enhanced disclosure obtained by the due diligence efforts of counsel in the corporate securities area often is not present in a municipal bond offering. This problem is especially apparent in the case of industrial development bonds. These securities, although grouped within the generic category of municipal bonds, depend upon the financial condition of the underlying corporation for their security. Nevertheless, the independent investigation and verification normally accompanying the issuance of corporate bonds often is not accorded an industrial development bond issue, even though the position of the investor is almost identical to that of a direct investor in bonds of the corporation itself.

V. The Secondary Market for Municipal Bonds

In contrast with corporate securities, each municipal security is unique. For example, while one hundred shares of a corporate security would represent an interest identical to that represented by any other one hundred share block of the same class, each municipal security may vary in any one of several ways — interest rate, maturity, rating level, and other factors, such as general obligation or revenue bond status.[74] These differences, coupled with the fact that municipal securities usually are traded only in fairly large dollar amounts, have caused the volume of secondary trades in municipal securities to be small in comparison to the secondary market for corporate securities.[75] Further, because the municipal securities trading market does not have the elaborate technological support associated with the exchanges or the NASDAQ system, it is difficult to obtain market data indicating actual trading volumes. Nevertheless, the daily average of municipal securities in which a market was made in 1973, as indicated by the *Blue List of Current Municipal Offerings*,[76] included 10,528 issues with an aggregate face value of 1,822 billion dollars, a highly significant trading market.

Because of the numerous factors affecting the value of municipal bonds, the method used to calculate the selling price of any particular bond is very complex. Dollar prices of municipal bonds usually are stated on a "yield basis" plus accrued interest. The term

73. Interview with Mr. James O. Bass, Jr. Esq. in Nashville, Tennessee, November 16, 1974.

74. Speer, *supra* note 5, at 146.

75. S. Rep., *supra* note 25, at 4.

76. The "Blue List" provides representative bid and ask prices for all bonds in wbich a market is made by municipal securities dealers. It is the chief pricing tool of municipal securities dealers and is similar to the "pink sheets" published by the National Quotation Bureau. *Id.*; Fundamentals, *supra* note 4, at 98.

"yield basis" means that the price of the bond is the return on investment that will be realized if the bond is held to maturity.[77] Because this return will always vary with the nominal interest rate carried by the bond, the date of maturity, and the desired yield, complex mathematical computations are required to determine the dollar price of a bond at a specified yield basis.[78] The person holding the bond on the interest payment date receives all of the interest paid subsequent to the last interest payment date. But, since each person owning a bond is entitled to interest for the period during which he held the bond, the purchaser, on acquiring the bond, must pay the seller accrued interest up to the date of purchase.[79] This accrued interest, plus the dollar amount required to yield the interest rate currently demanded by the money market, constitute the two basic elements in the total dollar price of a municipal bond. Because of the complex elements in the mathematical calculation of bond prices, it is readily apparent that an unsophisticated investor interested in these instruments could be misled easily by an unscrupulous bond dealer making false representations about the value of a bond.

The comparison between the nominal rate of the bond and the market rate is not the sole determinant of municipal bond prices; obviously, supply and demand are also critical factors. In addition, the market's assessment of the financial condition and prospects of each issuer affects the risk perceived in holding its bonds and accordingly affects the price of the bonds.[80] As in the underwriting process, bond ratings constitute the major manifestations of the market's assessment of a municipality's financial condition. The determination of qualitative factors by bond ratings is also a complex process that an unsophisticated investor would not readily understand.

Thus, because all of the considerations described in this section affect the pricing of each bond, an unscrupulous bond dealer easily could take advantage of investors by misrepresenting a single characteristic. The next two sections will examine the municipal bond exemptions contained in the 1933 and 1934 Acts and the pertinent legislative history in an effort to sketch the current regulatory framework and discern the policies Congress actually was attempting to further by enacting the current regulatory scheme.

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77. FUNDAMENTALS, *supra* note 4, at 4.

78. *Id.* at 4-5. The calculations are facilitated by the use of "basis books," which show the dollar prices required for a bond bearing a particular interest coupon to yield a desired interest rate.

79. *Id.* at 5.

80. *Id.* at 5-6.

VI. The Existing Framework of Municipal Bond Regulation

A. *The Securities Act of 1933*

The Securities Act of 1933 provides a broad set of prospectus delivery and disclosure requirements in connection with the public distribution of securities. That act, however, also creates classes of exempted securities[81] and exempted transactions,[82] which, if the requisite conditions are met, are free from the registration and prospectus delivery requirements of section five. The 1933 Act also contains two antifraud provisions, sections 12(2) and 17(a),[83] that apply regardless of whether a registration statement is used. Municipal securities receive special treatment in section 3(a)(2) of the Act, which defines them as "exempt securities" not subject to the prospectus delivery and disclosure requirements.[84] Moreover, while section 12(2) generally applies to exempt securities, that section expressly exempts from its operation those exempt securities falling within the scope of section 3(a)(2).[85] Thus, the sole substantive section of the 1933 Act applicable to municipal bonds is section 17(a), the broad prohibition against fraud, material omissions, and material misstatements in the offer or sale of securities.

As will be seen later, the antifraud provisions of section 17(a) of the 1933 Act, as well as the almost identical antifraud provisions of section 10(b) of the 1934 Act and Rule 10b-5 promulgated thereunder, have been broadly construed by the courts both in general and in the municipal securities area specifically.[86] These provi-

81. Securities Act of 1933 §§ 3(a)(1)-(8), 15 U.S.C. §§ 77*c*(a)(1)-(8) (1970).

82. Securities Act of 1933 §§ 3(a)(9)-(11), 4, 15 U.S.C. §§ 77*c*(a)(9)-(11), 77d (1970).

83. Securities Act of 1933 §§ 12(2), 17(a), 15 U.S.C. §§ 77*l*, 77*q* (1970).

84. Securities Act of 1933 § 3(a)(2), 15 U.S.C. § 77*c*(a)(2) (1970) (text quoted note 3 *supra*).

85. The pertinent text of section 12(2) is as follows:

Sec. 12 Any person who—

. . .

(2) offers or sells a security (whether or not exempted by the provisions of section 3, other than paragraph (2) of subsection (a) thereof) . . . .

15 U.S.C. § 77*l* (1970).

86. *See* notes 144-228 *infra* and accompanying text. It is important to note that while some courts have recognized the existence of a private right of action under § 17(a) of the 1933 Act, *e.g.*, Goldstein v. Grayson, [1969-1970 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 92,645 (S.D.N.Y. 1970); 223 F. Supp. 756 (S.D.N.Y. 1963), other courts have refused to do so, *e.g.*, Dyer v. Eastern Trust and Banking Co., 336 F. Supp. 890 (D. Me. 1971). Nevertheless, the distinction is academic because insofar as sales of securities are concerned, § 17(a) of the 1934 Act and Rule 10b-5 are virtually identical and no difference exists between their substantive rules. Further, virtually every antifraud complaint includes allegations under both provisions, which obviates the need for a definitive judicial pronouncement on the § 17(a) issue. H. Jennings & R. Marsh, Securities Regulation, Cases and Materials 1074-75 (1972). [hereinafter cited as Jennings & Marsh].

sions have provided a wide array of investor protection, creating liability for a multitude of deceptive or misleading statements and omissions, and have not been restricted by requiring proof of the elements of common law fraud. In contrast, however, to the registration and prospectus delivery requirements of the 1933 Act, which provide for elaborate disclosure standards and SEC review before sale, the effect of the antifraud provisions is largely retrospective. This distinction becomes particularly important because the information available to investors making municipal bond investment decisions can be of questionable usefulness. No mandatory standards exist that require disclosure of specific information in every municipal offering.[87] Thus, while some offerings may indeed provide the investor with adequate disclosure because of pressure from underwriters and bond counsel, no formal device for effective prescreening exists to prevent unscrupulous persons from perpetrating a fraudulent public sale of municipal securities.[88] Moreover, while bond ratings may be accurate general indicators of municipal bond quality, the rating agencies make no pretense that their determinations can serve as a substitute for individual examination and reflection by prospective investors. In view of this need for individual investor evaluation of data pertaining to municipal securities, it is curious that municipal bond issues are exempt from the prospectus delivery requirements of the 1933 Act.[89]

B. *The Securities Exchange Act of 1934*

Unlike the 1933 Act, the Securities Exchange Act of 1934 contains a number of different types of substantive provisions, one of which is the method devised to regulate the activities of brokers and dealers acting in interstate commerce. Although an in-depth exposition of the 1934 Act provisions is beyond the scope of this Note, a brief description of this broker-dealer regulatory framework and its application to municipal bond transactions is necessary.[90]

87. *See* text accompanying note 58 *supra*.

88. *See In re* Walston & Co. and Harrington, [1966-1967 Transfer Binder], CCH FED. SEC. L. REP. ¶ 77,474 (SEC 1967).

89. It is also important to note that the proposed Federal Securities Code would seek to continue the present exemptions of municipal securities from regulation under the federal securities cases. Proposed § 301(a) would include municipal securities within the category denominated "American Governments," which are included within the classification of exempted securities and are not subject to registration under § 401. A.L.I. FED. SEC. CODE, Tent. Draft No. 1 (1972). Moreover, § 303 expressly states that no federal or state government is subject to the provisions of the Code "unless a particular provision makes a specific reference thereto." A.L.I. FED. SEC. CODE, Tent. Draft No. 3 (1974).

90. For an excellent treatise on the regulation of brokers and dealers see E. WEISS, REGISTRATION AND REGULATION OF BROKERS AND DEALERS (1965).

The broadest powers granted to the SEC by the 1934 Act to control broker-dealer activities emanate from the general antifraud provisions, which provide a general standard of conduct to be observed in all securities transactions.[91] Section 10(b) and Rule 10b-5 promulgated thereunder and sections 15(c)(1) and 15(c)(2) all prohibit the use of manipulative, deceptive or other fraudulent devices or contrivances in connection with the purchase or sale of any security.[92] These sections also empower the SEC to adopt rules necessary to their enforcement, including the specific authority to define manipulative, deceptive, or otherwise fraudulent devices, contrivances, acts and practices.[93]

In addition to these broad antifraud provisions, which generally contemplate after-the-fact enforcement against individual broker-dealer violators, the 1934 Act also provides a scheme of constant supervision of most brokers and dealers. This supervision is accomplished by efforts of the SEC and to a large extent by self-regulatory bodies. Under section 15(a)(1) of the Act,[94] no broker or dealer can make use of the mails or interstate commerce "to effect any transaction in, or induce the purchase or sale of, any security" unless he has registered with the SEC pursuant to section 15(b).[95] These broker-dealer registration provisions are particularly important since most brokers and dealers engage in interstate business and therefore are required to register.[96] The SEC has substantial regulatory power over registered brokers and dealers because it may revoke the registration of or otherwise discipline a registrant who willfully violates any provision of the securities acts or any rule promulgated thereunder. The Commission possesses the additional power to regulate registered brokers and dealers under various provisions of the Act and accordingly has established various rules governing, *inter alia*, record-keeping and reporting, financial responsibility, and hypothecation of customers' securities.[97]

The bulk of regulation of the securities markets, however, is accomplished by the self-regulatory bodies.[98] Under sections 5 and

91. *See* Cohen and Rabin, *Broker-Dealer Selling Practice Standards: The Importance of Administrative Adjudication in Their Development*, 29 LAW & CONTEMP. PROB. 691, 696 (1964).

92. Securities Exchange Act of 1934 §§ 10(b), 15(c)(1), 15(c)(2), 15 U.S.C. §§ 78*j*(b), 78*o*(c)(1)-(c)(2) (1970). Sections 15(c)(1) and 15(c)(2) apply to transactions by brokers and dealers while section 10(b) applies to transactions by any person.

93. Securities Exchange Act of 1934 § 23(a), 15 U.S.C. § 78*a* (1970).

94. 15 U.S.C. § 78*o*(a)(1) (1970).

95. 15 U.S.C. § 78*o*(b) (1970).

96. Cohen and Rabin, *supra* note 91, at 697.

97. *Id.*

98. JENNINGS & MARSH, *supra* note 86, at 675.

6 of the 1934 Act[99] all national securities exchanges are required to register with the SEC. Regulation of the over-the-counter market is accomplished by section 15A of the Act,[100] which allows the registration of national securities associations with the SEC. The National Association of Securities Dealers (NASD) is the only association registered under this provision, and its membership includes virtually all broker-dealers conducting an active business in the over-the-counter market.[101] Membership in the NASD is made almost compulsory by the strong economic inducement of section 15A(i),[102] which allows the rules of a registered securities association to require that no member may deal with any nonmember except on terms identical to those offerred to the general public. The 1934 Act allows the exchanges and the NASD to regulate and discipline their members, and to achieve this purpose, all of the exchanges and the NASD have enacted elaborate sets of rules to govern members' conduct.[103] In general, enforcement authority in the over-the-counter market is exercised in the first instance by the NASD in administrative proceedings against its members for rule violations.[104] The SEC has supervisory responsibility over NASD rules and the disciplinary actions of both the exchanges and the NASD,[105] but possesses no power to bring a direct action for noncompliance with NASD rules. Further, the oversight authority of the SEC is limited because although it can affirm, diminish or dismiss NASD sanctions, it may not increase a penalty assessed by the NASD.[106] Nevertheless, the enforcement authority reposed in the NASD remains an effective tool for preventing broker-dealer abuse, because the NASD rules are devised in a manner such that conduct requiring extensive proof at trial to establish a violation of the antifraud provisions normally would be accompanied by direct, easily provable violations of NASD regulations designed for the protection of investors.

Moreover, although the SEC cannot bring a direct action to enforce NASD rules, the broad registration requirement of section 15(a)(1) provides the Commission with an important enforcement mechanism. Since the 1934 Act does not expressly require that all

99. 15 U.S.C. §§ *78e-f* (1970).

100. 15 U.S.C. § 78o-3 (1970).

101. JENNINGS & MARSH, *supra* note 86, at 675.

102. 15 U.S.C. § 78o-3(i) (1970).

103. JENNINGS & MARSH, *supra* note 86, at 675.

104. Letter from SEC Chairman William J. Casey to the United States Congress, Dec. 28, 1971, BNA SEC. REG. & L. REP. No. 133 at D-1 (Jan. 5, 1972).

105. JENNINGS & MARSH, *supra* note 86, at 675.

106. Letter from SEC Chairman William J. Casey to the United States Congress, *supra* note 104, at D-1.

broker-dealers join the NASD,[107] a class of broker-dealers exists that is registered with the SEC but not included in the membership of the NASD. Pursuant to section 15(b) of the Act, the SEC has adopted its so-called "SECO" (SEC only) provisions, which are similar to many NASD rules and directly regulate SEC registrants who are not NASD members. These regulations include provisions governing general business conduct,[108] suitability of recommendations,[109] supervision of associated persons,[110] discretionary authority,[111] and record-keeping requirements.[112] Further, the Commission's ability to revoke the registration or otherwise discipline any registrant for willful violations of the Securities Acts or any rules promulgated thereunder provides it with a direct enforcement tool not limited to SECO brokers and dealers.[113] When a violation occurs, the SEC has several alternate methods of redress. It may seek an injunction or criminal conviction, or institute an administrative hearing to determine whether a violation has occurred and whether registration should be revoked or suspended.[114]

The siguificance of the regulatory scheme applicable to brokers and dealers required to register under section 15(a) is the efficiency and flexibility it injects into the enforcement of the securities laws. Because a registered broker-dealer is subject to regulation by the Commission and usually a self-regulatory body, matters of market abuse that otherwise would require lengthy court proceedings can be remedied by administrative action.

Unfortunately, the broker-dealer registration provisions do not apply to a significant sector of the municipal securities industry. Sections 3(a)(4) and 3(a)(5) of the 1934 Act expressly exempt banks from the "broker" and "dealer" definitions. Thus, registration of dealer banks is not required under section 15(a). Of course, broker-dealers dealing in municipal securities who are members of the NASD or are registered with the SEC come within the ambit of some or all of the registration and regulatory provisions. As noted, however, the Act does not require registration or NASD membership of all broker-dealers.

107. *See* text accompanying note 102 *supra*.
108. Rule 15b-10-2, 17 C.F.R. § 240.15b-10-2 (1974).
109. Rule 15b-10-3, 17 C.F.R. § 240.15b-10-3 (1974).
110. Rule 15b-10-4, 17 C.F.R. § 240.15b-10-4 (1974).
111. Rule 15b-10-5, 17 C.F.R. § 240.15b-10-5 (1974).
112. Rule 15b-10-6, 17 C.F.R. § 240.15b-10-6 (1974).
113. Without this power no action could be taken to prevent or terminate a violation without a final court judgment.
114. Cohen and Rabin, *supra* note 91, at 697. "The method which the Commission uses in a particular case depends on urgency, equity, nature of the alleged violations involved and a variety of other considerations." *Id.*

Additionally, section 3(a)(12) of the 1934 Act defines municipal securities as exempt securities. This provision does not, in contrast to the scheme of the 1933 Act, provide a blanket exemption from the substantive provisions of the 1934 Act. Rather, each substantive 1934 Act provision must be examined to determine the scope of its applicability.[115] Thus, sections 15(c)(1) and 15(c)(2), the broad, broker-dealer antifraud provisions do not exempt any brokers or dealers, although banks are not subject to these provisions. Also, section 10(b) and Rule 10b-5 apply to any person, including banks and broker-dealers. Conversely,the provisions of section 15(a)(1) requiring registration with the SEC of brokers and dealers acting in interstate commerce expressly exempt broker-dealers using the jurisdictional means to effect a transaction or induce the purchase or sale of an exempt security. In applying this section, the Commission has adopted a somewhat narrow construction, holding that it applies only to those brokers and dealers whose business is limited solely to exempt securities.[116] Thus, even though a broker-dealer engages in transactions in exempt securities, he remains a broker-dealer and must confine his dealings to that single category to escape the registration requirement.[117] Moreover, once a broker-dealer is found to be exempt from the registration requirements, he is likewise exempt from those SEC rules previously discussed that are applicable solely to registered brokers and dealers.

While from the preceding discussion one might conclude that NASD membership would still be the norm for municipal securities broker-dealers, this is not the case. Section 15A(m)[118] expressly states that "[n]othing in this section [15A] shall apply to any transaction by a broker or a dealer in a municipal security." Thus, the strong economic incentive to join the NASD is removed because the provision allowing the NASD to exclude nonmembers from treatment other than that accorded the general public does not apply to municipal bond transactions.

In summary, although some participants in the municipal securities industry are subject to regulation by the SEC and NASD, banks and unregistered, nonNASD-member broker-dealers are not. Rather, the banks are subject only to the antifraud provisions of

115. *See* 2 L. Loss, Securities Regulation 798 (2d ed. 1961). Professor Loss lists some of those provisions of the 1934 Act that do and do not apply to municipal securities.

116. H. Montgomery Snyder, Inc., [1970-1971 Transfer Binder] CCH Fed. Sec. L. Rep. ¶ 77,996 (SEC 1971). This no-action letter also expressly pointed out that despite the nonapplicability of the registration requirement, the antifraud provisions remained fully applicable.

117. *See* Gadsby, Federal Securities Exchange Act § 3.02 [a]; Sec. Exch. Act Rel. No. 5790 (1958).

118. 15 U.S.C. § 78*o*A(m) (1970).

section 10(b) and Rule 10b-5, and the nonNASD-member, unregistered broker-dealers are subject only to section 10(b) and Rule 10b-5, and the broker-dealer antifraud provisions of sections 15(c)(1) and 15(c)(2).

VII. THE LEGISLATIVE HISTORY UNDERLYING THE MUNICIPAL SECURITIES EXEMPTIONS

It is a curious result that the same legislative body that provided the pervasive scheme for the protection of investors contained in the 1933 and 1934 Acts should leave the primary and secondary municipal securities markets virtually unregulated, except for the antifraud provisions. Nevertheless, in the municipal securities area Congress has subordinated the needs of the investor when faced with the arguments of politically strong state and local governments.

In 1959, Mr. James A. Landis, Chairman of the Federal Trade Commission at the time of adoption of the 1933 Act, stated that "[t]he draftsmen had originally contemplated no exemption at all for municipal bonds, but they were exempted for obvious political reasons."[119] This same deferential attitude characterizes the testimony of another of the bill's drafters: "Of course, we do not think that any security of the United States Government, for example, needs the surveillance of the Federal Trade Commission, or the security of a State Government."[120]

Apparently because of the exemption of municipal securities in the original bill, extensive debate on the propriety of the exemption did not occur when Congress considered passage of the 1933 Act. Congress was advised, however, of known but rare instances of misrepresentation by municipalities of their assessed value and their ability to levy sufficient taxes to pay for bond issues.[121] Further, Congress heard the argument that in any municipal bond issue, as with other securities issues, a potential investor needs certain basic information whose disclosure should be required by the Federal Securities Act.[122] Nonetheless, Congress approved the bill creating the

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

120. *Hearings on H.R. 4314 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 1st Sess. at 29 (1933) (testimony of Mr. Huston Thompson).

121. *Hearings on S. 875 Before the Senate Comm. on Banking and Currency*, 73d Cong., 1st Sess. at 232 (1933) (testimony of M. H. MacLean, Vice President, Harris Trust and Savings Bank, Chicago, Ill.).

122. *Id.* at 65 (testimony of Col. A. H. Carter, Chairman of New York State Society of Certified Public Accountants).

broad exemption for municipal bonds from all sections of the Act[123] except the section 17(a) antifraud provision;[124] the committee report stated only that transactions in municipal securities were beyond the need of public protection because of the lack of "recurrent demonstrated abuses."[125] Although the decision to exempt municipal securities may have been justified in light of the slight potential for abuse and the possibly large potential expense to municipal issuers, Congress can be criticized for allowing an anticipated political outcry from state and local governments to stifle any serious investigation of the possible adverse effects upon the individual investor.

The legislative history of the municipal securities exemption contained in the 1934 Act clearly indicates that any significant effort to regulate municipal issuers under the 1933 Act would indeed have met with substantial resistance from municipal issuers. In contrast to the 1933 Act, the 1934 Act as originally drafted did not provide any exemption for municipal securities.[126] Consequently, extensive testimony was heard regarding the propriety of exempting municipal bond markets from regulation.

The proponents of the exemption argued that some of the provisions of the bill would place onerous burdens on the municipal securities industry. They argued that the original prohibitions against the extending of credit on nonlisted securities before thirty days after full payment and the limiting of borrowing on such securities to only forty percent of the value of the issue would severely harm the sale of new municipal bonds because underwriters simply would not have sufficient capital to put up the required sixty percent of new municipal issues.[127] Moreover, the requirement that all borrowing to finance purchases of securities be obtained from a federal reserve bank was regarded as unduly stringent. The limitations on dealer commitments to ten times a dealer's net capital were also

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123. The original House bill included municipal securities within the ambit of the antifraud provisions of section 12(2) while the Senate bill did not. This matter was resolved in conference committee in favor of the Senate bill without comment on the propriety of the exemption. CONFERENCE REPORT ON H.R. 5480, H.R. REP. No. 152, 73d Cong., 1st Sess. (1933).

124. The Senate Report on the initial bill made the following statement on the scope of antifraud liability:

> The act subjects the sale of old or outstanding securities to the same criminal penalties and injunctive authority for fraud, deception, or misrepresentation as in the case of new issues put out after approval of the act. In other words, fraud or deception in the sale of securities may be prosecuted regardless of whether the security is old or new, whether or not it is of the class of securities exempted under sections 11 or 12.

S. REP. No. 47, 73d Cong., 1st Sess. 4 (1933).

125. H.R. REP. No. 85, 73d Cong., 1st Sess. 7 (1933).

126. *Hearings on S.R. 84, S.R. 56 and S.R. 97 Before the Senate Committee on Banking and Currency*, 73d Cong., 2d Sess. 7037 (1934).

127. *Id.* at 7038-39.

viewed as particularly onerous because the bidding process often prevents a dealer from knowing in advance his total commitments.[128] The exemption supporters also complained that the proposals requiring the separation of the broker and dealer functions should not be applied to municipal bond broker-dealers because such a requirement might drive a number of firms into bankruptcy. Further, the possible requirements of independent audits of municipal issuers and SEC registration were perceived as creating undue cost burdens on municipal issuers.[129]

In addition to pointing out these specific deficiencies of the original draft of the 1934 Act, which indicate that the drafters probably did not consider the intricacies of municipal securities, the proponents of the municipal exemption also asserted a series of policy arguments supporting nonregulation of the municipal securities industry. Initially, the proponents of the exemption argued that although specific instances of abuse by municipal bond broker-dealers did exist,[130] voluntary compliance with the Investment Bankers Code—ethical standards promulgated by the Investment Bankers Association of America, a voluntary membership organization composed of municipal bond brokers and dealers—would sufficiently safeguard the customer.[131]

Secondly, they argued to Congress that trading in municipal bonds provided practically no opportunity for speculative abuse and since prevention of such abuse was a primary purpose of the Act, an exemption for municipal securities was appropriate.[132] The main rationale in support of this contention was that speculative abuse simply had not occurred on any significant scale and was not likely to occur, since the major purchasers of municipal bonds were public institutions, insurance companies, banks, and individuals purchasing for investment purposes.[133] Moreover, the proponents cited the method of sale by public bid, infrequent margin purchases, and the unique nature of each municipal security—which make short sales and wash sales virtually impossible—as additional considerations strongly supporting this policy argument.[134] Although subsequent

128. *Id.* at 7040.

129. *Id.* at 7042-43.

130. Specific evidence before the Senate committee indicated that some bond houses pushed securities upon customers even though the broker-dealer knew that the securities were "souring." *Id.* at 7041 (statement of Mr. Pecora).

131. *Id.* at 7040-41.

132. *Id.* at 7046, 7443.

133. These types of purchasers, it was argued, were not likely to speculate in the bond markets. *Id.* at 7443. While this may have been a correct conclusion in 1934, it does not appear to be the case today.

134. Since each municipal bond has unique characteristics, it is not possible to sell

events were to prove otherwise, this nonregulation rationale, in light of the conditions existing at the time of the enactment of the 1934 Act, seems most compelling.

Next, the supporters of the exemption argued that imposing requirements of stock exchange listing or registration with the SEC might decrease the marketability of municipal bonds, and thus impair the ability of the public to borrow for public purposes.[135] This argument perhaps weighed most heavily in the minds of Congress. Although this rationale appears well-founded in light of the credit limitations mentioned previously, FTC Commissioner Landis, in testimony before the House Committee, pointed out that the Act itself imposed no requirement of SEC registration or exchange listing unless the securities were already so listed, or the FTC imposed, by rule, a registration requirement on securities traded in the over-the-counter markets.[136] Since the Commission probably would not have imposed unduly harsh registration requirements on municipal securities, the contention that registration would impair marketability appears to have been of a bootstrap, makeweight nature. Also in favor of enhancing the marketability of municipal bonds the proponents argued that any regulation limiting the amount of bidding occurring in the municipal market would reduce competition and thus increase the cost of issuing municipal securities. This ground was advanced as a reason for nonapplication of net capital requirements to brokers and dealers bidding on municipal bond issues.[137]

Despite all of the foregoing arguments, little discussion of the interest in protecting the individual investor occurred. Thus, the bill finally enacted into law not only exempted municipal bonds and municipal issuers from the inartfully drafted provisions that otherwise would have proven particularly onerous to the process of issuing new municipal securities, but also exempted members of the municipal securities industry from the broker-dealer registration provisions of the Act. This occurred although the decision was unre-

short because a short seller would be unable to borrow bonds to cover his short sale if the holder of the particular bond sold is unwilling to part with it. *Id.*

135. *Id.* at 7444-45. As an example of the potential political conflicts that might have arisen had municipal bonds not been exempted, a memorandum from the Connecticut Investment Bankers Ass'n. stated that "local investors, corporations, and municipalities are bound vigorously to protest when they realize to what extent their position has been or is in danger of being impaired by the provisions of the bill as it now stands." *Hearings on H.R. 7852 and H.R. 8720 Before the House Committee on Interstate and Foreign Commerce*, 73d Cong., 2d Sess. 753 (1934).

136. *Hearings on H.R. 7852 and H.R. 8720 Before the House Committee on Interstate and Foreign Commerce*, 73d Cong., 2d Sess. 911-13 (1934).

137. *Hearings on S.R. 84, S.R. 56 and S.R. 97, supra* note 126, at 7447-48.

lated to the costs of issuing municipal securities, and no case was ever made for nonapplication of the broker-dealer registration provisions, which would have required broker-dealer practices to comply with the high ethical standards set by the Act and the SEC.

Congress next assessed the propriety of regulating the municipal securities industry in 1938 when it passed the Maloney Act, which created section 15A of the 1934 Act and required self-regulation of the over-the-counter market by national securities associations.[138] Again, Congress yielded to strong arguments that such regulation would interfere with issuance of securities by states and cities and created a blanket exemption for municipal securities in section 15A(m).[139]

Little subsequent legislative or administrative examination of the municipal securities industry occurred after 1938. In its Report of the Special Study of the Securities Markets, the SEC limited its examination of the over-the-counter markets to corporate equity securities. The Commission stated that the municipal securities markets were not examined because of the vastness of the task of evaluting over-the-counter markets and because the municipal exemptions in the 1933 and 1934 Acts had caused the SEC to divert its attention from the municipal securities industry and markets.[140] Thus, it appears that while the securities legislation of the 1930's did largely succeed in providing broad protection to investors, when faced with even a tangential impairment of the position of state and local governments in raising funds, Congress statutorily subordinated the interests of the individual investor.

VIII. Trading Abuse in the Municipal Securities Markets During the Post 1933 and 1934 Act Period

Although the decision to grant exemptions to municipal securities from the 1933 and 1934 Acts perhaps can be justified by the lack of trading abuse evident at the time of enactment of that legislation, developments in the following forty-year period cast considerable doubt on the wisdom of continuing those exemptions in their entirety. This section will discuss the case law, administrative proceedings, and litigation releases pertinent to a description of the nature and extent of abuses that have occurred in the municipal securities industry and to an evaluation of the efficacy of current statutory provisions in dealing with those abuses.

138. *See* text accompanying notes 118-19 *supra*.

139. *Hearings on S. 3255 and H.R. 9634 Before a Subcommittee of the House Comm. on Interstate and Foreign Commerce*, 75th Cong., 3d Sess. at 12 (1938).

140. Report of the Special Study of the Securities Markets 542 n.8 (1963).

Unlike the experience of the corporate securities industry, fraud or misrepresentation cases in the municipal securities industry were not numerous until recently. The early reported cases involved fraudulent activities by both municipal issuers and persons engaged in the distribution process. The first major municipal securities fraud case in the post 1933 and 1934 Act period was adjudicated in a series of five decisions in the Southern District of New York in 1954 and 1955. In those cases, the plaintiffs had purchased revenue bonds of the Bellevue Nebraska Bridge Commission in reliance on false and misleading matter contained in an offering circular and a report of estimated vehicular traffic and toll revenue prepared by the defendants, and on oral misrepresentations made by an individual seller.[141] Since the purchasers had no specific statutory remedy,[142] suit was brought under the broad antifraud provisions of section 17(a) of the 1933 Act and section 10(b) of the 1934 Act and Rule 10b-5 promulgated thereunder. In each of these decisions, defendants—the members of the bridge commission, their securities and engineering firms, and an individual seller—tried to vacate extraterritorial service by countering plaintiffs' allegations of antifraud liability with the argument that since Congress had expressly exempted municipal bonds from civil liability arising under section 12(2) of the 1933 Act, Congress intended to exempt municipal bond sales from all of the antifraud provisions of the securities acts. Therefore, defendants argued, it would be inconsistent with and contrary to the legislative intent to imply civil causes of action to municipal bond transactions under the similar antifraud provisions of section 17(a) of the 1933 Act, and section 10(b) and Rule 10b-5 of the 1934 Act.[143]

The first two decisions dealing with defendants' argument, *Baron v. Shields*,[144] and *Connecticut Mutual Life Insurance Co. v. Shields*,[145] contained no allegations of section 17(a) violations and held that a violation of section 10(b) of the 1934 Act and Rule 10b-5 had occurred. Therefore, a ruling upon the scope of the exemption of section 3(a)(2) of the 1933 Act was deemed unnecessary and irrelevant.[146] The remaining three cases, however, involved alleged viola-

141. *E.g.*, Thiele v. Shields, 131 F. Supp. 416, 418 (S.D.N.Y. 1955).

142. *See* text accompanying notes 81-118 *supra*.

143. *E.g.*, Thiele v. Shields, 131 F. Supp. 416, 419 (S.D.N.Y. 1955); Greenwich Savings Bank v. Shields, 131 F. Supp. 368 (S.D.N.Y. 1955).

144. 131 F. Supp. 370 (S.D.N.Y. 1954).

145. 131 F. Supp. 363 (S.D.N.Y. 1954).

146. In this regard, Judge Dimock stated as follows:

> The fact that the Bellevue Bridge Commission (Nebraska), the issuer of the security, may well come within the class of a political subdivision of the state or a public

tions of both section 10(b) of the 1934 Act and section 17(a) of the 1933 Act.

The third decision, *Citizens Casualty Co. of New York v. Shields*,[147] adopted defendants' argument, reasoning that it would be illogical to conclude "that Congress made punishable under [section 17(a)] what it exempted from the [1933] Act's operation under [sections 3(a)(2) and 12(2)]."[148]

While the fourth decision, *Greenwich Savings Bank v. Shields*,[149] did not discuss the *Citizens Casualty* rationale in finding that plaintiffs had stated a claim under sections 10(b) of the 1934 Act and 17(a) of the 1933 Act,[150] the final decision, *Thiele v. Shields*,[151] dealt with all of the preceding cases. In *Thiele*, Judge Kaufman distinguished the scope of liability for omissions and misrepresentations under section 12(2) of the 1933 Act from that under sections 10(b) of the 1934 Act and 17(a) of the 1933 Act. Under the former he concluded that a plaintiff must show only that the falsehood existed and that he lacked knowledge of the untruth or omission. Conversely, the court found that sections 10(b) and 17(a) do not on their face apply to negligent omissions, nor should they apply, without an express provision like section 12(2), to shift the burden of proof to the defendant.[152] Having differentiated between the elements required to sustain the causes of action, the court concluded that it was not inconsistent to find liability under sections 17(a) of the 1933 Act and 10(b) of the 1934 Act even though section 12(2) of the 1933 Act expressly exempted municipal securities. The court stated:

> Therefore, even assuming plaintiff's allegations are based *solely* on a "prospectus or oral communication" within the municipal bond exemption to the stringent liability imposed by section 12(2), a claim under section 17(a)

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instrumentality of the state and tbat the bonds would then qualify as exempted securities under section 3 of the Securities Act of 1933 . . . is insignificant. As I have just stated, plaintiff has brought himself within section 10(b) of the Securities Exchange Act of 1934 and that section deals with sales of "any security". The fact tbat plaintiff states a claim under the Securities Exchange Act of 1934 is determinative of his right to serve the moving defendants in Nebraska.

131 F. Supp. at 372.

147. [1954 Transfer Binder] CCH FED. SEC. L. REP. ¶ 90,683 (S.D.N.Y. 1954).

148. *Id.*

149. 131 F. Supp. 368 (S.D.N.Y. 1955).

150. To defendants' argument that their acts were based solely on the falsity of a prospectus and communication and that § 12(2) prescribes the only liability in connection with prospectuses and communications, the court held both that plaintiffs' claim (wbich included allegations of concerted action) was not based solely on falsity of the prospectus and communication and that section 12(2) was not the exclusive remedy for such falsity. 131 F. Supp. at 369-70.

151. 131 F. Supp. 416 (S.D.N.Y. 1955).

152. *Id.* at 419.

and 10(b) would still be sustainable if knowing or intentional misrepresentation with regard to municipal bonds were alleged (and proven) by the plaintiff. That Congress intended to exempt a seller of municipal bonds from liability for failure to prove that he exercised reasonable care in investigating the truth of a representation is not inconsistent with the subjection to civil liability of the same seller after the purchaser proves that he knowingly misrepresented a fact.[153]

Although the holding of the majority of these cases has been criticized as an unwarranted extension of civil liability[154] under sections 17(a) of the 1933 Act and 10(b) of the 1934 Act, the position espoused by Judge Kaufman appears to be a valid construction of the statutory language, avoiding what otherwise would have constituted a severe legislative loophole that would have relegated persons engaged in municipal bond transactions to their common law remedies.[155] This result was particularly important because, while the facts of the fraudulent scheme probably would have satisfied the requirements of common law fraud, only by recognizing a cause of action under the antifraud provisions of the securities acts could Judge Kaufman allow plaintiffs to take advantage of the extraterritorial service of process provided by the acts.[156]

In a 1962 case, *Texas Continental Life Insurance Co. v. Dunne*,[157] the municipal issuer sold a two million dollar revenue bond issue to an individual purchaser in exchange for 335,000 dollars in cash and a promissory note for 1,725,000 dollars payable in seven equal annual installments at five percent interest. The promissory note contained a clause providing that with the exception of the first installment, all other installments could be paid in cash or

153. *Id.* at 419-20. (Emphasis in original).

154. *See* 3 L. Loss, Securities Regulation 1786-89 (1961); Comment, 69 Harv. L. Rev. 771 (1956). Professor Loss, in discussing this group of cases, questions the validity of allowing a private right of action under § 17(a). He states that this requires attributing to Congress "the rather elaborate intention" to allow a purchaser to avoid the statute of limitation of § 13 "as well as the possibility of having to post security for costs and perhaps the necessity of proving his own lack of knowledge of falsity as in §12(2), if he voluntarily elects to assume the burden of proof on an issue (*scienter*) as to which Congress carefully shifted the burden of proof to the defendant in §§ 11 and 12(2)." Loss, *supra* at 1786. He further questions the validity of allowing a buyer to sue under Rule 10b-5, even if he can not sue under § 17(a), reasoning that "[i]n view of the close relation between the two acts — and especially the fact that Congress actually tightened §§ 11 and 13 of the 1933 Act simultaneously with its adoption of the 1934 Act — it seems reasonable to conclude . . . that Congress could not have 'casually nullified' in § 10(b) of the 1934 act the detailed procedural and other requirements with which it had surrounded §§ 11 and 12(2) of the 1933 act." *Id.* at 1787.

155. Moreover, this result is consistent with Congress' intent to prevent fraud and deception in the sale of securities regardless of whether they are of the classes exempted under sections 11 or 12. S. Rep. No. 47, 73d Cong., 1st Sess. (1933), *supra* note 124.

156. Securities Act of 1933 § 22, 15 U.S.C. § 77*v*; Securities Exchange Act of 1934 § 27, 15 U.S.C. § 78*aa* (1970).

157. 307 F.2d 242 (6th Cir. 1962).

by the transfer without recourse of the revenue bonds to the holder of the note. Although the city passed an ordinance allowing the bond sale, the ordinance made no mention of the purchaser's right to rescind. Moreover, the bonds were not advertised or offered for sale through normal channels. Plaintiff purchased 100,000 dollars of the bonds from the original purchaser and was not given notice of the provision allowing repayment by transfer of bonds. Subsequently, the original purchaser defaulted on the balance of the bond issue after making only two payments on the note. Thus the city received only a small part of the bond sale proceeds and was unable to construct the improvements for which the bonds had been issued. Without these improvements the city was unable to collect revenues to create a sinking fund to pay the interest and principal due on the bonds, and the issue went into default.

Plaintiff sued the municipality's underwriter and its selling agent and claimed that defendants' failure to disclose the facts of the credit sale and right to transfer bonds as payment of the note constituted omissions of material facts necessary to make the prospectus that had accompanied the issue not misleading.[158] The Sixth Circuit agreed unhesitatingly with plaintiff's allegations that defendants' omissions constituted a violation of section 10(b) of the 1934 Act and Rule 10b-5 and affirmed the trial court's directed verdict in favor of the plaintiff.[159]

A 1967 SEC decision, *In Re Walston & Co. and Harrington*,[160] concerned another fraudulent underwriting of a municipal bond issue. The SEC instituted this administrative action under sections 15(b), 15A and 19(a)(3)[161] of the 1934 Act to determine what action should be taken against a registered broker-dealer and its divisional municipal bond manager. While NASD rules also were probably violated, the Commission was not required to rely on the NASD to take enforcement action, because the defendants' conduct as alleged violated the antifraud provisions of section 17(a) of the 1933 Act and sections 10(b) and 15(c)(1) of the 1934 Act and Rules 10b-5 and 14c1-2 promulgated thereunder.

On behalf of the broker-dealer, the municipal bond manager purchased 250,000 dollars of a 550,000-dollar issue of 5.5 percent bonds of a local California services district. The bonds were resold to thirty-four customers of the broker-dealer. The issuer was a spe-

158. *Id.* at 246-47.

159. 187 F. Supp. 14 (W.D. Ky. 1960). The district court directed a verdict in favor of the plaintiff without considering the effect of the section 12(2) exemption of municipal securities. *See* 3 L. Loss, SECURITIES REGULATION 1789 (2d ed. 1961).

160. [1966-1967 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,474 (SEC 1967).

161. 15 U.S.C. § 78s (1970).

cial assessment district that had been formed for the benefit of the promoter of a speculative real estate development who had neither prior experience in selling real estate nor the financial ability to service the bonds himself. Also, the unfavorable location of the district severely depressed its assessed valuation.[162] The broker-dealer and its manager made no independent investigation of the bond issue beyond a routine portfolio review, and the only information provided the broker-dealer's securities salesmen was contained in an offering circular adapted by the manager from a prior misleading offering circular issued by the principal underwriter. The salesmen relied on the information given and made recommendations that the bonds were "good" or "high grade" or "secure" tax-free municipal bonds. Various customers purchased the bonds in reliance on these representations and on a general impression that the bonds were safe and conservative investments. Some buyers were also given the impression that the bonds were issued by a district in a rapidly growing part of the country or issued for the expansion of an established community.[163]

The SEC reasoned that firms participating in an offering and dealers recommending municipal bonds as "good municipal bonds" have a duty "to make diligent inquiry, investigation and disclosure as to material facts relating to the issuer of the securities and bearing on the ability of the issuer to service such bonds." The Commission further stated that "dealers offering such bonds to the public [must] make certain that the offering circulars and other selling literature are based upon an adequate investigation so that they accurately reflect all material facts which a prudent investor should know in order to evaluate the offering before reaching an investment decision."[164] Finding that the offering circular fell far short of this disclosure standard, the Commission held that the broker-dealer and its manager willfully violated and willfully aided and abetted violations of section 17(a) of the 1933 Act, sections 10(b) and 15(c)(1) of the 1934 Act and Rules 10b-5 and 15c1-2[165] thereunder, in connection with their offer and sale of the bonds.[166] The SEC determined, however, that because the broker-dealer made exten-

162. The district consisted of undeveloped farm land situated 12 miles from the nearest shopping center and with no public transportation available. The tract was in the general vicinity of and under the pattern of approach to a metropolitan airport and within a zone of intense noise. The assessed value of the tract, which represented approximately 25% of its fair market value was $15,500. CCH FED. SEC. L. REP., at 82,944.

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

164. *Id.* at 82,945.

165. 17 C.F.R. 240.15c1-2 (1974).

166. CCH FED. SEC. L. REP., at 82,945.

sive mitigating efforts by offering to repurchase the bonds from each of the purchasers, revocation of their licenses was not in the public interest, and thus decreed a consent order imposing only public censure and temporary suspensions of the broker-dealer and its manager.

The foregoing analysis of the few municipal bond fraud cases involving both issuers and broker-dealers decided under the securities acts through the mid-1960's reveals several important facts about the present scheme of municipal securities regulation. Application of the registration and prospectus requirements of the 1933 Act might have prevented the occurrence of the fraud in all of the situations scrutinized. Further, the potential use of administrative proceedings against registered brokers and dealers, as indicated by the *Walston* case, provides the SEC with desirable flexibility; the Commission need not sue in federal court to vindicate alleged fraud in the sale of municipal securities, and it can prescribe standards of due diligence to govern the sale of municipal securities, notwithstanding the nonapplicability of sections 11 and 12 of the 1933 Act. Unfortunately, as previously noted, the broker-dealer registration provisions do not apply to unregistered, nonNASD-member firms solely engaged in the municipal bond business, and that situation has caused considerable difficulty in recent years.

Suits for fraud solely by brokers and dealers in connection with municipal bond transactions, like those involving both broker-dealers and municipal issuers, occurred only rarely through the mid 1960's. When the suits were instituted, however, the courts again applied the antifraud sections broadly to provide investors with an adequate remedy. Thus, in *Shapiro v. Schwamm*,[167] the court had no difficulty finding a 10b-5 violation in a case involving fraud by a broker-dealer. The defendant, a registered broker-dealer, falsely represented to plaintiff that an eight percent return on investment would be earned and that it was purchasing particular bonds in the open market, while defendant actually sold plaintiff lower quality bonds from its own portfolio. Finding that the plaintiff had stated a 10b-5 cause of action, the court held that New York's six-year statute of limitations in fraud cases was applicable rather than the shorter three-year federal limitation applicable to other sections of the 1933 and 1934 Acts.

In the late 1960's and early 1970's a change occurred in the previously calm municipal securities industry. One type of abuse that previously had plagued the corporate securities market was the

167. 279 F. Supp. 798 (S.D.N.Y. 1968).

so-called "boiler room" operation, which involved a high-pressure selling campaign for particular securities, usually executed through long-distance telephone solictation by salesmen to prospective buyers named on a "sucker list."[168] The merchandise sold "is usually highly speculative, overpriced if not worthless, and most of the time is being sold without registration under the 1933 Act. The representations made to the customers are typically highly colored and without any foundation."[169] To counter a rash of boiler room operations in the early 1960's the SEC stepped up its enforcement efforts and applied the "shingle theory"[170] under which "a broker-dealer who goes into business . . . impliedly represents that he will deal fairly and competently with his customers and that he will have an adequate basis for any statements or recommendations which he makes concerning securities."[171] The courts accepted this approach and readily sanctioned the use of boiler room techniques in connection with the sale of corporate securities as violations of the antifraud provisions.[172] The Commission proposed a *per se* rule in 1962 that with certain exceptions, would have made it a " 'fraudulent, deceptive or manipulative act or practice' for any broker or dealer to offer or sell any equity security at $10 or less by telephone to a person unknown to him[173] . . . ." This rule, however, was never adopted.

Today, the classic boiler room operation is prevented by the "suitability" requirements imposed by NASD Rules and "SECO" provisions.[174] The NASD suitability rule prohibits recommendations by broker-dealers of "speculative low-priced securities" to customers "without knowledge of or attempt to obtain information concerning the customer's other securities holdings, their financial situation and other necessary data."[175] The pertinent "SECO" provision, the Commission's Rule 15b10-3,[176] has substantially the same

168. JENNINGS & MARSH, *supra* note 86, at 822.

169. GADSBY, FEDERAL SECURITIES EXCHANGE ACT § 6.01[1] at 6-12.2(2) (1974).

170. JENNINGS & MARSH, *supra* note 86, at 822-24.

171. *Id.* at 821-22. Charles Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir.), *cert. denied*, 321 U.S. 786 (1943) was the first case to recognize this theory in an action for violation of the antifraud provisions by a broker-dealer.

172. *E.g.*, Berko v. SEC, 316 F.2d 137 (2d Cir. 1963); Kahn v. SEC, 297 F.2d 112 (2d Cir. 1961).

173. JENNINGS & MARSH, *supra* note 86, at 824.

174. *Id.*

175. The quotation is taken from a policy statement of the NASD Board of Governors and imposes a duty of inquiry on broker-dealers in certain circumstances. Art. III, § 2, NASD Rules of Fair Practice, CCH NASD MANUAL ¶ 2152 (1970). The actual rule " . . . requires only that the broker-dealer have reasonable grounds for believing that the recommendation is suitable 'upon the basis of the facts, if any,' disclosed by the client." JENNINGS & MARSH, *supra* note 86, at 810-11.

176. 17 C.F.R. § 240.15b10-3 (1974) (the rule became effective Oct. 2, 1967, Sec. Exch. Rel. No. 8135).

effect. Since, however, section 15(a) of the 1934 Act expressly exempts municipal bond broker-dealers from registration with the SEC, and section 15A(m) exempts transactions in municipal securities from regulation by a national securities association,[177] transactions by brokers and dealers engaged solely in municipal bond transactions are not subject to the "suitability" regulations.[178]

This lack of regulatory authority over municipal bond brokers and dealers[179] has caused considerable difficulty in the municipal securities industry during recent years. In the late 1960's and early 1970's the industry became proliferated by a group of unethical dealers who forced municipal bonds on generally unsuspecting and unsophisticated individual investors through high-pressure sales techniques and intentional misrepresentations.[180] These activities were facilitated by a change in the nature of municipal bond purchasers who in the past had been chiefly institutions and sophisticated individuals.[181] The recent trend toward sales of smaller units of municipal securities to less affluent individuals desiring tax-free income has provided prime opportunities for the fraudulent efforts of unscrupulous municipal bond salesmen,[182] and widespread abuses[183] have occurred in a number of states.[184] The SEC has re-

177. *See* text accompanying notes 118-19 *supra.*

178. *See* text accompanying notes 117-18 *supra.*

179. Municipal bond broker-dealers still remain subject to the antifraud provisions of § 17(a) of the 1933 Act and §§ 10(b) and 15(c) of the 1934 Act. *See* text accompanying notes 81-118 *supra.*

180. 120 Cong. Rec. 16,596 *et seq.* (1974) (remarks of Senator Williams); *A Misdeal in Municipals?*, 98 DUNS 37 (Dec. 1971).

181. *Paragon—of What?*, 111 FORBES 19, 20 (Feb. 1, 1973). "Traditionally the big underwriters of municipals were banks and the big buyers were banks and fire & casualty companies. All these were presumably able to take care of themselves." *Id.*

182. Address by SEC Commissioner Evans, 68th Annual Meeting of Municipal Finance Officers, 256 BNA SEC. REG. & L. REP. A-13 (Jun. 12, 1974).

183. The types of abuses perpetrated by these unethical municipal bond dealers include a broad range of techniques. The following are the principal methods employed:

1. Misquotations are made of bond ratings, nominal coupon rate, maturity and yield. Since all four of these are elements of municipal bond prices, a misstatement of any one will take advantage of the customer. The complexity of the pricing process, however, makes discovery by an unsophisticated investor difficult.

2. Tax exempt municipal bonds are pushed on lower income investors who may be unsuitable prospects because their marginal tax rate is not high enough to obtain more than negligible benefits from municipal investments.

3. Misrepresentations are made that all municipal securities are equally marketable. This is untrue because the scarcity of some small issues, for example, often prevents the development of any market for the bonds.

4. Investors are often overcharged by prices demanded for bonds. This is facilitated by the purchase of all the bonds of an entire issue and marking them up an inordinate amount. Because no other market for the bonds exists, the investor is unable to compare prices.

5. A practice of "bond swaps" has developed under which persons already owning municipal bonds who wish to establish year-end tax losses are encouraged to trade their bonds

sponded by instituting several injunctive actions under the antifraud provisions and has obtained district court judgments in two cases.[185]

In *SEC v. Charles A. Morris & Associates, Inc.*,[186] the court unhesitatingly and skillfully applied the antifraud provisions of section 17(a) of the 1933 Act, section 10(b) of the 1934 Act, and Rule 10b-5 to a broad range of abuses and granted the SEC an injunction. This litigation involved an unregistered, nonNASD-member broker-dealer defendant who engaged in a classic boiler room operation designed to induce hasty investment decisions[187] by financially secure, middle and older age investors, including a substantial number of retired professionals and widows. The defendant employed inadequately trained salesmen and placed tremendous pressure on them to produce large profits. Moreover, defendant kept few of the records traditionally maintained by broker-dealers.[188]

The court stated initially that notwithstanding the existence of municipal bond exemptions from certain parts of the securities acts, the antifraud provisions are fully applicable to municipal bond transactions.[189] In analyzing the defendant's violations, the court

for "equal quality" bonds of the unscrupulous seller who does not disclose that the new bonds received will have a later maturity and lower price. Thus, the seller turns a significant profit, even if he charges no commission.

6. Misrepresentations of the quality of municipal bonds are also made, for example, by claiming that general obligation bonds are being sold to an investor and actually delivering revenue bonds, or by claiming falsely that a particular bond has a high rating. *A Misdeal in Municipals?*, *supra* note 180, at 37-38.

184. In addition to the heavy concentration tbat occurred in Memphis, Tennessee, significant fraudulent operations have taken place in Florida, Arizona, New Jersey, Arkansas, and New York. *See A Misdeal in Municipals?*, *supra* note 180.

185. SEC v. R.J. Allen & Assoc., Inc., CCH FED. SEC. L. REP. ¶ 94,920 (S.D. Fla. 1974); SEC v. The Senex Corp., CCH FED. SEC. L. REP. ¶ 94,735 (E.D. Ky. 1974) (summary of complaint); SEC v. Charles A. Morris & Assoc., Inc., [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,756 (W.D. Tenn. 1973); SEC v. Paragon Securities Co., Sec. Act Lit. Rel. No. 6005 (1973); SEC v. Investors Assoc. of America, [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,644 (W.D. Tenn. 1972) (summary of complaint).

186. [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,756 at 93,300 (W.D. Tenn. 1973).

187. *Id.* at 93,302.

188. The broker-dealer maintained few of the records traditionally maintained by securities broker-dealers. It did not maintain customer ledger accounts, security position records, firm trading accounts or customer open account cards. Althougb a securities purchase and sales blotter was maintained, it was grossly inaccurate and inadequate. For example, this record contained no entry for any sale whicb was subsequently cancelled. In addition, the date was usually neither the trade date nor the settlement date. Often the trade date was ascertained from the broker-dealer's clearing house. By that time the transaction had been entirely consummated. *Id.* at 93,303.

189. The court cited the langnage of § 17(c) of the 1933 Act, 15 U.S.C. § 78q(c) (1970), which states that "[t]be exemptions provided in section 3 shall not apply to this section", as including municipal bonds. Likewise, since it concluded that a municipal bond is clearly

separated defendant's misrepresentations and omissions into those related and those not related to the price of the municipal securities involved. Defendant's salesmen made the following nonprice misrepresentations: that bonds were being sold by persons needing to establish tax losses or to raise money to pay taxes; that only a limited supply of bonds was available; that certain revenue bonds were general obligation bonds; that low rated bonds had a good rating; and that the financial condition of certain unsound issuers was good.[190] The salesmen also failed to advise prospective purchasers of the following facts: the low "B" rating received by certain bonds; the speculative nature of certain investments; the selling by the defendant as principal for its own account rather than as an agent for a customer; the maturity dates reaching into the distant future; the financial difficulty of issuers and their potential inability to pay principal and interest; and the negligible interest rate on certain bonds, which equalled only a fraction of one percent.[191] The court then found that since these representations and omissions constituted the kind of information to which a reasonable investor would attach significance in making his investment decision, they were "material" facts within the meaning of section 17(a) of the 1933 Act and Rule 10b-5 promulgated under section 10(b) of the 1934 Act[192] and accordingly were violations of these antifraud provisions.[193]

Next, in reviewing the price-related misrepresentations and omissions, the court pointed out that the salesmen both misrepresented that the offering prices were equal to or below the current market prices and omitted to inform customers that the offering prices of the bonds greatly exceeded the then-current market price. Reasoning that "the purchasers had a right to know that . . . the bonds could be purchased at lower prices,"[194] the court concluded that the salesmen had misrepresented and had failed to disclose material facts within the meaning of section 17(a) and Rule 10b-5.

The court also held the defendant corporation liable on the theory of respondeat superior for the unlawful acts of its salesmen.[195]

within the definition of a security contained in § 3(a)(10) of the 1934 Act and is not expressly exempted from § 10(b), transactions in municipal bonds are covered by § 10(b) and Rule 10b-5. *Id.* at 93,302-03.

190. *Id.* at ¶ 93,304.

191. *Id.*

192. SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968).

193. SEC v. Charles A. Morris & Assoc., Inc., [1972-1973 Transfer Binder] CCH FED. SEC. L. REP., at 93,304.

194. *Id.* at 93,305. The court cited Charles A. Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir. 1943).

195. [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,756, at 93,305-06.

Further, the top management officials were subjected to sanctions as aiders and abettors of the salesmen's fraudulent conduct.[196]

In evaluating the entire scheme, the court reasoned that defendants' classic boiler room operation conflicted with the securities acts' purpose of protecting investors and that implementation of that purpose requires the abolition of boiler room operations. Thus, the court held that the maintenance of boiler room conditions "in and of itself constitute[d] a violation by the corporation and those in control of provisions (1) and (3) of § 17(a) and provisions (a) and (c) of Rule 10b-5."[197]

After finding that the SEC had established prima facie violations, the court further concluded that defendant's past conduct indicated a reasonable likelihood of future violations. It therefore granted a preliminary injunction and ordered a disgorgement of profits, as requested by the SEC.

Two other SEC injunctive actions, *SEC v. Investors Associates of America*[198] and *SEC v. Paragon Securities Co.*,[199] attacked boiler room operations similar to that in the *Morris* case. The *Paragon* case, which also involved churning and the abuse of discretionary accounts, is of particular interest for two reasons. First, it indicates the broad potential reach of municipal bond fraud; the defendants in *Paragon* went so far as to solicit business through television advertisements aimed at the general public, backed up by high-pressure telephone sales.[200] Secondly, it illustrates the crucial importance of the 1934 Act broker-dealer registration requirements in providing effective statutory and administrative tools for regulating broker-dealer misconduct.

While the defendant purported to deal solely in municipal bonds, the SEC alleged that defendant also transacted business in nonexempt securities and thus was required to register with the Commission in accordance with section 15(a)(1) of the 1934 Act. Moreover, since defendant was required to register, it was subject

196. *Id.* at 93,306; Brennan v. Midwestern Life Ins. Co., 259 F. Supp. 673, 681-82 (N.D. Ind. 1966), *aff'd*, 417 F.2d 147 (7th Cir. 1969), *cert. denied*, 397 U.S. 989 (1970). The court cited management's general supervision of the entire operation, its establishment of policies, and failure properly to train and supervise employees as management's violations. Further, the court reasoned that under the well-recognized "shingle" theory, a dealer in securities warrants to the public that it will deal competently and in good faith. Charles A. Hughes & Co. v. SEC, 139 F.2d 434 (2d Cir. 1943). It concluded that "Tax Free's top officials made no effort to uphold this guarantee." CCH FED. SEC. L. REP. ¶ 93,756, at 93,306.

197. [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,756, at 93,306.

198. [1972-1973 Transfer Binder] CCH FED. SEC. L. REP. ¶ 93,644 (summary of complaint).

199. SEC Litigation Release No. 6005 (Aug. 2, 1973); Hearings, *supra* note 12, at 67.

200. *Paragon—of What?*, 111 FORBES 19, 20 (Dec. 1971).

to the "SECO" provisions that regulate the conduct of broker-dealers in the areas of suitability of recommendations,[201] supervision of associated personnel,[202] discretionary authority,[203] and record keeping.[204] Defendant also was subject to section 17(a) of the 1934 Act, which prescribes specific reporting requirements for all brokers and dealers registered with the SEC.[205] Significantly, the SEC can suspend a broker's registration by administrative action upon a showing of an infraction of one of these provisions.[206] Similarly, if it can establish that a broker-dealer should have registered but did not, the SEC in seeking court relief will not have to engage in a possibly detailed reconstruction of fact situations to meet the strict requirements for proving an antifraud violation. Rather, to vindicate the public interest the Commission need only show a violation of the rules promulgated to regulate broker-dealer activities. This distinction appears especially important in light of SEC Commissioner Evans' remark that in *Morris* the defendant's poor record keeping caused the Commission considerable difficulty in reconstructing the relevant facts and thus in proving fraud.[207] If, however, the defendants had been subject to the regulatory provisions requiring record keeping and reporting, the SEC's role in preventing fraud in the municipal securities industry would have been facilitated. Thus, while the *Morris* decision uses the antifraud provisions to supply the SEC and the public with a broad remedy for deceptive practices in the municipal securities industry, the limitations placed upon the exercise of that remedy by practical problems of proof at trial reveal a critical shortcoming of the current scheme for regulation of nonregistered broker-dealers.

Another SEC injunctive action brought in connection with abuses in the municipal securities industry, *SEC v. The Senex Corp*,[208] did not involve fraud in the secondary market for municipal securities. Rather, the complaint alleged that a firm engaged as a consultant and developer of public facilities, and others, violated the antifraud provisions of the federal securities laws in connection with the underwriting of 4,425,000 dollars of municipal revenue

201. Rule 15b10-3, 17 C.F.R. § 240.15b10-3 (1974).
202. Rule 15b10-4, 17 C.F.R. § 240.15b10-4 (1974).
203. Rule 15b10-5, 17 C.F.R. § 240.15b10-5 (1974).
204. Rule 15b10-6, 17 C.F.R. § 240.15b10-6 (1974).
205. 15 U.S.C. § 78*q*(a) (1970).
206. *E.g.*, In re Walston & Co. and Harrington, [1966-1967 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,474 (1967).
207. *Hearings, supra* note 12, at 67.
208. CCH FED. SEC. L. REP. ¶ 94,735, at 96,441-42 (E.D. Ky. July 24, 1974) (summary of complaint).

bonds issued to finance a proposed nursing home. The defendants allegedly convinced officials of Covington, Kentucky to build a nursing home by withholding or attempting to discredit two contemporaneous studies that reflected adversely on the need for such a facility. Further, the complaint charged that the defendants claimed falsely that an underwriter and investment banker were extremely interested in the project and secured a misleading feasibility study that made a favorable report on the need for the home. In addition, allegations stated that certain defendants controlled the broker-dealer appointed as underwriter and financial advisor to the project, and thus a misleading offering prospectus was distributed to potential investors and utilized to secure an "A" rating for the bonds. The bond rating and the prospectus were then used together to facilitate the sale of the bonds to dealers and ultimately to individual investors.[209] It is readily apparent that had these municipal bonds been subject to the registration and due-diligence requirements of the 1933 Act, perpetuation of such a large scale fraud would have been unlikely. Nevertheless, as indicated by the *Thiele* and *Dunne* cases, the court probably will experience little difficulty in fashioning an appropriate remedy under the antifraud provisions.

Another interesting aspect of the *Senex* case is revealed in *In re Ferguson*,[210] a Rule 2(e) proceeding[211] brought against the *Senex* bond counsel. Bond counsel plays a critical role in the issuance of any municipal security.[212] The *Ferguson* case represents the first SEC action against bond counsel for failure to investigate and disclose material information in a municipal bond prospectus.

The SEC found that the following material omissions should have been disclosed in the prospectus:

A. Senex Corporation, developer of the project, had entered into a contract with a local contractor to construct the nursing home for a contract price which was $650,000 less than the price for which it had negotiated and agreed with city officials; to construct the facility;
B. The purportedly independent consultant who passed on the need for and

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209. *See* text accompanying notes 47-63 *supra*.

210. Sec. Act Rel. No. 5523, 5 SEC DOCKET 37-38 (Sep. 3, 1974).

211. 17 C.F.R. § 201.2(e)(1974). The Rule provides in part:

The Commission may deny, temporarily or permanently, the privilege of appearing or practicing before it in any way to any person who is found by the Commission after notice of and opportunity for hearing in the matter (i) not to possess the requisite qualifications to represent others, or (ii) to be lacking in character or integrity or to have engaged in unethical or improper professional conduct, or (iii) to have willfully violated, or willfully aided and abetted the violation of any provision of the Federal securities laws . . . or the rules and regulations thereunder.

Id.

212. *See* text accompanying notes 68-73 *supra*.

feasibility of the project had an agreement to share 50 percent of the developer's profits;
C. Two feasibility consultants, one of which had been specifically hired to render an opinion about the project, had rendered reports bearing unfavorably on the need for such a project;
D. The project's financial adviser, which received a fee of $135,000 was owned and controlled by the developer;
E. An independent securities dealer could not be found to underwrite the bonds; and
F. The financial adviser caused itself to be appointed underwriter for the issue.[213]

The Commission issued a consent order, finding that "bond counsel assumed principal legal responsibility for reviewing a prospectus [or 'official statement'] used in the offer and sale [of the bonds and] . . . willfully aided and abetted violations of section 17(a) of the Securities Act and section 10(b) of the Securities Exchange Act and Rule 10b-5 thereunder."[214]

The Commission also found that "[b]ecause of his review of the prospectus, his pre-existing relationship with the developer on other offerings of municipal bonds, and other factors that had come to his attention, [bond counsel] should have known . . . that the prospectus omitted material facts."[215]

Significantly, the bond counsel's law firm was required to adopt novel internal procedures to prevent recurrence of the situation, as a condition to the Commission's consent to mere censure of the firm. The SEC described these procedures as follows:

(1) Every two weeks, members of the firm meet and discuss all of their active cases. Affirmative approval of each partner is required before the issuance of any legal opinion. (2) The firm will undertake an appropriate investigation in connection with acting as bond counsel including, among other things, obtaining independently-audited financial statements and inquiring into the background of the various parties connected with the offering. Written evidence of such investigations and the results thereof will be reviewed by the partners of the firm. (3) An appropriate "engagement letter" will be sent to all interested parties, emphasizing that the firm's duty is to the issuer and the bondholders. It will define the scope of the firm's work as bond counsel and require submission to it of certain pertinent information. (4) The firm will require that it receive independently-audited financial statements, representations from appropriate interested persons concerning the accuracy and completeness of the statements about them in any offering circulars, and a statement from counsel for any lessee or guarantor that such counsel has reviewed the offering circular and is aware of no inaccuracies therein. (5) Partners and associates of the firm will attend, at least annually, municipal bond workshops and seminars.[216]

Although *Ferguson* was only a section 2(e) disciplinary proceed-

213. 489 F.2d 535 (2d Cir. 1973).
214. 5 SEC. DOCKET 37-38 (Sep. 3, 1974).
215. *Id.*
216. *Id.*

ing, the rationale adopted by the Commission logically applies to an injunctive or private damage action. The extent of the remedial procedures required by the SEC are surprisingly extensive and serve as a startling reminder of the importance attached by the Commission to the role played by counsel in the issuance of securities. Recent developments in the area of attorneys' liability under the securities acts have focused on the pivotal role played by attorneys in the enforcement of the securities acts.[217] In *SEC v. Spectrum Ltd.*,[218] an attorney was held liable as an aider and abettor for failing to make adequate investigation and disclosure of the facts surrounding his issuance of an opinion letter regarding the application of a 1933 Act registration exemption to his client's activities. These developments are particularly relevant to the issue of holding counsel liable on his opinion letter for irregularities in the issuance of municipal bonds and other securities. The thrust of the SEC's position clearly seems to be that counsel will be liable for infirmities in his opinion letter, even if they result from conduct that would amount only to negligence under the common law. Thus, the Commission's position will require that bond counsel prove compliance with the obligations of due diligence to avoid liability under the antifraud provisions, either directly or as an aider and abettor.

In purchasing a municipal bond, an investor has a legitimate basis for assuming that bond counsel will be liable to him in the event of a negligently issued opinion.[219] This assumption appears particularly justified in the municipal securities area because of the

217. For recent discussions of the role of counsel under the federal securities laws, see, *e.g.*, Freeman, *Opinion Letters and Professionalism*, 1973 DUKE L.J. 371; Sonde, *Professional Responsibility and Securities Laws*, 68 NW. U.L. REV. 1 (1973); Note, *Public Acocountants and Attorneys: Negligence and the Third Party*, 47 NOTRE DAME LAW. 588 (1972). This area is also discussed in W. PRIFTI, SECURITIES: PUBLIC AND PRIVATE OFFERINGS §§ 91-104 (1974). SEC Commissioner A. A. Sommer stressed the nature and importance of the role of the attorney in the following language:

> I would suggest that in securities matters (other than those where advocacy is clearly proper) the attorney will have to function in a manner more akin to that of the auditor than to that of the advocate. This means several things. It means he will have to exercise a measure of independence that is perhaps uncomfortable if he is also the close counselor of management in other matters, often including business decisions. It means he will have to be acutely cognizant of his responsibility to the public who engage in securities transactions that would never have come about were it not for his professional presence. It means he will have to adopt the healthy skepticism toward the representations of management which a good auditor must adopt. It means he will have to do the same thing the auditor does when confronted with an intransigent client—resign.

The Emerging Responsibilities of the Securities Lawyer, Address by SEC Commissioner Sommer before the Section on Banking, Corporation and Business Law of the New York State Bar Ass'n, Jan. 1974, PRIFTI, *supra* § 104, at 144; 237 BNA SEC. REG. & L. REP. A-11 (Jan. 30, 1974).

218. 489 F.2d 535 (2d Cir. 1973).

219. Freeman, *supra* note 217, at 390.

historical reasons for employing independent bond counsel as discussed above.[220] Indeed, the main purpose for employing bond counsel was to gain the confidence of the investing public by inducing reliance on the opinion of reputable counsel. Moreover, the very presence of the good name of counsel enhances the price paid by the public for the security upon which the opinion has been given.[221] Thus, it can be expected that future decisions will continue to expand the scope of bond counsel's liability on his opinion letter.

The decision of the district court in *SEC v. R. J. Allen & Associates, Inc.*,[222] provides a final example of abuse by a broker-dealer in the purchase and sale of municipal securities. This case also was an SEC injunctive action for antifraud violations by a nonNASD-member broker-dealer not subject to SEC registration requirements. While the case basically involved a classic boiler room operation, some additional fraudulent activities were present.

Defendants' business consisted of the sale of industrial development bonds, which, unlike many of the instruments falling within that classification, were of particularly low quality and involved substantial risk to a prospective investor.[223] In connection with the sale of these bonds, defendants engaged in a solicitation program directed at the general public, and in particular, at returning Vietnam Prisoners of War who had amassed considerable backpay during their years of imprisonment and generally were unsophisticated in financial matters. Using false and misleading representations designed to gain the trust and condfidence of these individuals, defendants solicited purchases of particularly high-risk, speculative industrial development bonds.[224] The court's analysis of the more speculative nature of industrial development bonds is instructive:

> These bonds, while generally included in the class of "municipal bonds" are of a particular type in that they are not general obligation bonds of a political entity, nor are they backed by the full faith and credit of any municipality, state, or local taxing unit. Rather, their viability depends in full measure upon the ability of the company funded by the proceeds from the bond sales to generate sufficient revenues to meet the principal and interest payments due on the bonds. As such, IDR's are speculative, high-risk securities includable in the class of "municipal bonds" only because of the tax-exempt feature of the interest payments made to investors in them.[225]

220. *See* text accompanying notes 68-70 *supra*.

221. Freeman, *supra* note 217, at 390.

222. CCH FED. SEC. L. REP. ¶ 94,920 at 97,149 (S.D. Fla. 1974).

223. *Id.* at 97,154.

224. *Id.* at 97,152-53.

225. *Id.* at 97,152. The court did recognize that an expert called by the Commission had testified that "many of the IDR's [industrial developments bonds] on the market are sound investments because of the companies behind them but that those IDR's sold by defendants

In the course of these dealings, even if a customer had not placed an order after telephone solicitations, defendants often sent out confirmations so that some customers might accept the transactions and pay for securities that were never ordered.[226]

Frequently, defendants also misrepresented to customers that the interest and principal on the bonds sold were fully insured. Further, defendants falsely promised clients that they would repurchase bonds at a future date for the price the client had paid. In addition, defendants utilized a practice known as "switching," in which a customer was induced to purchase a particular bond but received a confirmation and a certificate for an entirely different bond at the same price but of lower quality. Customer inquiries would be met with the argument that the bonds actually sent were "just as good."[227] Lastly, the defendants employed a practice called "bucketing" under which they accepted clients' payments for bond purchases but pocketed the money without ever making the purchases.[228]

Faced with this extensive fraudulent scheme, the court had little difficulty in determining that defendants' misrepresentations and omissions were material[229] and that defendants had violated the antifraud provisions of section 17(a) of the 1933 Act and section 10(b) of the 1934 Act and Rule 10b-5.

Thus far, the discussion of abuses in the municipal securities markets has centered on activities of securities brokers and dealers. As stated at the outset, however, banks play a key role in both the new issue and secondary municipal securities markets,[230] functioning as underwriters, brokers, dealers, and even large investors. In his testimony before the Senate Subcommittee on Securities, SEC Commissioner Evans stated that banks were engaged in improper activities similar to those of nonbanks.[231] Thus, the previous discussion of abuses in the municipal markets appears equally applicable to banks. In addition, certain wrongful activities in the municipal securities industry appear to be unique to the banking sec-

were among the worst, from an investment standpoint, that he had seen in 24 years in the business." *Id.*

226. *Id.* at 97,153.

227. *Id.* at 97,154. The court pointed out that one client had been "switched" into $25,000 face amount of bonds, which, because they bore a very low interest rate (0.05%), had a market value of only 15% of their face amount of $25,000, or approximately $4,000. *Id.*

228. At least 8 customers were "bucketed" in amounts totalling in excess of $246,000 in addition to $60,000 used in defendants' business that purportedly was being held in trust for various customers. *Id.*

229. *Id.* at 97,156.

230. *See* text accompanying notes 41-46 *supra.*

231. Hearings, *supra* note 12, at 70.

tor. Because of their dual roles as both dealers and investors, banks participating in the underwriting of municipal securities are able to obtain a cheaper bond purchase price than the general public.[232] Banks that hold themselves out as dealers receive the dealer concession on new issues, which in turn may be passed on to their investment portfolio to yield a net purchase price less than the public offering price.[233] NASD rules prevent this practice in the corporate securities area by precluding a member from passing a selling discount, concession, or allowance to a bank or any other customer.[234] As stated previously, however, NASD rules do not apply to municipal securities offerings. Instead, the problem actually is aggravated by municipal syndicate rules that often give priority to bank orders.[235]

Another abusive practice stemming the banks' status as a municipal investor is "adjusted trading."[236] Under this practice, depressed bonds are purchased from banks by bond dealers at the bank's book value, a price in excess of fair market value. In exchange, the banks agree to purchase other bonds from the dealer, also at prices that exceed the current market value. The object of this scheme is to delay the time when the bond value loss will become known and be reported by the bank's accounting system.[237] In these situations, not only is the unscrupulous banker violating federal criminal provisions covering misapplication of bank funds, false entries, and conspiracy, but quite often he is unwittingly subjecting the bank to the possibility of monetary loss by fraud resulting from the dealer's mispricing of the marketed issues.[238]

Although specific instances of improper bank activities are difficult to document, probably because of the traditionally discreet method of regulation adopted by most bank regulatory agencies, other types of bank abuses probably occur. For example, although the Glass-Steagall Act of 1933[239] prohibits banks from underwriting revenue bonds, banks purchase these bonds for investment. If bonds ostensibly purchased for investment are sold shortly thereafter to trust department accounts, at least the spirit, if not the letter of the

232. *Id.* at 177.

233. *Id.* at 176-77.

234. *Id.* at 176.

235. *Id.* at 177.

236. *Id.* at 63.

237. *Id.*; Weberman, *Banker Lured by Adjusted Trade Is Warned to Resist Temptation*, AMERICAN BANKER, Nov. 14, 1974 [hereinafter cited as Weberman].

238. Weberman, *supra* note 237.

239. 12 U.S.C. § 24 (1970).

Glass-Steagall Act provision is violated.[240]

The object of this section has been to illustrate the nature and scope of abuses in the municipal securities markets created by the nonregulation of banks and certain broker-dealers under the 1933 and 1934 Acts. While the broker-dealer registration provisions of section 15 of the 1934 Act provide the SEC with significant prophylactic and remedial methods of regulation in some sectors of the securities market, their nonapplicability to the municipal securities sector has permitted the occurrence of many extensive abuses. The industry, however, has not remained oblivious to these occurrences, and several important proposals have been made to remedy the regulatory gap in the municipal securities area. These proposals are the subject of the next section.

IX. Statutory Proposals for Reform of the Municipal Securities Industry[241]

The initial impetus for reform of the municipal securities markets came from the industry itself. In 1972, the Securities Industry Association (SIA), a broker-dealer trade association, publicly recognized the need for additional regulation,[242] and by early 1973 had devised a proposed regulatory scheme.[243] Of paramount importance to the SIA proposal was the concept that abuses in the industry had been perpetrated by a small number of individuals and firms and that the best method to overcome these difficulties would be the use of a new industry self-regulatory body patterned after the NASD.[244]

240. Interview with Mr. Clarence Haley, Vice President of J. C. Bradford & Co., in Nashville, Tenn., Nov. 14, 1974.

241. Although not within the scope of this note, it is also important to recognize that the individual states are in an important position to enact legislative reform of the municipal securities industry. For example, in response to an outbreak of fraudulent municipal bond sales operations in Memphis, Tennessee, the Tennessee legislature enacted the Tennessee Municipal Securities Act of 1972, TENN. CODE ANN. § 9-1401 *et seq.* (1973). The Act created a state municipal securities board charged with the responsibility of licensing municipal securities brokers and dealers and prescribing rules of conduct governing the underwriting and trading of municipal securities, and advising municipalities of the manner of financing municipal projects and marketing municipal securities. TENN. CODE ANN. § 9-1405 (1974 Supp.).

242. *See* Mann, *The Public Securities Market and Where It is Headed,* The Commercial and Financial Chronicle, Oct. 26, 1972, § 2, at 10 [hereinafter cited as Mann].

243. *See SIA Panel Seeks Regulation of Municipals Dealers,* The Commercial and Financial Chronicle, Feb. 12, 1973, at 11 [hereinafter cited as *SIA Panel*].

244. The industry's fear of undue federal intervention is apparent from remarks made at its First Public Finance Conference at Colorado Springs, Colo.:

> Unnecessary Federal regulation would have a potentially critical impact on the autonomy of State and local borrowers in the form of restrictions and guidelines that would probably have little effect in eliminating undesirable dealer practices. In this regard,

To satisfy the industry's desire for self-regulation and the need for closer governmental supervision, the SIA proposed the formation of two new regulatory bodies, one designed to promulgate and enforce rules governing daily broker-dealer activities,[245] the other a governmental agency with which registration of all bank and nonbank securities firms would be required and which would have authority to review all rules and disciplinary proceedings of the first.[246]

Primary opposition to the SIA proposal came from commercial banks who claimed that they were already overregnlated and who advocated regulation by the Comptroller of the Currency and other bank regulators as the optimal method of regulation.[247]

On September 11, 1973, the SEC sent its own proposal to Senator Harrison A. Williams, Chairman of the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs.[248] The Commission proposed that the 1934 Act be amended by revoking the exempt status of municipal bonds for purposes of sections 15 and 15A of the Act, making broker-dealers that confine their activities solely to municipal securities transactions subject to regulation under those sections. Also, the SEC proposal would have eliminated the exemption of banks from the definition of the term "dealer" under section 3(a)(5) of the Act to the extent they engage

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self-policing by the industry, rather than a plethora of Federal rules and regulations, is clearly the most desirable remedy.

Mann, *supra* note 242, at 11, col. 5.

245. The first body, the National Association of Municipal Securities Dealers (NAMS) would have been an industry association responsible for the daily regulation of the industry. It would have promulgated and have been responsible for enforcing rules for dealers, including financial requirements and underwriting and selling practices. *SIA Panel*, *supra* note 243, at 11.

246. The second proposed association, the Joint Agency for Municipal Securities Dealers (JAMS) would have been a government agency composed of three members — an SEC Commissioner, a federal bank regulator, and a chairman chosen from the public at large. JAMS would have had review authority over NAMS disciplinary proceedings, the right to disapprove NAMS rules, and rule-making authority over fraudulent practices. It also would have been empowered to bring enforcement actions for rules violations in the event that NAMS failed to do so, or it could refer cases to the SEC, the bank regulatory authorities, or the Justice Department. Registration with JAMS would have been a condition precedent to activity in the municipal bonds market by municipal securities firms, including banks.

Although membership in NAMS would have been voluntary, strong economic inducements to join were provided by barring nonNAMS members from participating in syndicates with NAMS members and preventing the grant of dealer discounts to non-NAMS members. Moreover, compliance with NAMS rules would have been insured by NASD inspection of securities firms and bank examiner inspections of bank dealers. Municipal dealers found to be violating NAMS rules could bave been suspended or barred from registration with JAMS and/or membership in NAMS. Further, fines could have been imposed for violations. *Id.*

247. *Municipal Dealers May Be Regulated*, The Commercial and Financial Chronicle, Jan. 7, 1974, at 5.

248. *Hearings*, *supra* note 12, at 77.

in the business of buying and selling municipal securities in other than a fiduciary capacity.[249] Thus, with the original SEC proposal, which apparently would have required that dealer banks also become NASD Members, three alternative methods of regulating the municipal securities industry had been proposed.

In response to these diverse positions, Senator Williams, on September 24, 1973, introduced the original draft of S. 2474 in the Senate.[250] That bill was an attempt to take into account all pertinent regulatory considerations by creating a novel statutory framework for regulating municipal securities professionals, closely parallelling the 1934 Act provisions governing brokers and dealers transacting business in nonexempt securities.[251] The original draft of S. 2474 advocated the creation of a new self-regulatory organization, the National Association of Municipal Securities Dealers, similar to the NASD, which would have primary regulatory responsibility for all member municipal securities dealers, including banks. Transactions in municipal securities and municipal securities dealers would have been subject to the regulatory provisions of sections

249. *Id.*

250. *Id.*

251. In the words of the SEC, the original bill would have done the following:

(i) amend the definition of the term "exempted security" to deprive municipal securities of exempt status for purposes of section 15 and 15A of the Act;

(ii) create a new class of dealers called "municipal securities dealers", which would include a bank or a separately identifiable division or department thereof to the extent that it engages in the business of trading municipal securities for its own account other than in a fiduciary capacity;

(iii) provide for a new self-regulatory organization, desiguated as a National Association of Municipal Securities Dealers, which would have primary responsibility for regulating the municipal securities activities of and disciplining its members and which would bave statutory duties closely paralleling those of securities associations registered under section 15A of the Act (*i.e.* . . . the NASD . . .);

(iv) provide for Commission regulation of all municipal securities dealers which are not members of the municipal securities association with respect to their transactions in municipal securities by subjecting such persons to the scope of paragraphs (8), (9) and (10) of section 15 of the Act;

(v) subject municipal securities dealers to the provisions of paragraph (1) and (2) of section 15(c) of tbe Act, concerning manipulative, deceptive and otherwise fraudulent devices, contrivances, acts and practices, and, in addition, regulating "fictitious" quotations, while continuing the exemption of bank municipal securities dealers from section 15(c)(3), concerning financial responsibility;

(vi) subject municipal securities dealers and persons associated with such dealers to Commission disciplinary authority under section 15(b)(5) of the Act; and

(vii) provide for "consultation" and "cooperation" between the Commission and the bank regulatory agencies with respect to the establishment of record keeping requirements, the adoption of rules governing the issuance of orders applicable to and the taking of disciplinary action against municipal securities dealers which are banks or divisions or departments thereof, all so that any such action "may contribute to sound banking practices to the maximum extent consistent with the protection of investors and the public interest."

Id. at 77-78.

15 and 15A of the 1934 Act and the SEC would have been required to "consult and cooperate" with bank regulatory agencies in carrying out its own regulatory responsibilities.

Although very few parties were satisfied with S. 2474 in total, its framework became the basis for future compromise and consensus. The bulk of the testimony given at the hearings on the bill centered on the methodology rather than the propriety of municipal securities industry regulation.[252] Prior to the hearings, the SEC played a key role by consulting with all interested parties and attempting to reach a consensus on the important issues. Despite this, at the commencement of the hearings, SEC Commissioner Evans pointed out that disagreement existed in three major areas:

(1) the scope of regulation;
(2) the role of self regulation; and
(3) the uniformity and placement of enforcement powers.[253]

A discussion of the policy arguments involved in each of these issues and the Committee's ultimate resolution of them follows. As will be seen, the Committee ultimately gave great weight to recommendations of the SEC in forming its final legislative proposals. Thus, it is appropriate at this point to set forth the major policy goals that Commissioner Evans indicated were considered by the Commission in redrafting S. 2474:

> First, all persons engaging in the same activity should be subject to the same rules and regulations. Second, the enforcement of rules and regulations should be equal. Third, federal regulation of private institutions should not exceed the minimum necessary to assure the protection of investors and the public interest. Fourth, regulation of securities activities should consider and be consistent with the regulation of nonsecurities activities.[254]

On the issue of the proper scope of federal regulation of the municipal securities industry, the SEC strongly advocated that any regulatory scheme should apply equally to both bank and nonbank brokers and dealers. SEC Commissioner Evans pointed out that the prestigious position of banks, both as strong financial institutions

252. In light of the above described widespread abuses in the municipal securities industry, it might be expected that no objection to the basic idea of imposing some type of regulatory framework would arise. Nevertheless, when hearings on S. 2474 commenced in May, 1974, the first item placed in the record was a written statement by Edward C. Shmults, General Counsel of the Treasury, which seriously questioned the need for the legislation. He argued that the incidences of abuse in the industry did not evidence a need for federal intervention and that any benefit that might accrue to municipal investors would go to relatively large, wealthy investors with little need for federal protection. Mr. Schmults' view represented a distinct minority, however. *Id.* at 46-48.

253. *Id.* at 52.

254. Remarks of SEC Commissioner Evans before the American Bankers Ass'n in New Orleans, Feb. 27, 1974, in 241 BNA SEC. REG. L. REP. A-8, E-1.

and as substantial investors in municipal securities, provided the banks with significant economic advantages, in that they could, in dealing for their own accounts, hold municipal securities until they wanted to sell, while nonbank institutions generally had to turn over their inventories more rapidly.[255] Commissioner Evans also contrasted the discrete nature of traditional bank regulation designed to insure public confidence in banks with the SEC policy of making all material information available to investors. Thus, an unequally applied method of regulation could impose economic risks upon nonbank brokers and dealers as a result of adverse public reaction, and, when added to the already existing economic advantages of banks, it might seriously impair the continued survival of these nonbank members of the industry. Moreover, the Commissioner viewed the survival of these competitors in the municipal securities markets as crucial to the proper functioning of the capital markets, particularly from the viewpoint of the municipal issuers who must look to the municipal securities markets for necessary financing.[256] Although taking the position that banks had been the "defraudee" rather than the "defrauder" in municipal securities market abuses, the Comptroller of the Currency agreed with the SEC that sufficient evidence of abuse existed to justify some degree of federal regulation.[257] Finally, although not without controversy, consensus was reached, and the bill finally reported out of committee applied to "any person (including a separately identifiable department or division of a bank) engaged in the business of buying and selling municipal securities for his own account, through a broker or otherwise . . . ."[258]

In considering whether the legislation should impose direct obligations on municipal issuers, the Committee was confronted with the same intrusion issues that faced Congress when enacting the 1933 and 1934 Acts.[259] Although recognizing that the bill was not desigued to regulate issuers directly, municipal issuers contended that information disclosure requirements might translate into the imposition of *de facto* requirements of issuer registration, and thus result in delays and costs beyond those necessary "to achieve a

255. *Hearings, supra* note 12, at 51.

256. *Id.*

257. *Id.* at 228-29.

258. S. REP., *supra* note 25, at 41.

259. *Hearings, supra* note 12, at 127 (statement of Wayne F. Anderson, Effective Government Policy Committee, National League of Cities), 129 (statement of William J. Reynolds, Member of the Governmental Debt Administration of the Municipal Finance Officers Ass'n).

sensible standard of investor protection."[260] In response to these arguments, the Committee assumed the same deferential posture taken by Congress in formulating the original securities acts and included a provision expressly prohibiting any requirement that issuers of municipal securities "file . . . any application, report, document or other information in connection with [the securities'] . . . issuance, sale or distribution."[261]

The original draft of S. 2474 clearly contemplated a new self-regulatory association that both bank and nonbank municipal securities professionals would be required to join. This proposal met with strong opposition both from bank dealers, who desired to avoid being subjected to an additional federal regulatory agency, and from bank regulatory agencies, who urged that any new federal regulation should be consistent with their traditional concerns for bank solvency and depositor confidence.[262] Conversely, the SEC and securities firms favored the maintenance of the historical system of self-regulation used by the securities industry generally.[263] The Committee reconciled these divergent views by adopting an SEC compromise proposal that would create a new entity, the Municipal Securities Rulemaking Board, whose sole function would be to exercise rulemaking power with respect to all persons engaged in the municipal securities business. The Board would perform the self-regulatory functions of establishing uniform and fair regulatory standards, but would have no inspection or enforcement powers. Its membership would be democratically selected from representatives of securities firms, dealer banks, investors in municipal securities, and municipal issuers, and it would function under the broad premise that a high level of professional conduct can best be achieved by ethical standards adopted by persons actually engaged in the municipal securities business.[264]

In promulgating rules, the Board would be required to comply with specific procedural standards, and its actions would be subject to SEC review and approval. In addition, consistent with the provisions of the proposed National Securities Market System Act of 1974,[265] the Board would be fully accountable to the SEC. Thus, "[t]he Commission would have clear authority to abrogate, alter, or supplement any rule of the Board and to require amendment of

260. *Id.* at 131.
261. S. REP., *supra* note 25, at 72.
262. *Id.* at 11.
263. *Id.*
264. *Id.* at 12.
265. S. 2519, 93d Cong., 2d Sess. (1974).

the Board's rules in any respect consistent with the Exchange Act."[266] Further, since the board itself is not a membership organization in the sense that all municipal securities dealers must join, the act would also require that all nonbank brokers and dealers become NASD members. Thus, all participants in the municipal securities industry also would be subject to regulation by either the NASD or an appropriate bank regulatory agency.[267]

The Senate Committee's disposition of the final major regulatory policy difficulty — the uniformity and placement of enforcement powers—represented another novel compromise. The SEC strongly opposed any requirement that it balance banking interests in protecting public confidence in banks against the SEC enforcement philosophy, which focuses on the protection of investors and the public interest. Conversely, the bank regulatory agencies exhibited a particular aversion to any enforcement scheme that made no allowance for bank solvency, preferring the regulation of bank dealers whenever possible "in the traditional, discreet, and generally nonpublic manner in which bank enforcement occurs."[268] In this way, the banks argued, the lawful, ethical, and fair performance of the market function of dealer banks could be assured, with only minimal sacrifices of the traditional goals of bank solvency and investor protection, because the potential for publicity would be minimized.[269]

To reconcile these differences the committee ultimately adopted an SEC proposal that places the initial responsibility for inspection and enforcement with the NASD for NASD members and with the bank regulatory agencies for dealer banks. The provision makes clear, however, that the Commission has the "ultimate responsibility and authority for the supervision of the municipal securities industry and markets, and for the fair administration and uniform enforcement of the securities laws."[270] Thus, the Commission would be invested with broad rulemaking and disciplinary powers, and although it could not review a bank agency's decision in an enforcement action, as it could a decision of the NASD, it would possess the authority to bring an independent action against any dealer bank.[271] Further, the bill would insure cooperation and avoid duplication in enforcement by requiring the exchange of reports, the

266. S. REP., *supra* note 25, at 17.
267. *Id.* at 16.
268. *Id.* at 230.
269. *Id.*
270. S. REP., *supra* note 25, at 19.
271. *Id.*

giving of notice, and consultation among the various agencies concerning the feasibility and desirability of coordinating disciplinary action.[272]

Thus, the final draft of S. 2474 as reported out of committee on September 11, 1974 represented a series of compromises by all parties concerned. Basically, the broker-dealer registration provisions of section 15 of the 1934 Act would for the first time be made equally applicable to bank dealers and nonbank brokers and dealers who transact business in municipal securities. Instead of allowing indiscriminate application of existing regulatory rules to the municipal securities industry, the bill would create an independent board that would promulgate rules, subject to SEC review, taking into account both the need for high ethical standards in the municipal securities market and that market's unique attributes. The task of investigation and enforcement would be lodged in the first instance in the NASD and bank regulatory agencies, again subject to the oversight of the SEC. Finally, the Committee was very careful to specify its desire that no form of issuer registration whatsoever be required. The bill reached the floor of the Senate and was passed on September 16, 1974.[273]

X. Conclusion

Unquestionably, the antifraud provisions of the securities acts simply are not adequate, in and of themselves, to protect municipal investors. This situation exists in large part because of the complex nature of municipal securities and the inability of the average investor to evaluate the statements and actions of unscrupulous brokers and dealers. Moreover, although the SEC always has had antifraud jurisdiction over this area, its reluctance to interfere with bank regulation has created an additional bar to the development of honest municipal markets. As illustrated by the *Walston* case, the application of the broker-dealer registration requirements of the 1934 Act contemplated by S. 2474 will provide the SEC, NASD, and bank regulators with highly efficient and flexible methods to correct the types of abuses that have occurred in the market to date. Indeed, the mere requirements of broker-dealer registration and reporting provide an important prophylactic effect, as evidenced by the recent lack of such blatant abuse by broker-dealers in the corporate securities area. On reflection, it seems surprising that Congress originally exempted brokers and dealers transacting business exclusively in

272. *Id.*

273. CCH Fed. Sec. L. Rep. Special Report No. 552 at iii (Sept. 19, 1974).

municipal securities from the broker-dealer registration requirements of the 1934 Act, and it is unfortunate that a period of forty years expired before serious attempts were made to close the regulatory gap. Clearly, the House of Representatives should not hesitate to follow the Senate's lead in approving S. 2474 and extending the benefits of broker-dealer regulation to all areas of the securities markets.

In assessing the novel approach taken by the regulatory framework specified by S. 2474 Commissioner Evans stated during the hearings that he was aware of no precedent for the concept of one administrative agency (the SEC) overseeing and supervising the actions of another administrative agency (the bank regulatory agencies). The Committee adopted this approach in response to unusual jurisdictional conflicts presented by bank activities, which Congress apparently failed to consider in enacting the general bank regulatory provisions. The greatest potential difficulty with this approach is obvious; jealousy between the two types of agencies may result in inter-agency disagreements, especially when the basic policies underlying bank regulation and securities regulation come into conflict in deciding regulatory questions. The bill requires that all concerned regulatory entities give notice, exchange information, and cooperate in their enforcement efforts. Only if these bodies rigorously comply with these requirements can the new regulatory framework function properly. This problem was reflected by the testimony of both Commissioner Evans[274] and Comptroller Smith,[275] each of whom stated that he would be reluctant to subordinate the purposes of his agency in a given situation. Nevertheless, the framework contemplated by the proposed Act, giving the SEC oversight power over rulemaking and also the ability to bring an independent action when dissatisfied with a bank regulator's enforcement efforts, suggests that the SEC should have the last word in matters involving municipal securities transactions. This position implies that the policies of protecting the investor and promoting public confidence in the securities markets are paramount to those of bank solvency and depositor confidence. Indeed, this conclusion is consistent with the Statement of Policy for the American Capital Markets published by the Treasury Department, which states that the SEC should have control over all institutions that participate in any aspects of the process of buying or selling securities or effecting the transfer of their ownership.[276] Inevitably, as banks continue to ex-

274. *Hearings, supra* note 12, at 73.
275. *Id.* at 230.
276. United States Treasury Department, Statement of Policy for the American Capital Markets, Feb. 7, 1974.

pand the scope of their business activities, traditional banking concerns will come into conflict with other public policies. If in such cases other public policies were required to give way uniformly to bank regulatory policies, contrary to this instance, the public interest would be served better by precluding banks from engaging in such activities.

Another important aspect of the Municipal Securities Regulation Board should be recognized. As previously explained, the municipal securities markets, while somewhat similar, differ from the corporate securities markets in many respects.[277] This situation provided a major topic of debate when Congress considered the scope of application of the 1934 Act provisions, many of which simply were not drafted with municipal securities in mind. In constituting the MSRB, whose members would be highly aware of the unique nature and problems of the municipal securities industry, the bill appropriately recognizes the impropriety of indiscriminately adopting all of the existing broker-dealer regulations, since some regulations might prove unduly harsh in the municipal securities area, while other problems unique to municipal securities brokers and dealers might go unremedied.

Although it may be clear that the appropriate method of preventing abuses in the secondary market for municipal bonds is to apply the broker-dealer registration requirements of the 1934 Act in the manner contemplated by S. 2474, the most suitable method of regulating the underwriting process remains uncertain. As previously demonstrated, Congress in passing the 1933 Act gave little attention to the municipal securities industry, summarily concluding that sufficient evidence of recurrent abuse was not present to warrant the application of the prospectus delivery and disclosure requirements.[278] No affirmative effort was made to evaluate the needs of the municipal bond investor in making an intelligent investment decision. This represents an important consideration because all municipal bonds cannot be lumped into a single category of equal quality. Concededly, because general obligation bonds are secured by the full faith, credit, and taxing power of the governmental issuer, prospective purchasers need only counsel's opinion that the bonds are valid obligations and the hard data concerning assessed valuation and taxing power contained in the short offering circulars usually furnished with these instruments. But what of the purchasers of other types of municipal obligations, the revenue and

277. *See* text accompanying notes 1-80 *supra*.

278. *See* text accompanying notes 119-125 *supra*.

industrial development bonds? In these instances the investor stands in a position no different from that of an investor in corporate securities. His investment will be secure only if the underlying project produces revenues sufficient to meet all of the required principal and interest payments, a result that depends on a multitude of business factors. Consider for example revenue bonds issued by a large state university for the construction of a dormitory that would be paid off from rents collected from students. While at first glance this investment might not be expected to involve substantial risks, it should be noted that in recent years trends have occurred in student-housing preferences that indicate an increased desire to live off campus. Thus, the decision to build a dormitory requires the exercise of significant business judgment by university officials. In light of the uncertainties inherent in the initial decision to proceed with the project, the investor should at least be furnished with all the pertinent data, assumptions, and projections used by the officials in making their decision so that his decision to invest his capital in the project can be the result of informed reflection and evaluation.

If the revenue bond example just stated indicates the need for enhanced disclosure to investors, the issuance of industrial development bonds demonstrates even more cogently the position of the investor. As stated by the court in the *R.J. Allen* case, the viability of industrial development bonds depends upon the ability of the participating corporation, not the governmental issuer, to generate revenues sufficient to pay off the bond obligations. In effect, the investor is investing his money in that corporation. Thus, a disparity arises; if the same investor had invested directly in that corporation, the 1933 Act would have required that he receive substantial disclosures in the form of a standardized prospectus and would have provided additional civil remedies and the benefits of the due-diligence requirements imposed on persons connected with the issuance of the registration statement; the mere fact that he invests in the same corporation through the conduit of an industrial development bond deprives him of these protections. It may be argued, however, that the requirements of the antifraud provisions remain applicable and in themselves require disclosure of all material facts necessary to permit informed investment decisions. Yet this approach lacks the elements of standardized disclosure and SEC review associated with the use of registration statements and also precludes the availability of the less-strict civil remedies provided by the 1933 Act. Furthermore, even though reputable municipal bond counsel, underwriters, and issuers may have set standards of disclosure by industry custom that adequately protect investors, the *Walston, Shields, Senex,* and *Dunne* cases vividly illustrate that instances of fraud in the distribution of municipal securities can and do occur. The *Walston* case is especially important because the broker-dealer that distributed the bonds was a highly reputable concern that would not be expected to participate in a fraudulent underwriting. Consequently, it appears that the nonapplicability of the due diligence and disclosure requirements of the 1933 Act has facilitated the perpetration of the issuer's fraud.

Against this position it might be argued that the cited cases represent only isolated instances of abuse in the municipal securities markets; admittedly, default on municipal securities obligations has occurred rarely, and then often in a technical sense only. Nevertheless, this argument can be faulted on two grounds. First, as illustrated by the recent defaults on the notes of the New York Urban Development Corporation and recent trends in the quality municipal securities,[279] it can no longer be stated with certainty that all municipal securities are highly secure investments—a characterization frequently applied to these instruments in the past.[280] If general economic conditions continue to worsen, the risk associated with purchasing municipal bonds will continue to increase, and investors at the very least should have access to information by which they can intelligently evaluate these risks. Secondly, default constitutes only one manifestation of abuse in the marketing process. Another important effect of the lack of full disclosure may lie in the rates of interest paid and received on municipal bonds. As pointed out above, the rating agencies do not purport to have devised fool-proof methods for analysis of municipal issues. Indeed, the large volume of debt issues that require rating renders the task of making quality assessments very difficult. Without full disclosure of all material facts, the result will be either than an investor will not be aware of the pertinent risks involved, probably causing him not to demand an appropriately high return on his capital, or that investors will not be informed of all positive material facts, resulting in the municipality paying an unduly large amount to borrow funds. In either event the market system will be abused because the participants will not be acting with full knowledge of the facts.

While this discussion has proceeded in light of the policy of the securities acts to protect investors, the arguments made are equally relevant to another, less frequently articulated policy of those acts—the economic policy advocating the most efficient use of capi-

279. *See* text accompanying notes 21-24 *supra.*

280. *See* text accompanying notes 18-20 *supra.*

tal. Because capital is a limited resource, society should seek to optimize its use by channeling funds into projects that provide the highest social value. This approach is implicit in the requirements of disclosure espoused by the securities acts, which exist not only to protect individual investors from fraud, but to maintain free and open capital markets.[281] As one commentator has pointed out, "[t]his concern over a free market was based on a theory that, given adequate information, the laws of supply and demand, combined with action by each purchaser for his own best interest, would establish a true market value for each security."[282] To the extent that the underwriting of municipal securities, especially revenue and industrial development bonds, is not subjected to full disclosure requirements, fraudulent schemes like those in *Walston*, the *Shields* cases, *Dunne*, and *Senex* will continue to occur, thwarting this important public policy.

Unfortunately, disclosure as contemplated by the 1933 Act cannot be regarded as an ideal solution. In the corporate securities area, a prospectus frequently does not reach a potential investor in time to affect his investment decision.[283] Moreover, even when an investor does obtain a prospectus at a sufficiently early date, he often either will not take the time to read it and analyze the information presented, or will be unable to understand the meaning of the information disclosed because of its sophisticated, esoteric nature, and the complicated method of presentation.[284] Nevertheless, these criticisms are valid only when made with reference to unsophisticated, lay investors. In the hands of professional analysts and sophisticated investors the information contained in a 1933 Act prospectus is an important tool providing data necessary to make an informed comparison of the registered securities with other investment opportunities that will result in an optimal use of capital. Further, as one commentator has pointed out, the only effective method by which an unsophisticated investor can weigh the merits of potential investment alternatives is to obtain the advice of a qualified financial advisor.[285] Thus, despite the criticisms made of the disclosure scheme provided by the 1933 Act, its registration statement and prospectus requirements provide a most important vehicle for

281. *See* Knauss, *A Reappraisal of the Role of Disclosure*, 62 MICH. L. REV. 607, 614 (1964).

282. *Id.*

283. *See, e.g.*, Kripke, *The SEC, the Accountants, Some Myths and Some Realities*, 45 N.Y.U.L. REV. 1151, 1156 (1970).

284. *Id.* at 1165.

285. *Id.* at 1169.

achieving the regulatory goals of protecting investors and optimizing the use of capital. In the municipal securities area—with the exception of general obligation bonds for which the customary disclosures about assessed valuation and taxing power allow informed investment decisions—the achievement of these goals mandates dissemination of information about the parties to a municipal bond issue equal in quantity and quality to that required for a corporate securities issue. Thus, application of the 1933 Act to the distribution of revenue and industrial development bonds, with its requirements of due diligence and prospectus delivery, appears appropriate.

Obviously, any decision concerning the propriety of various methods of underwriting municipal securities must be made in light of an assessment of all the factors discussed above. Indeed, the strongest criticism applicable to Congress in evaluating its efforts to date in this area concerns its unwillingness to consider the matter in depth when faced with strong political pressures from municipal issuers. Furthermore, the drafters of the proposed Federal Securities Code are subject to the same criticism. Although the proposed Code contemplates simplification of the corporate underwriting process by requiring detailed disclosures in annual, publicly available registration statements to be filed with the SEC by certain corporate issuers[286] and requiring somewhat streamlined disclosures in prospectuses accompanying the distribution of new securities to the public,[287] the drafters have not examined the propriety of registration of municipal securities. Instead, they have simply perpetuated the existing municipal securities exemption and, if anything, have extended its scope by excluding governmental issuers from any of the Code's provisions unless they are expressly included.[288] The issuers' arguments that neither increased expenses nor administrative delays should be allowed to interfere with the public's ability to raise funds admittedly are valid, but they constitute only another set of public policies to be considered in the balancing process and should not be elevated to paramount siguificance. Moreover, the issuers' most practical argument—the increased expense problem—remains debatable; no reliable data on the expenses of compliance with the 1933 Act incurred by well-established companies that frequently enter the capital market are available to compare with the present expenses of issuing municipal securities. Also, an analysis of the expenses associated with properly insuring that a municipal securities issue complies with the full-disclosure requirements of

286. A.L.I. FED. SEC. CODE §§ 401 *et seq.*, Tent. Draft No. 1 (1972).
287. A.L.I. FED. SEC. CODE §§ 501 *et seq.*, Tent. Draft No. 1 (1972).
288. See the discussion of the proposed provisions at note 89 *supra*.

the antifraud provisions would indicate that no great disparity should exist, because the same types of investigation and disclosure efforts ideally should be undertaken to satisfy both the antifraud and 1933 Act prospectus disclosure requirements.

Hopefully, Congress in the future will take a more affirmative approach in evaluating the propriety of municipal securities regulation by assessing all relevant factors in light of the policies underlying securities regulation. In this way a system can be developed that not only will accommodate the needs of municipal issuers, but will optimize the functioning of the securities markets.

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