March 2014

Leaning Tower: Do the Proposed Amendments to SEC Rule 15c2-12 Violate the Securities Acts Amendments of 1975

Mark Edward Laughman

Follow this and additional works at: http://scholarship.law.nd.edu/ndlr

Recommended Citation
Available at: http://scholarship.law.nd.edu/ndlr/vol69/iss5/12

This Note is brought to you for free and open access by NDLScholarship. It has been accepted for inclusion in Notre Dame Law Review by an authorized administrator of NDLScholarship. For more information, please contact lawdr@nd.edu.
The Leaning Tower: Do the Proposed Amendments to SEC Rule 15c2-12 Violate the Securities Acts Amendments of 1975?*

I. INTRODUCTION

The aggregate size of the municipal debt market approaches the size of the corporate debt market. Investors held a total of $1038.2 billion in state and local obligations at the end of the third quarter of 1993, compared to $1203.0 billion in corporate obligations.1 Despite this similarity in size, the disclosure protections municipal investors receive are significantly less defined than those in corporate finance.2 The historical market perception that municipal securities are second only to federal government securities in terms of safety explains, in part, this disparity.3

Despite the perception of safety, the municipal market has, from time to time, embroiled itself in scandals resulting in congressional investigations and increased regulatory attention.4 Events in the late 1960s and early 1970s, including the scandals

---

* The author wishes to express his gratitude to Robert and Yukari Vincent of California Municipal Statistics, Inc., San Francisco, for their training and guidance in the field of public finance. The opinions expressed herein are solely those of the author.

1 Summary of Credit Market Debt Outstanding, 80 FED. RES. BULL. A43 (Mar. 1994).
3 See id. Section 3(a)(29) of the Securities Exchange Act of 1934 defines "municipal securities" as:

[S]ecurities which are direct obligations of, or obligations guaranteed as to principal or interest by, a State or any political subdivision thereof, or any agency or instrumentality of 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.

involving so-called "boiler room" operations and the 1974-75 New York City fiscal crisis, gave rise to increased regulatory scrutiny, and ultimately, legislative action.\(^5\) In the mid to late 1980s, the default of the Washington Public Power Supply System (WPPSS) brought increased scrutiny of the municipal bond market.\(^6\) More recently, in late April 1993, the municipal market was shaken by the announcement that Merrill Lynch and New York City Comptroller Elizabeth Holtzman were under investigation by various federal and local authorities for alleged abuses involving campaign contribution practices.\(^7\) This latest scandal has served as a backdrop for renewed inquiry into the ongoing problem of inadequate secondary market disclosure, and regulatory attention is once again centered on the municipal marketplace.\(^8\)

Many of the current investigations into disclosure practices focus on who controls the process of selling municipal bonds. Control over this process comes from various sectors. Conflicts typically arise not only with regard to federal and state powers but also among those who participate in the industry.\(^9\) The type of obligation sold is often determinative. Currently, disclosure questions are often resolved by the interplay between market participants and not as a direct result of federal or state disclosure obligations.\(^10\) The way in which a deal is sold also determines disclosure obligations. For example, in a competitive transaction, the financial advisor to the issuer is primarily responsible for adequate primary market disclosure.\(^11\) In negotiated transactions, however, this responsibility typically shifts to the lead or managing underwriter.\(^12\)

To alleviate market uncertainty over disclosure obligations, the Securities and Exchange Commission (SEC) issued a statement ("Statement") on March 9, 1994 to provide guidance to market participants on the application of the antifraud provisions of the federal securities laws to transactions in municipal securities.\(^13\)

\(^5\) See Robert A. Fippinger, The Securities Law of Public Finance 490 (2d ed. 1993); see also Lamb & Rappaport, supra note 2, at 227, 229-30, 253-55; Seligman, supra note 4, at 661-70.

\(^6\) See Fippinger & Pittman, supra note 4, at 130-31.

\(^7\) See infra note 104.

\(^8\) See infra Part III.B.

\(^9\) See Lamb & Rappaport, supra note 2, at 230-32.

\(^10\) See id. at 227-39.

\(^11\) See id. at 238.

\(^12\) See id.

\(^13\) Statement Regarding Disclosure Obligations of Municipal Securities Issuers and
The Statement advises issuers and underwriters of ways to minimize potential exposure to antifraud liability through disclosure in both the primary and secondary municipal securities markets. In addition, the SEC, in a separate release, proposed rule amendments ("Proposed Amendments") which, if adopted, would make it unlawful for any broker-dealer to underwrite new municipal issues when the issuer does not commit to provide ongoing disclosure to the market by depositing information in a repository. The Proposed Amendments would also require broker-dealers to review ongoing disclosure prior to recommending secondary market transactions in municipal securities. Finally, the SEC proposed a new rule and rule changes regarding confirmations of transactions in municipal bonds.

This Note examines the federal regulation of municipal securities in light of the current regulatory activity in the market. Part II provides an overview of the current state of federal regulation of municipal bonds. Part III discusses the ongoing problem of inadequate secondary market disclosure and summarizes the SEC's Statement and Proposed Amendments. Part IV examines the legislative history behind the creation of the Municipal Securities Rulemaking Board (MSRB) and the adoption of the Tower Amendment to the Securities Acts Amendments of 1975 ("1975 Amendments"). Part IV argues that the SEC must acknowledge the congressional intent behind the creation of the MSRB and the adoption of the Tower Amendment.

14 Id.
16 Id. at 12,760. This Note will use "broker-dealer" to refer to any broker, dealer or municipal securities dealer.
17 Id. at 12,762.
18 Exchange Act Release No. 33,743, 59 Fed. Reg. 12,767 (Mar. 9, 1994). The SEC proposes to amend Rule 10b-10 under the Securities Exchange Act of 1934 to clarify the operation of the Rule. Id. In addition, the SEC is proposing a new rule, Rule 15c2-13, to require broker-dealer disclosure of certain pricing and rating information. Id. This Note will limit its discussion to the Statement and the Proposed Amendments.
19 See infra Part II.
20 See infra Part III.A.
21 See infra Part III.B.
22 See infra Part IV.A.1.
24 See infra Part IV.B.
entirely appropriate for the SEC to provide guidance to market participants on the application of the antifraud provisions of the federal securities laws, the Proposed Amendments violate the spirit of the Tower Amendment and the congressional intent behind the creation of the MSRB. This Note argues that any decision regarding the regulation of issuers, either directly or indirectly, must be made by Congress.25

II. FEDERAL REGULATION OF MUNICIPAL BONDS

A. In General

Historically, federal involvement in the municipal securities market has been minimal. The Securities Act of 193326 ("1933 Act") and the Securities Exchange Act of 193427 ("1934 Act") generally exempt municipal issuers from the registration and regulatory requirements imposed upon private corporate issuers. While municipal securities are categorized as "securities" under the 1933 Act,28 they are exempt pursuant to section 3(a)(2).29 This exemption excludes issuers of municipal securities from registering prospectuses and certain disclosures.30 The section 3(a)(2) exemption also includes those sections of the 1933 Act which relate to the sales of securities made prior to the registration of offering memorandum.31 Section 17,32 the general antifraud provision, is the only restraint on municipal bonds contained in the 1933 Act. It deals with the omission or material misstatement of facts in an official document given to a potential investor.33

The 1934 Act does not contain a broad exemption for municipal securities similar to section 3(a)(2) of the 1933 Act, and each section of the 1934 Act must be reviewed to determine if municipal securities are exempt from coverage. Section 10 of the 1934 Act34 prohibits the use, by any person, of any deceptive device in connection with the purchase and sale of any security. Rule 10b-5,35 promulgated under section 10(b)36 and adopted in 1942,

25 See id.
27 Id. §§ 78a-78jj.
29 Id. § 77c(a)(2).
30 Id.
31 Id.
32 Id. § 77q.
33 Id.
34 Id. § 78j.
generally prohibits fraud in connection with the purchase or sale of any security, but does not specifically state that municipal securities are contained within its provisions.

Events in the late 1960s and early 1970s, including the numerous incidences of fraudulent practices exposed by the SEC, gave rise to increased congressional scrutiny of the municipal marketplace. And federal action was not limited to Congress. The SEC investigated the events leading up to the 1974-75 fiscal crisis in New York City and took a strong stand against the participants and practices within the municipal securities industry. As a result of the near-bankruptcy of New York City, questions of adequate disclosure and what constitutes reasonable care in investigating and presenting the nature of an issuer were argued at length for the first time.

Prior to 1975, section 17 of the 1933 Act and section 10 of the 1934 Act were the only federal limitations relating to the issuance of municipal securities. While the original version of section 10(b) of the 1934 Act did not apply to municipal issuers, the 1975 Amendments added "government, or political subdivision, agency or instrumentality of a government" to the definition of "person" in section 3(a)(9). The 1975 Amendments also removed the exemption from SEC registration for broker-dealers who trade municipal securities. Applications to trade municipal securities must now be filed with the SEC, and the SEC may deny an applicant according to its guidelines.

Perhaps most significantly, the 1975 Amendments created the MSRB. Pursuant to section 15B(c)(1) of the 1934 Act, every

38 See Fippinger, supra note 5, at 490.
39 See Lamb & Rappaport, supra note 2, at 208, 214.
40 See Fippinger, supra note 5, at 490-91; Seligman, supra note 4, at 661-68.
42 Id. § 78j.
46 Id. § 78o-4(a)(1).
47 Id. § 78o-4(a)(2).
48 Id. § 78o-4(b)(1). See generally Roswell C. Dikeman, Municipal Securities Rulemaking Board: A New Concept of Self-Regulation, 29 Vand. L. Rev. 903 (1976); Thomas P. Peacock,
An underwriter or broker-dealer of municipal securities must comply with rules promulgated by the MSRB. The purpose of the MSRB is to oversee practices within the municipal securities industry. Congress established the MSRB as an independent, self-regulatory organization that would be the primary rulemaking authority for the municipal marketplace. Pursuant to section 15B(d)(1), the MSRB is composed of members who serve two-year terms: (a) five public representatives not associated with any broker-dealer, at least one of whom shall be an issuer representative; (b) five nonbank representatives who are associated with municipal securities broker-dealers; and (c) five dealer bank representatives. The composition of the MSRB is heavily weighted towards the broker-dealer community due to the Board's primary function of formulating rules which exclusively govern the conduct of municipal securities broker-dealers.

A key provision of the 1975 Amendments which restricts the regulatory efforts of both the SEC and the MSRB is the Tower Amendment, codified at section 15B(d) of the 1934 Act. Section 15B(d)(1) of the Amendment provides that no issuer of a municipal security shall be required to file with the SEC or the MSRB prior to the sale of securities any document or information in connection with such sale. In addition, pursuant to section 15B(d)(2), the MSRB is not permitted to require any issuer to furnish to the MSRB or any purchaser "any application, report, document, or information with respect to such issuer." The MSRB may, however, require municipal securities broker-dealers to provide any such disclosure information to the MSRB or purchasers or prospective purchasers of municipal securities. The congressional intent in adopting the Tower Amendment, as this Note argues, was to eliminate issuer responsibility for disclosure obliga-

---

50 Id.  
51 Id. § 78o-4(b)(2).  
52 See FIPPINGER, supra note 5, at 502; see also infra Part IV.A.1.  
54 See id. § 78o-4(b)(2).  
55 See id. § 78o-4(d). For a discussion of the legislative history of the Tower Amendment, see Peacock, supra note 48, at 2051-53; infra Part IV.B.2.  
57 Id. § 78o-4(d)(2).  
58 Id.
tions, shifting the disclosure and regulatory burden in almost all circumstances to municipal securities broker-dealers. The municipal securities industry reacted to the increase in federal oversight and potential liability by increasing disclosure. Underwriters and financial consultants had customarily prepared "offering circulars" for new municipal issues. Throughout the 1970s these circulars began to contain more detail and form. By the late 1980s, the official statement had become the standard disclosure document for municipal securities issues. These booklet form documents are typically consistent in the information they provide and are patterned after the section 10 prospectus required for corporate securities registration under the 1933 Act. This consistency results in part from the publication of the Guidelines for Offerings of Securities by State and Local Governments by the Government Finance Officers Association. These Guidelines, published in final form in 1976 and updated periodically, are heavily promoted and continue to play an important role in institutionalizing and improving the content and consistency of offering documentation.

B. Securities Exchange Act Release No. 26,100 and Rule 15c2-12

On September 22, 1988, the SEC made its report to Congress on its investigation into the WPPSS bond default, the largest default by any municipal issuer in United States history. With its report, the SEC, in 1934 Act Release No. 26,100 ("Release"), published its interpretation ("Interpretation") of the legal responsibilities imposed by the general antifraud provisions of the federal securities laws on underwriters participating in municipal

59 See infra Part IV.A.2.
60 See LAMB & RAPPAPORT, supra note 2, at 229-32.
61 See id.; Peacock, supra note 48, at 2040.
62 See LAMB & RAPPAPORT, supra note 2, at 230-31; Peacock, supra note 48, at 2040.
63 See LAMB & RAPPAPORT, supra note 2, at 232-33.
66 See FIPPINGER, supra note 5, at 31-32; LAMB & RAPPAPORT, supra note 2, at 230-32; Peacock, supra note 48, at 2040.
67 SECURITIES AND EXCHANGE COMMISSION, STAFF REPORT ON THE INVESTIGATION IN THE MATTER OF TRANSACTIONS IN WASHINGTON PUBLIC POWER SUPPLY SECURITIES (Sept. 1988).
69 Id. at 37,787-91.
offerings. The Interpretation is the SEC's clearest statement of the standards applicable to underwriters of municipal securities and effectively mandates the use of an official statement in municipal offerings.70

1. The Interpretation

Section III of the Release sets forth the SEC's Interpretation of the general standard applicable to municipal underwriters.71 The Interpretation "emphasize[s] the obligation of a municipal underwriter to have a reasonable basis for recommending any municipal securities and its responsibility, in fulfilling that obligation, to review in a professional manner the accuracy of the offering statements with which it is associated."72 The Interpretation further explains that the standard of care required of an underwriter depends upon the circumstances.73 At a minimum, the SEC expects "that [municipal] underwriters will review the issuer's disclosure documents in a professional manner for possible inaccuracies and omissions."74 Beyond this "baseline" level of review, the SEC states certain factors that it and courts might consider relevant in determining whether the underwriter's investigation was reasonable.75

The Interpretation repeatedly asserts the SEC's position that a broker-dealer engaged in underwriting municipal securities has a heightened obligation to have a reasonable basis for recommending securities:

The underwriter stands between the issuer and the public purchasers, assisting the issuer in pricing and, at times, in structur-

70 See id. The effective mandate arises as a result of the SEC's emphasis upon the duty of an underwriter to review offering documentation prior to bidding on an issue. See id. at 37,788-89; see also infra notes 72-75, 148-49 and accompanying text. For a detailed discussion of the Interpretation, see Fippinger & Pittman, supra note 4, at 131-38.


72 Id. at 37,787.

73 Id. at 37,789.

74 Id.

75 Id. These factors, as modified in part by 1934 Act Release No. 26,985, include: (1) the extent to which the underwriter relied upon municipal officials, employees, experts, and other persons whose duties have given them knowledge of particular facts; (2) the role of the underwriter (manager, syndicate member, or selected broker-dealer); (3) the type of bonds being offered (general obligation, revenue, or private activity); (4) the past familiarity of the underwriter with the issuer; (5) the length of time to maturity of the bonds; and (6) whether the bonds are competitively bid or distributed in a negotiated offering. Id.; Exchange Act Release No. 26,985, 54 Fed. Reg. 28,799, 28,812 (July 10, 1989) [hereinafter 1989 Release].
ing the financing and preparing disclosure documents. Most importantly, its role is to place the offered securities with public investors. By participating in an offering, an underwriter makes an implied recommendation about the securities. Because the underwriter holds itself out as a securities professional, and especially in light of its position vis-à-vis the issuer, this recommendation itself implies that the underwriter has a reasonable basis for belief in the truthfulness and completeness of the key representations made in any disclosure documents used in the offerings.76

This provision is underscored by the SEC’s belief that investors in the municipal marketplace tend to rely upon underwriters to perform the investigative function and will weigh the reputation of an underwriter in determining whether to invest.77

The Interpretation clearly signals a more aggressive stance by the SEC in dealing with perceived abuses in the municipal marketplace. The Interpretation was drafted in lieu of taking enforcement action against the WPPSS underwriters to clarify what had previously been a gray area.78 The Interpretation states that:

It is incumbent on firms participating in an offering and on dealers recommending municipal bonds to their customers as “good municipal bonds" to make diligent inquiry, investigation and disclosure as to material facts relating to the issuer of the securities and bearing upon the ability of the issuer to service such bonds.79

Thus, the SEC has stressed the need for municipal underwriters to conduct a reasonable inquiry in all circumstances before recommending securities to their customers.80

2. Rule 15c2-12

At the same time the SEC published the Interpretation, it proposed,81 and in 1989 adopted,82 Rule 15c2-1283 ("Rule").

---

76 1988 Release, supra note 68, at 37,787.
77 Id. at 37,887-88.
78 See Fippinger & Pittman, supra note 4, at 130.
80 See id. at 37,787.
81 Id. at 37,782-87.
82 1989 Release, supra note 75.
83 17 C.F.R. § 240.15c2-12 (1993). For a detailed discussion of Rule 15c2-12, see
The Release outlines that the Rule is consistent with the SEC's implementation of a "reasonable basis" obligation on the part of underwriters: "The Commission believes that the provisions in the Rule also contribute to a municipal underwriter's ability to meet its 'reasonable basis' obligation." The Rule governs the dissemination of official statements prepared in conjunction with offerings or remarketings of municipal securities involving a principal amount of $1 million or more. The Rule applies to any broker-dealer or bank that underwrites a primary offering or participates in certain remarketings of municipal securities.

The Rule requires that a Participating Underwriter, prior to bidding for, purchasing, offering or selling municipal securities, obtain and review for completeness and accuracy an official statement that the issuer deems final. In the case of negotiated transactions, the putative underwriter must send a copy of the most recent preliminary official statement within one day to any prospective customer who requests it. This obligation ceases when the final official statement is available. In both negotiated and competitively bid transactions, the underwriter must contract with the issuer to receive, within seven business days after contracting or offering to purchase the issuer's securities, enough final official statements to meet its distribution obligations under the Rule. The distribution obligation commences upon receipt of the final offering statement and continues for a period of ninety days after the end of the marketing period. This distribution period may be reduced to twenty-five days if the offering statement is made available to any person at a central information repository.

For competitive transactions, the requirements of the Rule are not nearly as clear. The requirement of the Rule that has caused the most confusion is that prospective underwriters obtain and review a document deemed a "near final official statement"
(NFOS). The difficulty in interpreting this provision lies in whether underwriters may bid on competitive offerings in which disclosure deficiencies exist. The SEC, in a no-action letter, has stated that an underwriter will satisfy its obligation under the literal language of the Rule if it relies in good faith on the issuer's determination that the NFOS is "final as of its date." Therefore, an underwriter may utilize a NFOS to bid in a competitive offering, despite disclosure deficiencies, provided the issuer has deemed the NFOS final as of its date. To avoid antifraud liability, however, the underwriter must obtain assurances that the issuer will remedy these disclosure deficiencies at a later date.

The SEC adopted very limited exemptions to the Rule, all of which apply only to securities sold in denominations of $100,000 or greater. One exemption is for an offering which is sold to no more than thirty-five purchasers who meet certain criteria. A second exemption is for an issue having a maximum maturity of nine months or less. A third exemption covers an issue which, at the option of the bondholder, may be tendered for redemption at par at least as frequently as every nine months. The SEC has reserved the right to adopt transactional exemptions if it determines that such exemptions are consistent with the goal of protecting investors.

93 Id. § 240.15c2-12(b)(1); see also Fippinger & Pittman, supra note 4, at 140.
94 Fippinger & Pittman, supra note 4, at 141.
96 Id. at 77,962.
97 Fippinger & Pittman, supra note 4, at 142. The release containing the Proposed Amendments advocates amending the Rule to include an information requirement in the definition of final official statement. 1994 Release, supra note 15, at 12,762-63. The definition of final official statement also governs the items of information to be included in the NFOS, subject to availability considerations. Id. at 12,762. The proposed amendment would define the final official statement to include "information concerning the terms of a proposed issue of securities, and financial and operating information concerning the issuer that is adequate to provide a fair presentation of the issuer's current financial condition and results of operations and cash flows, including audited financial statements." Id. at 12,763. Such information also would be required for any significant obligor. Id. An obligor is viewed as 'significant' if it is the source of 20% percent or more of the cash flow servicing the obligations of the securities. Id.
98 Fippinger & Pittman, supra note 4, at 142.
99 17 C.F.R. § 15c2-12(c) (1993).
100 Id. § 240.15c2-12(c)(1).
101 Id. § 240.15c2-12(c)(2).
102 Id. § 240.15c2-12(c)(3).
103 Id. § 240.15c2-12(d).
Both the Interpretation and the Rule reflect a more active stance by the SEC towards disclosure and interpretive deficiencies in the municipal marketplace. By adopting the Rule and informing underwriters of what standards apply under the antifraud provisions of the federal securities laws, the SEC has attempted to improve disclosure and reduce fraud without subjecting municipal issuers to the costly and formalized registration and ongoing reporting requirements applicable to corporate issuers.

III. SECONDARY MARKET DISCLOSURE DEFICIENCIES

As a result of the investigations into campaign contribution practices in the municipal market, attention has once again

104 For a discussion of the scandal, see Leah Nathans Spiro & Kelley Holland, The Trouble with Munis, BUS. WEEK, Sept. 6, 1993, at 44. In late April 1993, the municipal market was shaken with the announcement that Merrill Lynch & Co., the leading underwriter of municipal bonds, had placed three of its highest ranking officials in its municipal bond department on administrative leave because of “apparent irregularities” in a New Jersey Turnpike Authority refunding issue. Patrick M. Fitzgibbons & Sean Monsarrat, Investigation Into New Jersey Bond Refunding Triggers Wary Reaction in Municipal Market, BOND BUYER, May 10, 1993, at 1. These irregularities allegedly arose from payments made to Armacon Securities, a New Jersey-based bond dealer 50%-owned by Joseph Salema, a former top aide to Governor Jim Florio. Vicky Stamas, MSRB’s Statement May Reveal Position on Campaign Money from Bond Firms, BOND BUYER, May 19, 1993, at 1. These payments are alleged to have been made to secure a better underwriting position for Merrill Lynch on $2.9 billion of negotiated refundings issued by the Authority. Id. The announcement by Merrill Lynch came as a result of widespread investigations into the refundings and Armacon’s relationship with Merrill Lynch, launched by various federal government authorities, including the SEC and the U.S. Attorney’s Office. Id.

Contemporaneously with the launching of the federal government investigation, the New York City Department of Investigation launched a probe into the selection of Fleet Securities as one of the co-managers on the city’s bond underwriting syndicate. Charles Gasparino, Holtzman Says Loan Didn’t Sway Choice of Fleet to Handle New York City Debt, BOND BUYER, Apr. 26, 1993, at 1. Fleet was chosen on the recommendation of Elizabeth Holtzman’s office after her failed Senate campaign received a $450,000 loan from its affiliate, Fleet Bank. Id. Holtzman has since lost a primary bid for reelection to the position of Comptroller, an event many view as being a direct result of voter dissatisfaction with underhanded dealings by politicians with Wall Street. John H. Allan, A Wake-Up Call in New York, BOND BUYER, Oct. 4, 1993, at 18. The New Jersey and New York investigations prompted other states, including Massachusetts and Louisiana, to launch their own investigations into questionable underwriting practices. See Spiro & Holland, supra, at 44, 50-51.

At its annual meeting held in late July 1993, the MSRB proposed a two-prong rule designed to control political contributions made by broker-dealers to issuers. Vicky Stamas, MSRB Says It Will Propose an Aggressive Rule to Curb Contributions Dealers Make to Issuers, BOND BUYER, Aug. 5, 1993, at 1. Under one part of the rule, broker-dealers would be prohibited from making direct or indirect payments that are designed to capture or keep an issuer’s bond business. Id. Under the second prong, broker-dealers would be required to disclose for both two years before and two years after they have done business with an issuer all political gifts made to that issuer. Id. The MSRB filed its proposed rule, designated as MSRB Rule G-37, with the SEC on January 12, 1994, and the SEC
become focused on the issue of inadequate secondary market disclosure. The SEC has responded by issuing the Statement and the Proposed Amendments, discussed in Subpart B below.

A. The Ongoing Problem of Deficient Secondary Market Disclosure


105 Shortly after the political contributions scandal broke, see supra note 104, several congressional investigations followed. On May 25, 1993, Rep. Ron Wyden, D-Ore., Chairman of the House Small Business Committee’s Subcommittee on Regulation, sent a letter to the SEC, the National Association of Securities Dealers (NASD) and the MSRB indicating that he may hold hearings and introduce legislation to overcome the lack of competitive bidding in the municipal bond market. Vicky Stamas & Lynn Stevens Hume, House Subcommittee Begins Investigation Into Negotiated Sale of Municipal Bonds, BOND BUYER, June 2, 1993, at 1. On May 26, 1993, the House Energy and Commerce Committee, chaired by Rep. John Dingell, D-Mich., announced that it was launching an investigation of the municipal market to determine if federal regulation should be tightened and if the Tower Amendment should be repealed. Vicky Stamas, Congressional Panel to Investigate Municipals, Review its Regulation, BOND BUYER, May 27, 1993, at 1. The congressional probe was announced in a letter addressed to the SEC, the NASD and the MSRB asking the three regulatory groups to investigate the current regulation of the market in light of the scandals, along with concerns over the scope of voluntary secondary market disclosure. Id.

On July 14, 1993, Rep. Dingell and Rep. Edward Markey, D-Mass., asked the SEC to broaden its inquiry to include bond counsel, consultants, and other experts involved in municipal bond financings. Vicky Stamas, Dingell, Markey Ask SEC to Expand Probe Into Firms’ Political Donations, BOND BUYER, July 15, 1993, at 1. The House Energy and Commerce Committee’s Subcommittee on Telecommunications and Finance, chaired by Rep. Markey, has since conducted hearings into the federal regulation of the municipal market. Vicky Stamas, Markey Leaning Toward Ongoing Disclosure Bill, BOND BUYER, Oct. 8, 1993, at 1. Markey has stated that he is “very seriously” considering drafting legislation that would require municipal bond issuers to provide ongoing disclosure. Id. To date, Markey has not taken any further action and has indicated that he would not introduce legislation to curb political contributions but would, for the time being, leave that issue up to regulators and the industry to solve. Id. The House subcommittee is likely to resume hearings on the municipal market this spring, but it is undetermined what the focus of those hearings will be. Vicky Stamas, Markey Subcommittee Will Probably Return to Municipals this Spring Aide Says, BOND BUYER, Feb. 24, 1994, at 7.

Finally, Rep. Jim Leach, R-Iowa, and Rep. Henry Gonzalez, D-Tex., introduced legislation in late June that would repeal the Tower Amendment and also require underwriters, bond counsel, and broker-dealers to disclose political contributions. Vicky Stamas & Lynn Stevens Hume, Proposal Would Repeal Tower; Seek Disclosure of Contributions, BOND BUYER, June 22, 1993, at 1. The bill was immediately referred to committee, raising questions on Capitol Hill as to whether it would meet with much success. Id. In what is being viewed as an escalating turf battle, Rep. Dingell has gone on record as saying that the proposed legislation is “fatally flawed” and that his panel will ignore the bill. Vicky Stamas, Dingell Warns Bill to Repeal Tower is Fatally Flawed, BOND BUYER, Aug. 10, 1993, at 1.

1990 and 1991, the SEC approved rule changes promulgated by the MSRB to commence the development of a central, electronic disclosure repository. MSRB Rule G-36 approved by the SEC in 1990 and amended in 1991 mandates that underwriters subject to the Rule send the MSRB a copy of the final official statement prepared in conjunction with an offering within one business day of receipt of the final offering statement from the issuer, but no later than ten business days after the sale date. Underwriters of municipal securities not covered by the Rule, such as underwriters of issues under $1 million, must send a final official statement to the MSRB within one business day of the closing if a final official statement was prepared in conjunction with the offering. Underwriters of offerings exempt from the Rule under section 15c2-12(c) are under no obligation to file offering documentation with the MSRB. In addition, Rule G-36 requires underwriters to file certain advance refunding documents and stickered final official statements in a manner similar to the filing requirements for final official statements.

The mandatory filing requirements were to be the first stage in the MSRB's plan to establish and operate a central electronic disclosure facility, which it refers to as the Municipal Securities Information Library (MSIL). Documents collected pursuant to Rule G-36 would be available electronically to market participants
and information vendors for use in value added products such as market analyses and document summaries.\textsuperscript{116}

To address the persistent problem of inadequate secondary market disclosure, the MSRB, as a supplement to the MSIL system, proposed a rule change in 1990 to add a facility plan to accept and disseminate voluntarily submitted continuing disclosure information (CDI).\textsuperscript{117} The rule change was adopted as a result of the MSRB's concern with information deficiencies in the secondary market:

The Board believes that improved access to CDI is necessary not only so that dealers can comply with the Board's customer protection rules, but also to enhance the integrity and efficiency of the market. The lack of access to CDI not only creates problems in specific transactions, but also creates general inefficiency in the market. Market participants are aware that their transactions may be executed based on incomplete or erroneous information about the securities and this is necessarily taken into account in pricing transactions, thus eroding the accurate pricing of those securities and the general efficiency of the market.\textsuperscript{118}

Thus, the MSRB publicly recognizes the deleterious effects upon the entire municipal market of inadequate secondary market disclosure.

Submission to the CDI portion of the MSIL is entirely voluntary.\textsuperscript{119} The MSRB was hopeful that creating a central repository would enhance efforts by market participants to increase ongoing disclosure:

\[T\]he Board believes that the existence of a central repository for CDI, which provides a neutral, fair and timely dissemination mechanism for disclosure information, would not only increase the availability of the CDI currently produced, but also encourage voluntary efforts in the industry to improve the content and timing of CDI.\textsuperscript{120}

The MSRB based its optimism, in part, on the greater responsibility which certain market participants assume in providing voluntary

\begin{itemize}
  \item \textsuperscript{116} See Exchange Act Release No. 29,298, \textit{supra} note 107, at 28,195.
  \item \textsuperscript{117} Exchange Act Release No. 28,199, 55 Fed. Reg. 29,691 (July 20, 1990); \textit{see also} FIPPINGER, \textit{supra} note 5, at 316-17.
  \item \textsuperscript{119} \textit{Id.} at 12,534.
  \item \textsuperscript{120} \textit{Id.} at 12,535.
\end{itemize}
market disclosure. For instance, in 1991 the American Bankers Association (ABA), representing bank trustees, published its own guidelines on trustee disclosure. Those guidelines are designed to help trustees determine the content and timing of various types of voluntarily provided CDI. The MSRB believed that the existence of a central repository would "facilitate voluntary efforts [by issuers and trustees] to address the information problems that continue to exist in the municipal market."

To date, it appears that the MSRB's optimism was unwarranted. Voluntary participation by issuers in the CDI system has been very low. A significant reason for the lack of voluntary efforts by issuers to provide secondary market disclosure may be the fear of violating the antifraud provisions of the 1934 Act. There is little doubt that postdistribution information voluntarily filed with the MSIL system would be subject to the same standard of care applicable to statements generally, if such proffered information was "calculated to influence the investing public." Therefore, voluntarily filed CDI subsequently found to contain inaccurate, misleading or incorrect statements would be subject to the duty to correct if the statements were deemed by a court to be material at the time of discovery. In the absence of further regulatory guidance, the duty to correct may provide a significant disincentive for voluntary disclosure, therefore making it less likely that issuers will provide ongoing disclosure unless required. The SEC issued the Statement in order to provide voluntary disclosure guidance to municipal issuers.

121 See id. at 12,538-39.
123 See FIPPINGER, supra note 5, at 324-27.
126 See FIPPINGER, supra note 5, at 293-94.
127 Id. at 243.
128 Id. at 293. This duty may extend to correcting or revising "a prior statement which was accurate when made but which has become misleading due to subsequent events." Ross v. A.H. Robins Co., 465 F. Supp. 904, 908 (S.D.N.Y. 1979). In addition, a duty may exist to update a prior accurate statement in a circumstance in which that statement "may have a forward intent and connotation upon which parties may be expected to rely." Backman v. Polaroid Corp., 910 F.2d 10, 17 (1st Cir. 1990).
129 See FIPPINGER, supra note 5, at 293. The additional duty to update forward-looking statements may provide another significant disincentive. Id. See supra note 128.
B. The Statement and the Proposed Amendments

1. The Statement

On March 9, 1994, the SEC issued the Statement to advise issuers and underwriters of ways to minimize potential exposure to antifraud liability through increased disclosure in both the primary and secondary municipal securities markets. While stressing that the Statement does not alter what constitutes an antifraud violation, the SEC addressed several key areas for improvements in disclosure practices. The staff of the Divisions of Corporation Finance and Market Regulation stated that the Statement and the Proposed Amendments are based upon recommendations submitted in December by the Public Securities Association, the Government Finance Officers Association, and other industry leaders.

The Statement focuses heavily upon primary market disclosure, which surprised some market participants. Recognizing "the significant improvement in disclosure practices in recent years as a result of voluntary initiatives," the Statement addresses the following five matters for increased attention in primary offering disclosure:

(a) disclosure of potential conflicts of interest and material financial relationships among issuers, advisers and underwriters, including those arising from political contributions;
(b) disclosure regarding terms and risks of securities being offered;
(c) disclosure of the issuer's or obligor's financial condition, results of operations, and cash flows;
(d) disclosure of the issuer's plans regarding the provision of information to the secondary market; and
(e) timely delivery of preliminary official statements to underwriters and potential investors.

131 See id.
132 See id. at 12,750-57.
134 Christopher Taylor, Executive Director of the MSRB, declared that one of the surprises in the Statement is that it addresses obligations with respect to the primary market. Id. at 352.
135 1994 Statement, supra note 13, at 12,748.
136 Id.
The Statement discusses each recommendation in detail and suggests ways that issuers and underwriters can comply with the SEC's suggestions.\footnote{See id. at 12,750-55.}

The second major focus of the Statement concerns disclosure in the secondary market for municipal securities.\footnote{See id. at 12,755-57.} The SEC highlights its concern in this area: "While significant progress has been made in primary market disclosure in recent years, the same development has not taken place with respect to secondary market disclosure."\footnote{Id. at 12,755.} According to the SEC's staff, the purpose of the Statement is to clarify the potential for antifraud liability of issuers in connection with public statements and reports upon which secondary market participants may rely.\footnote{SEC Issues Antifraud Guidance, supra note 133, at 351.} In particular, the Statement identifies the following suggested mechanisms for reducing potential liability exposure:

(a) publication of financial information, including audited financial statements and other financial and operating information, on at least an annual basis;
(b) timely reporting of material events reflecting upon the creditworthiness of the issuer or the obligor and the terms of its securities, including material defaults, draws on reserves, adverse rating changes and receipt of an adverse tax opinion; and
(c) submission of such information to an information repository.\footnote{1994 Statement, supra note 13, at 12,756-57.}

The Statement takes a tough stand on the issue of whether silence can shield an issuer from potential antifraud liability:

[I]ssuers and obligors are at times advised by their professional advisors that there is no duty under the federal securities laws to make disclosure following the completion of the distribution. At least some municipal issuers thus appear to believe that silence shields them from liability from what may later be found to be false or misleading information. As a practical matter, however, municipal issuers do not have the option of remaining silent. Given the wide range of information routinely released to the public, formally and informally, by these issuers in their day-to-day operations, the stream of information on which the market relies does not cease with the close of a
municipal offering. In light of the public nature of these issuers and their accountability and government functions, a variety of information about issuers of municipal securities is collected by state and local governmental bodies, and routinely made publicly available. Municipal officials also make frequent public statements and issue press releases concerning the entity's fiscal affairs.\(^{142}\)

The Statement therefore recognizes that, given the public nature of municipalities, complete silence is in fact impossible to maintain in the ordinary course of an issuer's activities.

The Statement explains that when a municipal issuer releases public information, it may be subject to the antifraud provisions even if the information was not intended to be the basis of investment decisions.\(^{143}\) The Statement asserts that:

The fact that [public statements] are not published for purposes of informing the securities markets does not alter the mandate that they not violate antifraud proscriptions. Those statements are a principal source of significant, current, information about the issuer of the security, and thus reasonably can be expected to reach investors and the trading market.\(^{144}\)

The Statement thus casts a wide regulatory net over information released to the public by municipal issuers.

The Statement addresses the risk to issuers of misleading investors by releasing public statements which may not be intended to be the basis of investment decisions, but which nevertheless may reasonably be expected to reach the securities markets.\(^{145}\) To minimize this risk, the Statement urges that "municipal issuers should establish practices and procedures to identify and timely disclose, in a manner designed to inform the market, material information reflecting on the creditworthiness of the issuer and the obligor in terms of the security."\(^{146}\) The Statement counsels

\(^{142}\) Id. at 12,755-56.

\(^{143}\) See id. at 12,756.

\(^{144}\) Id. The Statement also warns issuers that antifraud liability may attach for failure to update forward-looking statements contained within an official statement: "To the extent that the official statement in many cases remains the principal (or perhaps even the sole) source of information concerning an outstanding security, the potential for an obligation to update is of particular importance." Id. at 12,756 n.90; see also supra note 128.

\(^{145}\) See 1994 Statement, supra note 13, at 12,756.

\(^{146}\) Id.
issuers to adopt its suggestions, as outlined above, to accomplish this purpose.\textsuperscript{147}

Finally, the Statement advises underwriters of their duty to review the issuer’s disclosure documents before offering, selling, or bidding for the issuer’s securities.\textsuperscript{148} The Statement reiterates the SEC’s position in the Interpretation that municipal underwriters must have a reasonable belief as to the accuracy and completeness of the representations made in offering documentation.\textsuperscript{149} In addition, the Statement goes further than the Interpretation in stating that a broker-dealer must have a reasonable basis for recommending municipal securities in the secondary market.\textsuperscript{150} The Statement also repeats Chairman Levitt’s recommendation to Congress to repeal the exemption from the registration provisions of the securities laws for corporate obligations underlying certain non-governmental conduit securities.\textsuperscript{151}

2. The Proposed Amendments

With the Statement, in a separate release, the SEC issued the Proposed Amendments.\textsuperscript{152} The SEC is advancing the Proposed Amendments to “assist brokers, dealers, and municipal securities dealers in satisfying their obligations under the antifraud provision of the federal securities laws, and specifically under [1934 Act] Section 15(c)(2) [of the 1934 Act], by conditioning the underwriting and recommendation of municipal securities on the availability of current issuer information.”\textsuperscript{153} The SEC expects that the Proposed Amendments will help deter fraud in both the primary and secondary markets, and “assist investors in protecting themselves

\textsuperscript{147} See id.

\textsuperscript{148} Id. at 12,757-58.

\textsuperscript{149} See id. at 12,758.

\textsuperscript{150} See id. This duty makes it incumbent upon a broker-dealer to establish a reasonable basis by reviewing any publicly available disclosure. Id. The Statement further advises that if a broker-dealer discovers any factors indicating that the disclosure is inaccurate or incomplete, or which signals the need for further inquiry, he may need to obtain additional information, or seek to verify existing information. Id.

\textsuperscript{151} Id. at 12,755. “Conduit bonds” are “municipal securities issued by a state or local government for the benefit of a private corporation or other entity that is ultimately obligated to pay such bonds . . . .” Id. at 12,754-55 n.77 (quoting GOVERNMENT FINANCE OFFICERS ASSOCIATION, COMMITTEE ON GOVERNMENT DEBT AND FISCAL POLICIES, IMPROVEMENTS IN MUNICIPAL SECURITIES’ MARKET DISCLOSURE (Feb. 1, 1994)).

\textsuperscript{152} 1994 Release, supra note 15.

\textsuperscript{153} Id. at 12,760.
from misrepresentation or other fraudulent activity by brokers, dealers, and municipal securities dealers."\(^{154}\)

The heart of the Proposed Amendments is the suggestion to add paragraph (b)(5) to the Rule.\(^{155}\) This new paragraph would prohibit a Participating Underwriter from "purchasing or selling municipal securities in connection with an offering unless the Participating Underwriter has reasonably determined that the issuer or its designated agent has undertaken in a written agreement or contract for the benefit of holders of such municipal securities to provide certain information to a NRMSIR."\(^{156}\) This requirement contemplates that the issuer of municipal securities will undertake to provide such information to a NRMSIR at the time of delivery of municipal securities to a Participating Underwriter.\(^{157}\) The Participating Underwriter satisfies its obligation under the Proposed Amendments if it can conclude that the appropriate covenants have been made by the issuer.\(^{158}\) Thereafter, the duty will exist as an obligation that the issuer owes to its bondholders.\(^{159}\) Ultimately, therefore, the Proposed Amendments would create an ongoing disclosure requirement imposed directly upon issuers.

The specific information to be provided is set forth in the Proposed Amendments:

[Paragraph (b)(5)(i)(A)] would prohibit Participating Underwriters from purchasing or selling municipal securities in con-

\(^{154}\) Id.

\(^{155}\) Id.

\(^{156}\) Id. A "NRMSIR" is defined as a nationally recognized municipal securities information repository. \emph{Id.} While the term NRMSIR is currently used in paragraph (b)(4) of the Rule, it is not defined therein. 17 C.F.R. § 240.15c2-12(b)(4) (1993). NRMSIRs were discussed in the 1989 Release, \emph{supra} note 75, where the SEC noted that in determining whether a particular entity is a NRMSIR, it would look at, among other things, whether the repository: (1) is national in scope; (2) maintains current, accurate information about municipal offerings in the form of official statements; (3) has effective retrieval and dissemination systems; (4) places no limits on the issuers from which it will accept official statements or related information; (5) provides access to the documents deposited with it to anyone willing to pay the applicable fees; and (6) charges reasonable fees. \emph{Id.} at 28,808 n.65. The MSRB's MSIL system, discussed in the text accompanying notes 115-30, \emph{supra}, is not a NRMSIR, and the MSRB has yet to seek such a status from the SEC for the repository. \emph{See} 1994 Release, \emph{supra} note 15, at 12,764 n.25. The SEC is requesting comment on whether NRMSIR should be defined in the Rule, and what specific standards should be established for NRMSIRs. \emph{Id.}

\(^{157}\) Id. at 12,760.

\(^{158}\) Id. at 12,761.

\(^{159}\) Id.
nection with an offering unless the Participating Underwriter has reasonably determined that the issuer or its designated agent has undertaken to provide to a NRMSIR, at least annually, current financial information concerning the issuer of the municipal security and any significant obligors, including annual audited financial statements and pertinent operating information.  

This proposed paragraph does not dictate the format of the annual financial information, but rather stipulates that the issuer provide audited financial statements which "fairly present the current financial condition, the results of operations, and cash flows of the municipal issuer and any significant obligor. Proposed paragraph (b)(5) also does not dictate the content of the annual financial information, other than the audited financial statements." Frequent issuers may meet the standards of the Proposed Amendments by including financial information in sequential offering statements.  

Proposed paragraph (b)(5)(ii) stipulates that issuers would also be required to

specify what accounting principles will be used in the preparation of the audited financial statements, the time within which the annual information for each year will be available, and the specific operating and financial information that will be provided on an annual basis, in addition to the audited financial statements.  

This proposed paragraph does not specify the timing of the availability of annual financial information in each year, but rather requires that the issuer's undertakings to provide such information specify the annual time frame in which the information will be provided by the issuer and any significant obligors.

In addition to annual financial information, proposed paragraph (b)(5)(i)(B) requires Participating Underwriters to obtain assurances that issuers provide, in a timely manner, certain material event information. If material, the Proposed Amendments list the following events which issuers must report:

---

160 Id.
161 Id.
162 Id.
163 Id.
164 Id.
165 Id.
(1) principal and interest payment delinquencies;
(2) non-payment related defaults;
(3) unscheduled draws on debt service reserves reflecting financial difficulties;
(4) unscheduled draws on credit enhancement reflecting financial difficulties;
(5) substitution of credit or liquidity providers, or their failure to perform;
(6) adverse tax opinions or events affecting the tax-exempt status of the security;
(7) modifications to rights of security holders;
(8) bond calls;
(9) defeasances;
(10) matters affecting collateral; and
(11) rating changes. 165

The Proposed Amendments release states that the issuer must "determine whether information needs to be disseminated about a listed event in any particular situation, and if so, when the information dissemination should occur in order to be 'timely.'" 167 For example, an issuer would be free to determine that a de minimis draw on a reserve fund due to a delay by an obligor in transferring a payment, when the draw is replaced immediately, is not a material event requiring disclosure. 168 The Proposed Amendments provide no other guidance as to what constitutes a material event or when dissemination of such an event must occur to qualify as "timely."

Finally, proposed paragraph (c) would be added to the Proposed Amendments, which would prohibit any broker, dealer, or municipal securities dealer from recommending the purchase or sale of a municipal security unless such broker, dealer, or municipal securities dealer has reviewed the information the issuer of such information has undertaken to provide pursuant to paragraph (b)(5). 169

The Proposed Amendments release emphasizes that information placed in a NRMSIR may not be the only source of information which the broker-dealer must access to meet its obligations under

165 Id.
166 Id.
at 12,762.
168 Id.
169 Id.
A broker-dealer may "obtain information directly from the issuer, from professionals such as attorneys, accountants, or other municipal securities dealers, or from any reliable source." In addition, the broker-dealer may have to conduct further investigations if it discovers any factors suggesting that the disclosure is inaccurate or incomplete, or seek to verify existing information.

In addition to the exemption provisions already in the Rule, the Proposed Amendments include a new exemption. This broad provision exempts bonds of issuers who have less than $10 million in aggregate amount of securities outstanding after an offering, including the offered securities, and who have issued less than $3 million in aggregate amount of municipal securities in the forty-eight months preceding the offering. The SEC has conceded that a large number of conduit issues, a major area of disclosure concern for Chairman Levitt, will fall within this exemption because they are "fairly small."

The Proposed Amendments release gives only a brief discussion of the application of the Tower Amendment to the SEC's activities. The release states the SEC's belief that it is not subject to the provision of the Tower Amendment which prohibits the MSRB from requiring issuers, either directly or indirectly, to provide to the MSRB or prospective investors any documents, including financial statements. This Note argues that such a reading misinterprets the legislative purpose of the Tower Amendment.

---

170 Id.
171 Id.
172 Id.
173 See supra notes 85, 99-103 and accompanying text.
174 1994 Release, supra note 15, at 12,763-64. The Proposed Amendments also contain an exemption for municipal securities broker-dealers from the provisions of proposed paragraph (c) for those securities which are exempt from proposed paragraph (b)(5). Id. See supra notes 155-72 and accompanying text for a discussion of proposed paragraphs (b)(5) and (c).
175 SEC Issues Antifraud Guidance, supra note 133, at 352. The small issuer exemption in the Proposed Amendments is discussed further in the text accompanying notes 236-41, infra. For a discussion of Chairman Levitt's position with regard to conduit bonds, see supra note 151.
177 See id. For a further discussion of the SEC's position with regard to the Tower Amendment, see infra text accompanying notes 250-35.
178 See infra Part IV.B.
IV. DO THE PROPOSED AMENDMENTS VIOLATE THE SECURITIES ACTS AMENDMENTS OF 1975?

As already explained, Congress created the MSRB in 1975 to be the primary rulemaking authority in the municipal securities market. Subpart A will discuss the legislative history behind the MSRB’s creation, and detail the Board’s powers as delegated by the 1975 Amendments. Subpart A will also discuss the adoption of the Tower Amendment. Subpart B will argue that the Proposed Amendments violate Congress’ intent in creating the MSRB and adopting the Tower Amendment. That Subpart concludes by advocating that any decision to regulate issuers must come from Congress, and not the SEC.

A. The Creation of the MSRB and the Adoption of the Tower Amendment

1. The MSRB

The 1975 Amendments came in response to incidences of fraudulent trading practices brought to light by the SEC in the early 1970s. The SEC, seeking injunctions against seventy-two municipal securities broker-dealers, found a pattern of activity including churning of customer accounts, price markups, disregard of suitability standards, high-pressure selling tactics and other so-called “boiler room” conduct. The Senate Committee on Banking, Housing and Urban Affairs concluded that “the time has come to revise the [1934 Act] to subject municipal securities professionals to essentially the same regulatory scheme that applies to other securities activities.”

The 1975 Amendments created the MSRB as a self-regulatory organization. The MSRB functions primarily to establish rules which govern municipal securities broker-dealers. The Board is structured differently than other self-regulatory organizations, how-

179 See supra note 52 and accompanying text.
180 See infra Part IV.A.1.
181 See infra Part IV.A.2.
182 See infra Part IV.B.
183 FIPPINGER, supra note 5, at 490.
184 Id.
185 S. REP. No. 75, 94th Cong., 1st Sess. 43 (1975).
186 See FIPPINGER, supra note 5, at 500; Dikeman, supra note 48, at 905.
187 See FIPPINGER, supra note 5, at 500-01.
ever, because Congress authorized it to enact rules that have the same legal force as the rules of the SEC, provided the SEC grants approval of such rules. The other self-regulatory agencies, such as the national securities exchanges, the registered clearing agencies, and the National Association of Securities Dealers, were formed voluntarily by market participants, similar to the establishment of private corporations. These other agencies do not have the rulemaking authority of the MSRB, nor were they formed by an act of Congress. In addition, the MSRB is not a self-regulatory organization for purposes of section 19(a) of the 1934 Act, does not operate as a membership organization, and has none of the trade association characteristics sometimes identified with other self-regulatory organizations.

Congress created the MSRB to maintain the SEC's general authority over transactions in municipal securities, just as in other securities. Rules promulgated by the MSRB do not have the force of law until granted SEC approval, and section 19(c) of the 1934 Act empowers the SEC to abrogate, add to, or delete material from MSRB rules. Section 17(a) of the 1934 Act requires the MSRB to prepare such reports as the SEC determines to be within the public interest, and section 17(b) gives the SEC the power at any time to examine the MSRB in the public interest. Pursuant to section 15B(c)(8), the SEC, with due process safeguards, may remove from office or censure any member or employee of the MSRB for willful violation of the 1934 Act, the SEC's rules, or the MSRB's own rules, or for a willful abuse of authority. Section 15(c)(1) and (2) of the 1934 Act were amended to give the SEC rulemaking authority to prevent

188 Id. at 501.
189 Id. at 500.
190 Id.
191 Id.
192 Id.
193 Id.
194 Id. at 501.
197 Id. § 78q(a)(1).
198 Id. § 78q(b).
199 Id. § 78o-4(c)(8).
200 Id. § 78o(c)(1).
201 Id. § 78o(c)(2).
fraudulent, manipulative, or deceptive devices, a power the SEC arguably already enjoyed under section 10(b).

Section 15B(b)(3) provides that nothing in section 15B shall be construed to impair or limit the power of the SEC. Finally, the SEC retains the power, pursuant to section 21 of the 1934 Act, to enforce MSRB rules by injunction and administrative sanction.

Despite the powers retained by the SEC and the section 15B(b)(3) reservation of powers clause, the Senate Report to the 1975 Amendments ("Senate Report") makes quite clear that Congress intended the MSRB to serve as "the primary medium for regulation of the municipal securities industry . . ." Congress intended to follow the lead of the corporate securities market in extending the principal of self-regulation to the municipal securities market. The Senate Report points to the "historical reasons which persuaded our predecessors to delegate government authority to national securities exchanges and national securities associations" and the widespread industry support for self-regulation as key reasons for "the establishment of a self-regulatory structure for the municipal securities industry.

The Senate Report acknowledges that the uniqueness of the municipal market led to, in part, the creation of the MSRB. The Report states:

It is important that the regulation of the municipal securities industry by the [MSRB] and the [SEC] take into account the uniqueness of the industry and its distinctions from the corporate securities industry. Thus, rules which may be suitable and appropriate for the former may not be so for the latter.

Congress recognized the unique nature of public finance when compared with corporate finance and acknowledged the value of having rules developed by MSRB members with expertise in the municipal securities industry.

202 Id. § 78j.
203 Id. § 78o-4(b)(3).
204 Id. § 78u.
205 S. REP. NO. 75, supra note 185, at 48; see also Dikeman, supra note 48, at 905.
206 See S. REP. NO. 75, supra note 185, at 46.
207 Id.
208 Id. at 48.
209 See id. at 47-48; see also FIPPINGER, supra note 5, at 30; Peacock, supra note 48, at 2059 ("[T]he MSRB may well be a useful fund of practical knowledge in identifying abuses without unnecessarily regulating.")
The congressionally mandated SEC approval process for proposed MSRB rules is intended to provide "an administrative forum for the education of SEC Commissioners in the unique issues of public finance, an opportunity for widescale debate of MSRB rules, and an acceptance of those rules as part of the general system of securities regulation."\textsuperscript{210} Such a process recognizes the weaknesses of the SEC, with its orientation towards corporate finance, in the complex and diverse field of public finance.\textsuperscript{211} SEC Chairman Levitt has conceded the SEC's weakness in the public finance arena by recently stating that the agency is looking to hire new staff members with expertise in the field.\textsuperscript{212}

Specifically, in section 15B(b)(2) of the 1934 Act, Congress charged the MSRB to adopt rules to provide for: (1) standards of training, experience, and competence, as well as such other qualifications as the MSRB finds necessary or appropriate in the public interest or for the protection of investors; (2) the prevention of fraudulent or manipulative acts and practices; (3) the promotion of just and equitable principles of trade; (4) the periodic examination of municipal securities broker-dealers to determine compliance with the provisions of the 1934 Act, the rules and regulations thereunder, and the rules of the MSRB; (5) the form and content of quotations relating to municipal securities, including rules designed to produce fair and informative quotations, and to prevent fictitious or misleading quotations; and (6) the prescription of records to be made and kept by municipal securities broker-dealers and the periods for which such records shall be preserved.\textsuperscript{213}

Given the MSRB's mandate, it is apparent that Congress expected the Board to be more active than the SEC in regulating municipal securities. The Senate Report's discussion of the SEC's rulemaking authority in the municipal securities markets makes this clear: "In contrast to the expansive rulemaking functions of the [MSRB], the SEC's direct rulemaking with respect to transactions in municipal securities would be limited to the control of fraudulent, manipulative, and deceptive acts and practices."\textsuperscript{214}

\textsuperscript{210} FIPPINGER, supra note 5, at 51. For a discussion of the overlapping jurisdiction of the SEC and the MSRB, see id. at 502-07.

\textsuperscript{211} See id. at 30.


\textsuperscript{213} 15 U.S.C. § 78o-4(b)(2) (1988); FIPPINGER, supra note 5, at 502; see also Peacock, supra note 48, at 2052.

\textsuperscript{214} S. REP. NO. 75, supra note 185, at 50.
The Report also states that the MSRB "should be furnished ample opportunity to develop responsible rules for the industry." Congress intended to create a regulatory organization composed of market participants that have particular expertise in the area of public finance to promulgate rules to maintain market integrity and prevent widespread abuses.

2. The Tower Amendment

Prior to the adoption of the 1975 Amendments, issuers expressed serious concern that they remain exempt from any of the registration and reporting requirements contained within the 1933 and 1934 Acts. In crafting the 1975 Amendments, Congress recognized those concerns and struck a balance between intergovernmental comity and the need for greater market regulation by incorporating the Tower Amendment into the legislation. In section 15B(d)(1) of the 1934 Act, Congress prohibits both the SEC and the MSRB from requiring any issuer of municipal securities, directly or indirectly through a purchaser or prospective purchaser of securities from the issuer, to file with the Commission or the Board prior to the sale of such securities by the issuer any application, report or document in connection with the issuance, sale or distribution of such securities.

In section 15B(d)(2), Congress further precludes the MSRB from requiring any issuer of municipal securities, directly or indirectly through a municipal securities broker or municipal securities dealer or otherwise, to furnish to the Board or to a purchaser or prospective purchaser of such securities any application, report, document, or information with respect to such issuer.

Interestingly, the section 15B(d)(2) preclusion does not include the SEC. The final sentence of section 15B(d)(2) contains a reser-
vation of powers clause which states that "[n]othings in this para-
graph shall be construed to impair or limit the power of the Com-
mission under any provision of this title."\textsuperscript{221} There is nothing in
the Senate Report or the legislative history to the 1975 Amend-
ments which indicates why the SEC was not included in the sec-
tion 15B(d)(2) proscription.

The Senate Report to the 1975 Amendments clarifies
Congress' intent in adopting the Tower Amendment. The Report
states that "nothing in the legislation contemplates direct regu-
lation of issuers or the registration of their securities . . . ."\textsuperscript{222} In
its discussion of the need for the MSRB and the SEC to recognize
the uniqueness of the municipal securities industry, the Report
states that "[m]unicipal issuers generally are, and will continue to
be exempt from the registration and reporting requirements of
the [1933 and 1934 Acts]."\textsuperscript{223} In addition, the Senate Report
makes Congress' intent quite clear: The SEC's direct rulemaking
authority with respect to transactions in municipal securities is lim-
ited to the control of fraudulent, manipulative, and deceptive
practices.\textsuperscript{224}

\begin{itemize}
\item \textsuperscript{221} \textit{Id.}
\item \textsuperscript{222} S. Rep. No. 75, \textit{supra} note 185, at 44. The Senate debate on the 1975 Amend-
ments is further illustrative of Congress' intent to continue to exempt municipal issuers
from the federal securities laws:

With respect to the authority of the [MSRB], the [Tower Amendment] would
simply clarify the position the Committee articulated in its report, namely that
the bill is not intended to tamper in any way with prerogatives of State and
local governments in their sale of securities. The amendment thus states that the
[MSRB] may not impose on issuers, directly or indirectly, disclosure require-
ments. Surely there can be no argument with that result.

Tower reiterates this position:

Under the [Tower Amendment], the Board would not have the authority to
require State and local government units to provide information about their
operations. Much of this information will undoubtedly by made available in any
case. Furthermore, the Board can obtain such information from municipal secu-
rities brokers and dealers who already supply such information to investors. The
amendment is designed to make it clear that the bill will not be a means of
subjecting States, cities, counties, or villages to any unnecessary disclosure re-
quirements which could be promulgated by the new Board.

\textit{Id.} at S10,737.
\item \textsuperscript{223} S. Rep. No. 75, \textit{supra} note 185, at 48; \textit{see also} \textit{supra} note 222.
\item \textsuperscript{224} S. Rep. No. 75, \textit{supra} note 185, at 50.
\end{itemize}
B. Are the Proposed Amendments Beyond the SEC's Authority?

In light of the legislative history behind the Tower Amendment,225 the Proposed Amendments exceed the original congressional mandate for regulating the municipal bond industry. The Senate Report makes it clear that Congress did not contemplate the direct or indirect regulation of municipal issuers with the passage of the 1975 Amendments.226 Moreover, the Report states Congress' position that the MSRB, and not the SEC, is the primary regulatory authority in the municipal bond market.227 At the very least, it is unclear whether Congress intended to exclude the SEC from the explicit proscription it levied against the MSRB in section 15B(b)(2).228 Chairman Levitt frankly conceded this ambiguity in his remark that "a complete overhaul of the existing system . . . would be the only meaningful way to ensure comprehensive disclosure both on an initial and continuing basis."229

The release containing the Proposed Amendments states the SEC's current position with regard to the Tower Amendment.230 The SEC believes that the section 15B(b)(2) proscription does not prevent it from adopting rules which mandate ongoing issuer disclosure, provided those rules are reasonably designed to prevent

225 See supra Part IV.A.2.
226 See supra notes 222-23 and accompanying text.
227 See supra notes 205-09, 214-16 and accompanying text.
228 See Vicky Stamas, SEC May Seek New Legislation Aimed at Aiding Muni Disclosure, BOND BUYER, Sept. 3, 1993, at 1 ("Under current law, the commission can regulate the activities of municipal securities broker-dealers. But it is not crystal clear under the so-called Tower amendment whether the SEC has the authority to impose any rules that have indirect impact on the activities of issuers.").
229 SEC to Seek Improved Disclosure In Muni-Bond Market, Levitt Tells Panel, 25 Sec. Reg. & L. Rep. (BNA) No. 36, at 1234 (Sept. 17, 1993). Chairman Levitt made this statement on Sept. 9, 1993 in testimony before the House Energy and Commerce Committee's Subcommittee on Telecommunications and Finance. Id. Chairman Levitt further told the Subcommittee that the power to repeal the Tower Amendment, as well as to require full disclosure in the municipal bond market, is "there to be used if necessary." Id. For a discussion of the congressional investigations into the municipal market, see supra note 105. SEC Commissioner Richard Roberts, who along with Chairman Levitt has taken a very active stance with regard to the political contribution scandal and disclosure issues, has reiterated the Chairman's position that "legislation giving the SEC clear authority to require issuers to provide secondary market disclosure is the only meaningful way to ensure comprehensive disclosure in the municipal market." Vicky Stamas, SEC's Roberts Say He's Out of Patience, Regulators Must Act on Muni Disclosure, BOND BUYER, Sept. 16, 1993, at 1.
In discussing the last sentence of section 15B(d)(2), the release states that "while prohibiting the Commission from requiring municipal issuers to file reports or documents prior to issuing securities in Section 15B(d)(1), Congress expanded the Commission's authority to adopt rules reasonably designed to prevent fraud [in section 15B(d)(2)]."232

This expansive reading of section 15B(d)(2) finds no support in the Senate Report. Indeed, it is clear that Congress intended to limit the SEC's antifraud powers in the municipal market to those powers which it already had, while giving the MSRB expansive rulemaking authority.233 It is quite possible that Congress elected not to include the SEC in the section 15B(d)(2) proscription because it intended the MSRB to be the primary rulemaking authority in the municipal market and did not envision the SEC playing a significant primary role in the regulation of the market.234 The Senate Banking Committee therefore might not have foreseen the need to include a specific proscription of the SEC's already limited powers in regulating the municipal market. Moreover, it is difficult to conceive why Congress would have proscribed the MSRB from requiring issuers to provide ongoing disclosure if the SEC could accomplish the same result by promulgating mandates such as those in the Proposed Amendments. Such a result contradicts the congressional intent of the Tower Amendment in exempting issuers from the ongoing disclosure requirements of the 1934 Act.235

The Proposed Amendments are also flawed in exempting a large number of small issuers.236 As such, the Proposed Amendments may not significantly deter fraud and market manipulation, as the SEC asserts.237 Municipal market participants agree that the largest problem they face with regard to obtaining disclosure is with small, infrequent issuers.238 Larger issuers are typically not as problematic, due to their size, market sophistication, and the
frequency with which they provide the market with updated financial statements in official statements prepared in conjunction with each new offering.\textsuperscript{239} Municipal securities broker-dealers recognize that smaller issues in the secondary market which are infrequently put out for bid are the most difficult for which to form a reliable bid, and are therefore more subject to fraud and pricing inaccuracies.\textsuperscript{240} It remains uncertain, then, whether the Proposed Amendments will deter as much fraud and market manipulation as the SEC contemplates.\textsuperscript{241}

In addition to the factors above, it is debatable whether, in light of the Statement, the Proposed Amendments are even necessary. The Statement casts as wide a net as possible over much of the public information which a municipal authority issues, subjecting such information to the antifraud provisions generally.\textsuperscript{242} The Statement unambiguously suggests that issuers disclose financial information on at least an annual basis and report material events in a timely manner in order to reduce their potential liability.\textsuperscript{243} Is it unclear how issuers will react to the threat of increased antifraud liability contained within the Statement. Issuers will likely attempt to avoid such liability by following the SEC's suggestions in the Statement, thus rendering the Proposed Amendments unnecessary.

Finally, the Proposed Amendments would effectively create a new layer of market regulation in the absence of a clear congressional mandate. Moreover, it is now clear that the SEC has become the primary rulemaking authority in the municipal market. This result was not the intent of Congress in creating the MSRB in 1975.\textsuperscript{244} If the MSRB has become ineffective or unable to promulgate rules which govern the municipal market, Congress, and not the SEC, should draw this conclusion and address the problem.\textsuperscript{245} Given that Congress explicitly intended that municipal

\textsuperscript{239} Id.
\textsuperscript{240} Id.
\textsuperscript{241} See 1994 Release, supra note 15, at 12,759-60. As previously noted, the SEC has conceded that a large number of conduit issues will fall within the exemption. See supra text accompanying note 175.
\textsuperscript{242} See 1994 Statement, supra note 13, at 12,755-56; see also supra notes 142-47 and accompanying text.
\textsuperscript{243} 1994 Statement, supra note 13, at 12,756-57.
\textsuperscript{244} See supra notes 205-09, 214-16 and accompanying text.
\textsuperscript{245} This Note expresses no opinion as to the effectiveness of the MSRB in fulfilling its congressional mandate. The author recognizes, however, that there exists significant reasons why municipal market participants might prefer to be governed by an organiza-
issuers would continue to be exempt from the registration and reporting requirements of the 1933 and 1934 Acts, it should be left to Congress to determine that the time has come to alter the current regulatory environment to include municipal issuers.

V. CONCLUSION

This Note has examined the federal regulation of municipal securities in light of current regulatory activities. Historically, federal involvement in the municipal market has been minimal, due to the relative safety of municipal securities. In response to market scandals, Congress passed the 1975 Amendments to the 1934 Act to restore municipal market integrity and deter fraud. The 1975 Amendments created the MSRB as a self-regulatory organization to accomplish this purpose. The MSRB was established to promulgate rules governing municipal securities broker-dealers. Congress intended the MSRB to function as the primary regulatory authority in the municipal market.

Despite this broad mandate, Congress carefully drafted the 1975 Amendments to not extend the MSRB's jurisdiction to the regulation of municipal issuers. Congress' intent in adopting the Tower Amendment was to continue to exempt municipal issuers from the registration and ongoing disclosure requirements applicable to corporate issuers.

In the late 1980s, the SEC assumed a more aggressive stance with regard to municipal market regulation. In publishing the Interpretation and promulgating the Rule, the SEC has attempted to improve market disclosure practices without regulating the activities of issuers. By releasing the Statement, the SEC has taken the further step of advising issuers of ways to minimize their potential antifraud liability through voluntary disclosure.

The Proposed Amendments represent an attempt by the SEC to directly regulate the activities of municipal issuers. The Senate Report to the 1975 Amendments makes clear that Congress did not contemplate granting regulatory authority for the direct or indirect regulation of issuers. Furthermore, the SEC has now assumed the role of the primary rulemaking authority in the municipal market, a result not intended by Congress in creating the MSRB. Congress, not the SEC, should decide whether the time has come to dramatically alter the regulatory landscape which

---

ition composed of market participants with special expertise in public finance.
governs municipal securities. Therefore, the SEC should withdraw the Proposed Amendments and pursue a legislative solution.

Mark Edward Laughman