Mandatory Disclosure for Municipal Securities: Issues in Implementation

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Mandatory Disclosure for Municipal Securities: Issues in Implementation

Ann J. Gellis*

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I. INTRODUCTION

The Securities Act of 1933 (the Securities Act)1 exempts securities of state and local governments from its affirmative system of mandatory disclosure. Since 1933 the market for municipal securities2 has evolved into one where a much greater number of individual investors participate on a sustained basis and issuers utilize far more diverse and complex financing devices. Nevertheless, the decision to exempt municipal securities from mandatory disclosure went unquestioned until New York City defaulted in 1975.3 That default led Congress to reconsider the exemption.4 Investigations into the workings of the municipal securities market at that time made clear that the municipal securities market operated with very limited sources of information. Although Congress ultimately failed to enact any affirmative system of mandatory disclosure for municipal

2. The term “municipal securities” refers to the debt obligations of both states and local governments. Local governments include municipalities, counties, towns, school districts, and special districts. In 1986 there were 6516 new issues of long term bonds, consisting of 106 state issues and 5656 local government issues, with a total new issue volume of $136.98 billion. The Bond Buyer, Jan. 2, 1987, at 1; id. at 17. At the end of 1986, total municipal debt outstanding was $722.92 billion, of which individual investors owned 35.08%. The other major investors are: mutual funds (18.9%), commercial banks (29.2%), and insurance companies (12.5%). The Bond Buyer, Mar. 9, 1987, at 1; id. at 7.
3. In March 1975, with $600 million in short-term notes due, New York City found itself unable to market any more of its securities to refund the notes. In an effort to avoid default and bankruptcy, the state legislature enacted a moratorium on the enforcement of $1.5 billion of the City’s short term notes. The moratorium was held unconstitutional by the New York Court of Appeals in Flushing Nat. Bank v. Municipal Assistance Corp., 40 N.Y.2d 731, 739, 358 N.E.2d 848, 852 (1976), but judicial remedies for the benefit of bondholders were denied in order to give the City and the State time to make other refunding arrangements. Payments ultimately were made on the notes. See Shalala & Bellamy, A State Saves a City: The New York Case, 1976 DUKES L.J. 1119, 1127-32 (describing the various funding mechanisms used to save the City from default).
4. See infra notes 50-59 and accompanying text.
issuers, it did provide for regulation of municipal securities brokers/dealers by the Municipal Securities Rulemaking Board (MSRB) and made explicit that municipal issuers are subject to the antifraud provisions of the Securities Exchange Act of 1934 (the Exchange Act). Also, in 1976, the Government Finance Officers Association (GFOA) promulgated voluntary disclosure guidelines for the offering statements of municipal issuers. Disclosure did increase following the New York City crisis, at least in part due to these reforms. A second major default, however, only eight years later, by the Washington Public Power Supply System (WPPSS), in the staggering amount of $2.25 billion, raised the question of whether these reforms were sufficient.

In a prior article, I proposed that it is now time, whatever the validity of the municipal exemption in the past, to institute a system of federally mandated affirmative rules of disclosure for issuers of municipal securities. I identified the important social functions served by municipal disclosure and argued that there are good theoretical and empirical reasons for believing that municipal issuers do not provide voluntarily information sufficient to serve these functions. Demonstrating the need for a mandatory disclosure scheme is but the first step in dealing with the problem. The purpose of this Article is to determine the kind of disclosure regulation system that should be implemented. Making that determination requires consideration of a number of critical issues concerning the design of the system and a weighing of the costs and benefits of the possible alternatives.

Part II of this Article sets out the context in which the design of a system of affirmative disclosure must be discussed and sets out the issues that the rest

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5. 15 U.S.C. § 78o-4 (1982). Created in the 1975 amendments to the Securities Exchange Act as a new § 15B, the MSRB regulates municipal brokers/dealers in their underwriting and trading activities. The MSRB is prohibited by statute from adopting any rules which directly or indirectly require municipal issuers to file information prior to sale or to furnish information to investors. 15 U.S.C. § 78o-4(d)(1)-(2) (1982). These provisions of the statute are known collectively as the "Tower Amendment." MSRB Rule G-32 does require underwriters to make available any public information concerning the issuer and to furnish customers with copies of any official statement prepared by the issuer. MUNICIPAL SECURITIES RULEMAKING BOARD MANUAL (CCH) ¶ 3656 (1986).


7. Municipal Finance Officers Association, DISCLOSURE GUIDELINES FOR STATE AND LOCAL GOVERNMENTS (1979) [hereinafter GUIDELINES] set forth what information that should be presented in an official statement in order to "provide a complete, accurate and objective description of those factors that relate to the securities being offered and that are necessary to make an informed investment decision." Id. at 10. The GUIDELINES also suggest the format for such disclosure. First used in 1976 in the wake of the New York City crisis, the GUIDELINES have been accepted throughout the market as the industry standard for disclosure in the official statements of states and local governments.

of the Article addresses. Part III considers what roles, if any, an administrative agency should play in the scheme: rulemaking, \textit{ex ante} enforcement through review of proposed disclosures, and \textit{ex post} enforcement through actions against violators. Part IV considers what exemptions to the disclosure requirements, if any, should be available for private placements and small issues. Part V considers whether there should be mandatory periodic disclosure by municipal issuers to provide continuing information to the secondary market. Part VI considers the extent, if at all, that issuers, issuer officers, and underwriters should be liable civilly for damages resulting from false or misleading statements in violation of the disclosure scheme.

II. THE CONTEXT AND BASIC ISSUES

A discussion of proposed legislation must start with a consideration of the context. This part of the Article addresses several basic questions. What social functions should the legislation serve? What are the shortcomings of the existing law in promoting these functions? What existing regulatory schemes of analogous activities can serve as models for the proposed legislation and what has been the experience with these models? What previous proposals have been made to deal with the problems? From this consideration of context, a map emerges of the basic issues that must be addressed in the design of an affirmative system of mandatory disclosure for municipal issuers.

A. Functions of Municipal Disclosure

The starting point for designing a system of mandatory disclosure for municipal securities issuers is a consideration of the social functions that municipal disclosure serves. First, like disclosure in the corporate securities market, mandatory disclosure for municipal securities promotes fair treatment of investors by protecting them from fraud and misrepresentation. Defenders of the existing exemption for municipal issuers argue that investor protection, so vital to the purpose and shaping of the federal securities laws governing corporate issuers, is not as important in the municipal securities market because of the sophisticated nature of its investors. Today, however, the typical investor in the municipal securities market and the typical corporate securities investor look very much alike. Furthermore, while there are fewer opportunities for officials of municipal

9. See infra notes 14-59 and accompanying text.
10. See infra notes 60-144 and accompanying text.
11. See infra notes 145-64 and accompanying text.
12. See infra notes 165-83 and accompanying text.
13. See infra notes 184-249 and accompanying text.
14. In both the corporate and the municipal securities markets, the typical investor either is a financial institution or a wealthy individual. Fifty percent of stock holdings are held by families with incomes over $100,000. Federal Reserve Bulletin, \textit{Survey of Consumer Finance} 1983, 679, 689 (Sept. 1984). While most individual investors in the municipal market traditionally have been very wealthy, the increase in individual participation in the market has resulted in a less concentrated market. In 1953, the wealthiest 1.6\% of the population held nearly 100\% of the individually-owned municipal bonds. The Bond Buyer, Aug. 27, 1986, at 1. A recent study shows that in 1983, the wealthiest 1\% of households held 70.2\% of individually-held municipal bonds. Id. Corporate bonds are overwhelmingly held by institutional investors. \textit{Corporate Bond Risk Premiums and Public Policies, A Report Prepared by the Congressional Research Service for the Use of the Subcomm. on Telecommunications, Consumer Protection and Finance of the House Comm. on Energy and Commerce, 99th Cong., 1st Sess.} 13 (1985).
issuers to benefit monetarily from issuing securities on terms that would be unacceptable to a fully informed market, and thus incentives to do so, other motivations that cause these officials to withhold material information are stronger than in a corporate setting.  

Second, disclosure promotes the efficient allocation of resources. This function, which has received increasing attention by commentators in recent years concerning corporate disclosure, is of equal importance in the municipal securities market. In a time when governments engage in wide-ranging activities, both traditional and those once the domain of the private economy, and often commit enormous sums of money to such activities, accuracy in the pricing of municipal securities becomes critical to prevent misallocation of society's scarce savings.

The third function of disclosure is peculiar to government issuers. The municipal securities market, if informed, can insure more timely adjustments in the level of public services to match changes in the tax or other revenue bases of the issuer. Through accurate pricing, the market provides an early warning signal when the level of services cannot be sustained in the long run at politically acceptable tax rates, given the current tax base. Without disclosure, disparities between expenditure levels and the ability to finance such expenditures are likely to go unrecognized until the problem becomes extreme, requiring sudden, unplanned cutbacks in services. As a general matter, neither legislators nor citizens have access to sufficient budgetary information to exercise control over government managers in order to head off such crises with more timely and less severe curtailment of services.

B. The Existing Passive System for Municipal Issuers

The only existing federal laws relating to disclosure that apply to municipal issuers and their underwriters are the antifraud provisions of section 17(a) of the Securities Act and section 10(b)—and rule 10b-5 promulgated thereunder—of the Exchange Act. These provisions, applicable to both issuers and underwriters, prohibit materially false or misleading statements in connection with

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15. See infra notes 23-38 and accompanying text. See generally Gellis, supra note 8, at (providing a more specific analysis of the factors which motivate politicians and bureaucrats not to disclose relevant information to investors).

16. Organizational controls within government bureaucracies are not as effective as those within profit-making organizations. A. Downs, Inside Bureaucracy 78, 132 (1966); Tullock, What is to be Done?, in Budgets and Bureaucracies: The Sources of Government Growth 281 (T. Borcharding ed. 1977). First, there is more difficulty in detecting distortion and biases within the system because the measures of accountability which substitute for profit-making are less well-defined and therefore not as easily implemented. Rosenbloom, Accountability in the Administrative State, in Accountability in Urban Society 87, 96 (S. Greer, R. Hedland & J. Gibson eds. 1978). Second, outside controls such as legislators and citizens suffer from significant informational disparities compared with the government bureaucracy, and thus cannot be relied on to recognize problems of fiscal mismanagement early enough to be effective monitors. Gellis, supra note 8, at __.

17. 15 U.S.C. § 77q(a) (1982). Section 17(c) specifically makes the provisions of § 17 applicable to securities otherwise exempt by virtue of § 3. 15 U.S.C. § 77q(c) (1982).


the sale of securities.20 Both provisions can be enforced by the Securities and Exchange Commission (SEC).21 While an implied private right of action is available to persons damaged by a violation of rule 10b-5, the availability of such an action to those damaged by a violation of section 17(a) is in doubt.22 These provisions constitute a passive form of disclosure regulation because they apply only to what the issuer or underwriter voluntarily chooses to say; they do not solicit information affirmatively. Nevertheless, there are good reasons to believe that municipal issuers will not provide voluntarily sufficient information to adequately serve the basic social functions of municipal disclosure. Both

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22. In Superintendent of Ins. v. Bankers Life & Cas. Co., 404 U.S. 6, 12 (1971), the Supreme Court explicitly recognized the private implied remedy under § 10(b) that the lower courts had been allowing since Kardon v. National Gypsum Co., 69 F. Supp. 512, 514 (E.D. Pa. 1946). The Supreme Court has thus far avoided the question of whether an implied remedy attaches to § 17(a). The issue is critical to plaintiffs because the Supreme Court has held that a showing of scienter is necessary to establish a cause of action for damages under rule 10b-5. Ernst & Ernst v. Hochfelder, 425 U.S. 185, 193 (1976). Scienter, however, need not be shown to establish a violation of § 17(a)(2)-3. See Aaron v. SEC, 446 U.S. 680, 697 (1980). The lower courts are divided on the question of an implied remedy under § 17(a), although Professor Loss takes the position that "if anything in the 1933 Act can be statuted categorically, the answer should be no." L. Loss, FUNDAMENTALS OF SECURITIES REGULATION 1148 (1983) (emphasis in original). To allow such private remedy, he argues, would upset the scheme of explicit civil remedies provided in §§ 11 and 12 of the Securities Act. Id. at 1148-50. In a similar vein, Loss further argues that since municipal securities are exempt from the provisions of § 12(2) of the Securities Act, buyers of municipal securities should not be able to sue under rule 10b-5 and, thus, get around the Securities Act limitation on their remedies. See 3 L. Loss, supra note 21, at 1788.

While not addressing precisely the same question, in Herman & MacLean v. Huddleston, 459 U.S. 375 (1983), the Supreme Court held that the implied remedy of rule 10b-5 was available even if the purchaser had an explicit remedy under § 11 of the Securities Act because the two remedies were distinct causes of actions. Id. at 387. The Court noted that in the 1975 amendments to the Exchange Act, Congress had left § 10(b) intact, thus, ratifying the implied private right of action. Id. at 386. Given the specific 1975 amendment to the definition of "person" in § 3(a)(9) to include states and local governments, apparently Congress intended defrauded purchasers of municipal securities to have a private right of action under rule 10b-5, despite their inability to sue under § 12(2).

The question of civil liability under § 17 in connection with municipal securities was first presented in a series of cases arising from the issuance of revenue bonds by a Nebraska authority. In one case, the court held no action could be maintained under § 17 against parties in a municipal securities transaction because of the exception in § 12(2). Citizens Cas. Co. v. Shields [1952-1956 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 90,683 (S.D.N.Y. Nov. 9, 1954). In Thiele v. Shields, actions under § 17(a) against the underwriters and an official of the issuer were permitted, but the court held that intentional misrepresentation rather than negligence (as would be the case under § 12(2)) was required to be proven. Thiele v. Shields, 131 F. Supp. 416, 419 (S.D.N.Y. 1955). Two relatively recent cases (including one in the Southern District of New York) involving municipal securities denied a private cause of action under § 17(a) against the issuers on the general theory that there is no implied private remedy under § 17(a). In re New York City Mun. Sec. Litig., 507 F. Supp. 169, 187 (S.D.N.Y. 1980); Woods v. Homes & Structures Inc., 489 F. Supp. 1270, 1284 (D. Kan. 1980).
organization theory and public choice theory suggest there are strong incentives for both politicians and bureaucrats who manage and control budgetary information not to disclose information. For both groups, either personal goals, such as re-election, budget maximization, and job security, or strongly identified organizational goals, inhibit voluntary disclosure of information when the attainment of such goals is seen as being jeopardized by such disclosure. At the same time, government managers are insensitive to the higher borrowing costs which result from nondisclosure. This insensitivity occurs because politicians value short term goals and tend to emphasize visible accomplishments, thus the long-term costs of their nondisclosure will be ignored. A passive system of regulation cannot counter this phenomenon, with the exception that once something is stated voluntarily there are penalties for not saying more if it is necessary to make what has been stated not misleading.

The historical record confirms that the antifraud provisions of the federal securities laws alone do not adequately induce municipal issuers to provide sufficient disclosure. For the period prior to 1975, the evidence supporting this proposition is overwhelming. Both municipal issuers and their underwriters were covered by section 17(a) of the Securities Act since its inception in 1933, and underwriters were covered by the Exchange Act’s rule 10b-5. Yet there was virtually no disclosure. Studies reveal a market in which all investors, sophisticated and otherwise, relied almost exclusively on the two major rating agencies. At the time of New York City’s default in 1975, Moody’s and Standard and Poor’s each had staffs of approximately fifteen. Moody’s reviewed about 3000 new issues a year and Standard and Poor’s about 1,000 a year. There were

23. The term “organization theory” relates to the theory of organizations that is built upon the characterization of the motivations of an organization’s component parts (e.g. individuals, subgroups,) and of the communications among them. See, e.g., H. Simon, Administrative Behavior 8-16 (3d ed. 1976); H. Simon, Models of Man (1957). The “public choice theory” forms a subset of organization theory and describes a theory of politics based on the applications of certain behavioral propositions of economics to governmental organizations. See, e.g., J. Buchanan & G. Tullock, The Calculus of Consent (1962).

24. See Gellis, supra note 8 at .


26. Nor are there market forces operating to create incentives for government management to disclose information voluntarily as are said to exist in the corporate securities market. In my prior article, the question considered was whether the conclusion of the agency theory of the firm that corporate officials will voluntarily supply securities markets with the socially optimal amount of information would, if true, apply as well to municipal issuers. The conclusion there is that because the monitoring devices in the public sector are significantly weaker, they are not “effective in terms of either directly enforcing good fiscal management or in obtaining information that the market can use to do the job.” Gellis, supra note 8, at ; see also sources cited infra note 42.

27. See, e.g., Petersen, Doty, Forbes & Borque, Searching for Standards: Disclosure in the Municipal Securities Market, 1976 Duke L.J. 1177, 1187-97 (reporting the authors’ findings of a survey of then current disclosure practices of municipal issuers).


29. See SEC Report, supra note 28, chapter five, at 3. Even with increased staffs, the rating
few professional security analysts or investment advisors to generate additional information.\textsuperscript{30}

The New York City fiscal crisis in 1975 significantly changed municipal disclosure practices. Until that point, only a handful of suits had been brought against municipal issuers or underwriters under either section 17 or rule 10b-5.\textsuperscript{31} New York was the first large default in the post-depression period and generated the first large securities fraud litigation.\textsuperscript{32} The suits against the city were unsuccessful because of a court holding that an implied private right of action did not exist under section 17(a) of the Securities Act and that the Exchange Act, prior to the 1975 amendments, and hence rule 10b-5 with its implied right of action, did not apply to municipal issuers.\textsuperscript{33} The major underwriters, who also were sued, ultimately settled for approximately $13 million.\textsuperscript{34} One result of the New York default was the first promulgation of the GFOA voluntary disclosure guidelines.\textsuperscript{35} These guidelines have been accepted as the standard of disclosure for municipal offering statements. Nevertheless, problems of the adequacy of disclosure remain. For example, while progress has been made, particularly in the last five years, in upgrading the quality of the financial reports of both states and local governments, use of unaudited financial statements still is not an uncommon phenomenon.\textsuperscript{36} Studies reveal that the level of disclosure

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agencies' workload of over 5000 issues a year is so great that thorough reviews of the material submitted to them, followed up with further investigation, is not likely to occur. Although the agencies are subject to the antifraud provisions of the securities laws, including section 206 of the Investment Advisors Act of 1940, 15 U.S.C. § 80b-6 (1982), which specifically deals with fraud by investment advisers (such as the rating agencies), no rating agency has ever been held liable. 2 D. GELFAND, STATE & LOCAL GOVERNMENT DEBT FINANCING § 12:16 (1986).

\textsuperscript{30} See, e.g., Municipal Securities Full Disclosure Act of 1976: Hearings on S. 2574 and S. 2969 Before the Subcomm. on Securities of the Senate Comm. on Banking, Housing and Urban Affairs, 94th Cong., 2d Sess. 253 (1977) (testimony of Professor Forbes reporting the findings of a study of 87 major institutional investors to the effect that of those 87, 53 investors did not employ a full-time municipal credit analyst) [hereinafter 1976 Hearings].

\textsuperscript{31} Doty & Petersen, The Federal Securities Laws and Transactions in Municipal Securities, 71 NW. U.L. REV. 283, 373-77 (1976). The Doty and Peterson article contains an exhaustive compilation of the securities fraud cases involving municipal securities prior to 1976 and a thorough review of the case law as of that date. The first SEC action against a municipal issuer and its officials was filed in 1976. Id. at 286. It is interesting to note that the MSRB, which opposed mandatory disclosure requirements for municipal issuers at the 1976 Hearings, did concede that "it [was] clear that the anti-fraud provisions of the federal securities laws provide inadequate guidance to market participants as to their obligations and potential liabilities in bringing municipal securities to market and therefore do not serve to further the protection of investors." See 1976 Hearings, supra note 30, at 389-90. Advocating the views of underwriters, the MSRB sought legislation that would explicitly and significantly narrow the due diligence obligations of underwriters.

\textsuperscript{32} 2 D. GELFAND, supra note 29, § 8:51.


\textsuperscript{34} 189 N.Y.L.J., Oct.14, 1983, at 1, col. 4. The suit alleged $5.1 billion in notes and bonds had been sold to the plaintiffs in the period of Oct. 1974 to Mar. 1975. No specific damage amount was alleged. The City of New York, Official Statement, Mar. 21, 1979, at 129. Estimations are that the $1.6 billion of notes which were subject to the state moratorium lost 40% of their par value. Doty & Petersen, supra note 31, at 333. Using this discount percentage, the potential damages in the securities lawsuit would have been roughly $2 billion.

\textsuperscript{35} See supra note 7.

\textsuperscript{36} For example, recent studies of municipal disclosure practices, conducted in 1985 and 1986, found that a significant percentage of issuers of both general obligation and revenue bonds still do not use audited financial statements—46% for general obligation bonds and 39% for revenue
by municipal issuers falls off dramatically in areas not covered by the GFOA guidelines (for example, the use of credit enhancement devices, such as bond insurance, a phenomenon which post-dates the most recent version of the guidelines).\(^{37}\) This suggests that issuers, underwriters, and their respective counsel have not yet internalized a sensitivity toward matters of disclosure. Furthermore, the threat of liability under the antifraud provisions, while made real by New York City, may still not be potent. In the post "New York City" period, after a brief increase in the level of litigation under the antifraud provisions in the immediate wake of several other defaults in the mid-1970s, the level has returned to that of the period prior to 1975.\(^{38}\)

Arguably, whatever shortcomings still exist in municipal disclosure, nothing more than the existing antifraud provisions are needed. The level of litigation is low because, the argument goes, the amount of fraud is low. In the rare instances where fraud does occur, the antifraud provisions give the victim a means to obtain compensation. This argument has two flaws. First, the prospects are poor that a victim of municipal fraud will receive full compensation within a reasonable time period, if ever. If the victim is the holder of a revenue bond,\(^{39}\)

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\(^{37}\) See Financial Markets Research Center, School of Business, S.U.N.Y. at Albany, *Disclosure Practices on Tax-Exempt Bond Issues: The Case of Credit Enhancements* (Nov. 15, 1985). The authors of this report found, in the absence of specific disclosure guidelines for securities with credit enhancements (e.g. insured bonds), "very little uniformity" and "an absence of substantive financial information (e.g. audited financial statements) from the supplier of the credit enhancement." *Id.* at 2. Similarly, the GASB survey of local government financial reporting practices finds that reporting practices which are useful to external users but not currently required by GAAP generally are not used. R. Ingram & W. Robbins, *Financial Reporting Practices of Local Government* (1987).

\(^{38}\) Two recent surveys of the municipal securities fraud cases report about a dozen cases in the ten-year period since New York City's default—including the securities fraud litigation arising out of that default and including suits against underwriters and bond counsel, as well as against issuers. Dinces, *Disclosure Requirements and the Role of Counsel in Tax Exempt Financings*, in *Third Annual Institute on Municipal Finance Law* 587 (1984); 2 D. Gelfand, *supra* note 29, §§ 12:09-12:15. The number of cases in which there has been liability imposed against a municipal issuer or an injunction issued are extremely small—less than a half a dozen. *Id.* §§ 8:54, 8:58. As Robert Doty says, "[t]he risk of liability for issuers and their officials, while real, has been seldom realized . . . . Monetary liability has been a rare consequence." Doty, *The Disclosure Process and the Securities Laws*, in *State and Local Government Debt Financing* § 8:58.

\(^{39}\) The term "revenue bond" generally refers to the obligations of state and local governments that are not backed by the taxing power of the issuing government. Bondholders look to the stream of revenues generated by the project to which the bonds relate for payment of principal and interest. Feldstein, Fabozzi & Longley, *1 Municipal Bond Handbook* 8, 18 (F. Fabozzi, S. Feldstein, I. Pollack & F. Zarb eds. 1983).
the reason for the default is likely to be that the project which was supposed to generate the revenues to pay the bonds is not viable. The issuer may not have any other assets with which to pay a judgment. If the victim is the holder of a general obligation bond, a court is not likely to order the immediate payment of a damage claim when it would result in a severe curtailment of public services. In neither case are the officials of the issuer likely to be in a financial position to provide full compensation. The second flaw is that concerns with poor disclosure extend beyond investor protection. In cases when the victims of poor disclosure are, in fact, fully compensated, investors are protected, but the problems of misallocation of resources and more difficult adjustment to changes in fiscal realities remain.

C. The Existing Affirmative System for Corporate Issuers

In designing an affirmative system of mandatory disclosure for municipal issuers, the closest existing analogy, the affirmative system of mandatory disclosure for corporate issuers, obviously must be examined. After a half century of experience with the corporate system, the mandatory rules of disclosure for corporate issuers serves as a useful point of comparison. The Securities Act combines an affirmative system of disclosure in its registration statement and prospectus requirements with a passive system of regulation through the enforcement of the antifraud provisions. The SEC is given broad rulemaking powers to regulate corporate financing in order to effectuate the purposes of the Securities Act.

Section 5 and section 8 of the Securities Act by their terms establish a regulatory procedure which provides for a filing of a registration statement with the SEC by corporate issuers and a twenty day "cooling off" period between the time of such filing (or any amendment thereto) and the statement’s "effective

40. The term "general obligation bond" refers to the obligations of state and local governments backed by the taxing power of the issuing government—typically the property tax at the local level. For large cities and states it may include income taxes and sales taxes as well as property taxes. Id.

41. As a general matter, bondholders have few effective remedies to enforce a money judgment. Seizure of public property is not allowed nor, except in a few states, can the property of the inhabitants be seized. Taxes cannot be ordered increased in excess of state constitutional or state statutory restrictions. See 2 D. GELFAND, supra note 29, §§ 13:47, 13:49 (providing a general discussion of bondholders' remedies).

42. The current corporate disclosure system is not without its critics. In recent years there has been considerable discussion among economists and law scholars regarding the benefits of the corporate mandatory disclosure rules to the effect that the costs substantially outweigh the benefits to investors. This conclusion is based upon the work of a number of finance theorists who posit that management will disclose voluntarily the information that investors want in order to maximize share price. See, e.g., Ross, The Economics of Information and Disclosure Regulation Debate, in Issues in Financial Regulation (F. Edwards ed. 1979); Easterbrook & Fischel, Mandatory Disclosure and the Protection of Investors, 70 Va. L. Rev. 669, 682-83 (1984); Jensen & Meckling, Theory of the Firm, Managerial Behavior, Agency Costs and Ownership Structure, 3 J. Fin. Econ. 305 (1976); see also supra note 26 (discussing why these economic theories, even if assumed to be effective in the corporate market, are not applicable in the municipal securities market).

43. Section 19(a) authorizes the SEC “to make, amend, and rescind such rules and regulations as may be necessary to carry out the provisions of the title . . . .” It is authorized to prescribe forms and methods of accounting and other matters concerning the presentation of financial information. 15 U.S.C. § 77s(a) (1982).
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date," after which sales of the registered securities can commence.\textsuperscript{44} Congress’ purpose for this regulatory procedure was to assure time for the dissemination of adequate information to investors.\textsuperscript{45} The statute vests the SEC with formal powers to require amendments to the filed registration statement prior to effectiveness in order to correct inaccuracies or inadequacies, and to issue stop orders where particularly egregious problems are discovered after effectiveness.\textsuperscript{46} By administrative practice, an informal system has evolved whereby the SEC review generates a letter of comment with which the registrant is (as a realistic matter) required to comply.\textsuperscript{47} The SEC has achieved this ability to secure compliance through use of the power given it under the statute to grant issuer requests to accelerate the date of a registration statement’s effectiveness.\textsuperscript{48} Because the registration statement, as finally amended, requires information concerning the pricing of the securities, without acceleration, the issuer and its underwriter would be in the uncomfortable position given market volatility of having to decide the price of the securities twenty days before they could be sold. In recent years, in response to the volume of filings and in an effort to speed up the process of review, the SEC has created different classes of review which it gives to registration statements depending on the type of issuer, for example well-known issuers v. unknown first-time issuers. For certain issuers the SEC undertakes no review and the time period between initial filing and the accelerated effective date is a matter of a few days.\textsuperscript{49}

\textbf{D. Earlier Proposals for Affirmative Mandatory Disclosure}

The havoc created by New York City’s default quickly drew the attention of Congress. Congress made explicit the application of the Exchange Act to state and local governments, thereby clarifying the availability of an implied right of action, by the defrauded municipal security investor, against the issuer for damages.\textsuperscript{50} Furthermore, in part because of the perceived failure of the antifraud provisions to secure adequate disclosure, in 1976 Congress also con-

\begin{itemize}
\item \textsuperscript{44} 15 U.S.C. § 77h(a) (1982).
\item \textsuperscript{45} Section 8(a) of the Securities Act states that “the effective date of a registration statement shall be the twentieth day after filing thereof or such earlier date as the Commission may determine, having due regard for the adequacy of the information respecting the issuer theretofore available to the investors . . . .” 15 U.S.C. § 77h(a) (1982). \textit{See generally} I. L. Loss, \textit{supra} note 21, at 179-80 (providing a general description of the registration scheme provided in § 5 and § 8 of the Securities Act).
\item \textsuperscript{46} 15 U.S.C. § 77h(b)-(d) (1982). The stop order procedure in § 8(d) has been interpreted by the SEC to be available, in the pre-effective period as well as in the post-effective period, to cover situations where the inadequacy of the registration statement is not apparent on its face. I. L. Loss, \textit{supra} note 21, at 179, 302-04.
\item \textsuperscript{47} L. Loss, \textit{supra} note 22, at 129.
\item \textsuperscript{48} 15 U.S.C. § 77h(a) (1982).
\item \textsuperscript{49} Beginning in 1968, the SEC initiated a process of cursory review for certain registration statements. Division of Corporate Finance’s Procedures to Curtail Time in Registration under the Securities Act, Securities Act Release No. 5231, [1972 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 78509 (Feb. 3, 1972); Expediting Registration Statements Filed Under the Securities Act of 1933, Securities Act Release No. 4934, [1968 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 77,627 (Nov. 21, 1968); In 1980, the SEC began the process of selective review, whereby only a small percentage of repeat registrants receive full review. SEC New Digest, 80-222 (Nov. 17, 1980); \textit{see also} L. Loss, \textit{supra} note 22, at 128-30 (discussing the letter of comment procedures).
\item \textsuperscript{50} \textit{See sources cited \textit{supra} note 6.}
sidered, but did not pass, two bills which would have imposed an affirmative system of mandatory disclosure on municipal issuers. One bill, proposed by Senator Eagleton, would have removed the exemption in section 3(a)(2) of the Securities Act for securities of municipal issuers, thus subjecting such issuers to the registration process of section 5 and the other provisions of the Securities Act. The other bill, proposed by Senators Williams and Tower, provided for separate legislation geared toward municipal issuers, more limited in its requirements for registration of initial offerings, but including a form of annual disclosure reporting by large issuers.

Although the differences between the municipal and corporate securities markets have been exaggerated by opponents of any affirmative mandatory disclosure for municipal issuers, the approach of the Eagleton Bill, to remove the exemption in the Securities Act for municipal securities, is properly subject to the criticism that it fails to account for differences that do exist. For example, imposing regulation on municipal securities by simply removing the exemption does not adequately confront the problem of small issues which still account, in numbers, if not dollar volume, for a significant portion of the municipal market. Nor does removing the exemption take into account the segmentation of the market between general obligation bonds and revenue bonds and the differences in marketing these two forms of debt. While the SEC would be able to deal administratively with these differences, the legitimate concerns of states and local governments for the preservation of their sovereignty under the federal scheme of government suggest more specific legislation. Part III of this Article proposes a regulatory scheme that would define as closely as possible the scope of such regulation, although not to the point of eliminating agency rulemaking.

Because the Williams Bill specifically defined the scope of regulation for municipal securities, it received more attention by commentators and participants in the municipal securities market than the Eagleton Bill. The Williams Bill designated the SEC the administrative agency in charge of regulating municipal disclosure. The SEC was given broad discretion in the important task of setting uniform standards for financial reporting by municipal issuers. This task was viewed by nearly all observers other than the issuers, to be the most needed reform. For areas of disclosure other than financial reporting, however, the bill gave the SEC a more narrowly defined authority to engage in rulemaking than is the case with corporate disclosure under the Securities Act.

51. S. 2574, 94th Cong., 1st Sess., 121 CONG. REC. 33,907 (1975) [hereinafter Eagleton Bill].
52. S. 2969, 94th Cong., 2d Sess., 122 CONG. REC. 3321 (1976) [hereinafter Williams Bill].
54. See supra text accompanying notes 60-144.
55. Williams Bill, supra note 52, § 13A(e).
56. Compare the broad authority in § 19(a) of the Securities Act, 15 U.S.C. § 77s(a) (1982), with the language of the Williams Bill in new §§ 13A(a)(4), (b)(G) that would have permitted the SEC to require "similar and specific information" if it were "necessary or appropriate in the public interest or for the protection of investors." See also 1976 Hearings, supra note 30, at 20, 26 (testimony of Roderick M. Hills, Chairman, Securities and Exchange Commission, analyzing the difference in rulemaking approaches between the Securities Act and the proposed Williams Bill).
The Williams Bill contained a number of features to limit administrative interference with the states' and local governments' financial activities. In contrast to the regulation of corporate issuers under the Securities Act, there were no pre-filing requirements, nor was there a review process by the SEC of proposed issuer disclosures. The required "distribution statements" were to be made available to brokers and dealers for prospective purchasers, and were to be filed with a central repository chosen by the SEC.\(^57\) Issues of less than $5 million were not covered by the provisions of the bill.\(^58\) In addition, there was a blanket exemption for any issue of securities, regardless of size, where a state agency approved the disclosure contained in such issuer's offering statement as adequate for the protection of investors.\(^59\)

In rejecting an administrative review process, by broadly excluding all small issues, and by allowing undefined substitution of state regulation, the Williams bill was overly solicitous of the sovereignty concerns of the states and their political subdivisions. The Williams Bill forfeited both uniformity of standards and administrative flexibility.

**E. Major Issues to be Addressed**

Consideration of these earlier proposals suggests that a well-designed, affirmative system of mandatory disclosure for municipal issuers must promote the broad functions served by disclosure in the municipal securities market outlined above. At the same time, such a system of mandatory disclosure must take into account the legitimate differences between the municipal and corporate securities markets and the relationship between the federal government and the states. Four principal issues emerge and will be the focus of this Article. First, concerning the basic operating structure of the regulatory scheme, what roles, if any, should be played by an administrative agency? Should all the rules be specified by Congress in the statute or should rulemaking authority be delegated to an administrative agency and, if so, what agency? Should compliance with the rules be subject to administrative review, as is the case with disclosure by corporate issuers under the Securities Act? Second, given the large number of municipal issuers in the market, many of them quite small, what exemptions from disclosure regulations, if any, should be available to such issuers? Third, should disclosure regulation be limited to the time of issuance of the securities, creating some form of Securities Act for municipal issuers, or should the scheme also require on-going disclosure by some or all issuers similar to that found in the Exchange Act? Last, what should be the liability of issuers, their officials,

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57. Williams Bill, supra note 52, § 13A(f)(2)-(3). At least one commentator has suggested that, since the Williams Bill required that the distribution statements were to be prepared prior to an offer or sale, id. § 13A(b)(1), and § 13A(f) was silent about when the filing with the central repository was to be made, the SEC, in fact, would have had the authority to enact by regulation a pre-filing process of review by naming itself as the repository and requiring such filing prior to the offer or sale of securities. Comment, *Federal Regulation of Municipal Securities: A Constitutional and Statutory Analysis*, 1976 DUKE L.J. 1261, 1284-85. The legislative history seems clear that this was not intended. See 1976 Hearings, supra note 30, at 21-23.

58. Williams Bill, supra note 52, § 13A(b)(1). The SEC was given the power to change the minimum amounts set forth in the statute with respect to which issuers were required to prepare distribution statements and annual reports. Id. § 13A(d).

59. Id. § 13A(c)(1).
III. THE ROLE OF AN ADMINISTRATIVE AGENCY

A critical question in the design of any regulatory scheme concerns the use of an administrative agency. One approach would be to construct the affirmative system of mandatory municipal disclosure without an administrative agency. All of the stated requirements would be set forth in the statute and compliance would be secured by the threat of private damage actions. Another approach would be to copy the model of corporate disclosure under the Securities Act. Under that approach, the administrative agency would play three roles. First, the administrative agency would make rules which would supplement the requirements that Congress imposes explicitly by statute. Second, the administrative agency would have an *ex ante* enforcement role: to secure compliance with the system by reviewing a municipal issuer's proposed disclosures prior to the issuance of its securities. Third, the administrative agency would have an *ex post* enforcement role: to secure compliance by undertaking, after the securities have been issued, legal actions against those who have engaged in actual violations. Obviously, the administrative agency need not play all three of these roles.

The first approach, no administrative agency, involves the smallest change from the existing passive system of municipal disclosure regulation and has certain attractions. It is more easily instituted as an initial matter. On its face, the first approach appears to be the least expensive form of mandatory regulation and, as will be developed, it is a less intrusive form of federal interference with state sovereignty.

The discussion below, nevertheless, concludes that a municipal disclosure system which would utilize an administrative agency to play all three roles that the SEC plays in the corporate system is desirable. A number of factors are considered in reaching this conclusion: the need for uniform, comprehensive standards of disclosure; the speed with which uniform standards can be established and the speed with which such standards can adjust to changing circumstances; the minimization of violations; the concerns of federalism; and the total social costs of the system. The discussion also concludes that the existing SEC would be the best agency to administer the municipal system.

A. Uniformity and Comprehensive Standards

One of the most persistent complaints leveled against the municipal securities market is the lack of uniformity of standards, particularly with respect to financial reporting. Municipal issuers long have resisted any attempt to adopt generally accepted accounting principles. Without uniformity of standards, it is more

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60. The level of financial reporting at the time of the New York City fiscal crisis has been described as "dismal." Few issuers used audited financials and few issuers disclosed their methods of accounting. For example, in a survey of 176 local government official statements issued in the fall of 1975, none contained a balance sheet. Petersen, Doty, Forbes & Borque, *supra* note 27, at 1187. There has been steady improvement in government financial reporting, but there continue to be problems. For example, recent survey of general obligation bond official statements found only 17 out of 123 statements were complete in that they included "the statement of revenues and
difficult for investors to compare and to evaluate the risks associated with competing investment opportunities. These difficulties subject investors to unnecessary risks of loss and reduce the accuracy of securities prices, making resource allocation less efficient and needed adjustments in the level of government spending less timely.

Experience with mandatory corporate disclosure suggests that no statute passed at one point in time and intended to be controlling for a significant period thereafter can be sufficiently precise to provide the specifics required for comprehensive, uniform standards. At least initially, each issuer would be faced with a range of possible disclosure behaviors any one of which would arguably satisfy the requirements of the statute. In theory, comprehensive uniform standards of disclosure might develop eventually under a liability rule system as issuers learned a pattern of behavior that avoids liability from observing an accumulation of court decisions. However, as the discussion in the section below suggests, it would take a long time, if ever, for such standards to develop by this route. In the interim, society would continue to suffer the effects of nonuniform disclosure. Thus, while making the statute as specific as possible would be desirable, the need for uniform disclosure argues for the establishment of an administrative agency to make supplementary rules.

The need for uniformity also supports a system to review a municipal issuer’s proposed disclosures prior to its issuance of any securities. A system incorporating such a review process would facilitate more rapidly both the development and implementation of standards than would a system dependent on enforcement of expenditures and the balance sheet for all operating funds for the two most recent fiscal years, with an audit opinion from an independent auditor indicating that the statements were prepared according to generally accepted accounting principles (as required by the GFOA Disclosure Guidelines). Forbes & McGrath, supra note 36, at 212. The areas in which compliance with GAAP is the weakest are the reporting of fixed assets and the nonuse of accrual basis accounting. Conversation with Robert Stout, supra note 36. Pension fund reporting is another area where there has not been uniform use of generally accepted accounting principles. Only 17% of the statements surveyed in the study of general obligation bond issues had complete pension fund liability disclosure, applying the GUIDELINES disclosure requirements. Forbes & McGrath, supra note 36, at 215. Recent adoption by the GASB of a statement dealing with pension fund accounting should reduce this problem. See sources cited supra note 36, with respect to the significant number of issuers not using audited financials.

61. The importance of uniform standards for the presentation of financial information in evaluating credit risk is indicated by the position taken by one of the major rating agencies. Standard and Poor’s considers the absence of financials prepared in accordance with generally accepted accounting principles to be a negative factor in the rating process. STANDARD AND POOR’S, DEBT RATINGS CRITERIA 14 (1986). See generally COOPERS & LYBRAND, FINANCIAL DISCLOSURE PRACTICES OF THE AMERICAN CITIES: CLOSING THE COMMUNICATIONS GAP 18-21 (1978) (discussing the uses of municipal financial information and their needs in terms of developing uniform standards); S. DAVIDSON, D. GREEN, W. HELLERSTEIN, A. MADANSKY & R. WEIL, FINANCIAL REPORTING BY STATE AND LOCAL GOVERNMENT UNITS 10-15 (1977) (same).

62. Standardizing information requirements also allows the market to acquire and process information more cheaply. The reduction in costs in turn makes it possible for the production of more information since more analysts and professional traders will be able to enter the market and compete. As a result, the market operates more efficiently. COFFEE, Market Failure and the Economic Case for a Mandatory Disclosure System, 70 VA. L. REV. 717, 729 (1984); Gilson & Kraakman, The Mechanisms of Market Efficiency, 70 VA. L. REV. 549, 597-601 (1984).
liability rules. As the agency engages in the day-to-day experience of applying those standards to numerous other issuers in similar situations with similar kinds of offerings, the agency will gather a wealth of information that it can use to gradually refine its standards and to identify and adapt to changing circumstances. Furthermore, when an issuer's proposed disclosures are reviewed by an administrative agency, two entities, the issuer and the agency, will have attempted to apply the existing set of rules to the issuer's situation instead of just one. Since the second entity, the agency, also reviews the proposed disclosures of all other issuers, the review process tends to promote more uniform interpretation and, hence, more uniform disclosure.

B. Dynamic Considerations

Compared to a system that utilizes agency rulemaking and agency review of proposed disclosure, reliance on the courts alone to provide issuers with guidance concerning future behavior has the major disadvantage of requiring significant time to develop the rules of the road through case-by-case decision-making. Speed is of concern in terms of both the need initially to develop a comprehensive, uniform set of standards of behavior and the need to change these standards from time to time as circumstances change.

The development of standards of behavior and communication of expectations through court dispositions and the courts' opinions require that there be a sufficient number of cases from which to fashion such rules. The experience in the corporate securities market with litigation under section 11 and section 12 of the Securities Act suggests that the amount of nonfraud litigation will be insufficient to provide a mechanism for the making of comprehensive, uniform rules.

The amount of litigation for omissions or misstatements of material information in a registration statement always has been exceedingly small. According to Professor Loss' data in his treatise, Securities Regulation, in the first thirty-five years after enactment of the Securities Act, the number of cases which were based in part on section 11 or section 12(1) totalled 111, less than half of which were finally adjudicated. Admittedly, the number of cases would have been

63. See Ehrlich & Posner, An Economic Analysis of Legal Rulemaking, 3 J. LEGAL STUD. 257, 264-65, 278-79 (1974) (discussing the relative costs and benefits of legal rules versus legal standards—rules being defined as more precise and specific than standards—in the efficient regulation of conduct and, more specifically, for an analysis of legislative rulemaking versus judicial rulemaking). Because rules are more precise, rules reduce the amount of socially undesirable activity, making litigation outcomes more certain and, therefore, increasing settlements. Thus, rules speed both communication of information about the behavior to be regulated and the resolution of disputes. Because legislative rulemaking involves high transactions costs of negotiation, however, legislatures delegate rulemaking to administrative agencies and the courts. Of the two, administrative agencies are better able to respond to changing conditions and to alter rules accordingly. Professors Ehrlich and Posner conclude that in a complex, changing society one would expect more administrative rulemaking, which they note corresponds to reality. See Cranston, Regulation and Deregulation: General Issues, 5 U.N. S.W. L.J. 1, 7-8 (1982); Pierce, Encouraging Safety: The Limits of Tort Law and Government Regulation, 33 VAND. L. REV. 1281, 1310-11 (1980) (discussing the relative merits of administrative and judicial rulemaking in terms of the process of setting standards of conduct and the effectiveness of enforcement).

64. Cranston, supra note 63, at 1; Pierce, supra note 63, at 1281.

65. 3 L. Loss, supra note 21, at 1685-91; 6 id. at 3824 (2d ed. Supp. 1969).
larger if the Securities Act had not incorporated a system of SEC review of proposed disclosures. To say that, however, is only to complement the prophylactic benefits of such review. The additional cases would have arisen entirely out of violations that were prevented under the existing system of review. In fact, as the discussion concerning compliance in the section below suggests, the increase in the number of cases that would have to occur would require a more than commensurate increase in the number of violations.66

At least as important to a comparison of the dynamics of systems with and without review of proposed disclosures is the experience with corporate disclosure. Such experience shows that the number of issues that need to be resolved to develop a comprehensive, uniform set of standards is very large. With or without a review mechanism, it is implausible that even over several decades there would be a sufficient number of cases to provide definitive resolution of all of these issues.

From the point of view of dynamic considerations, there is one disadvantage to administrative review. Compared to a system with no review, regulation which includes such a review process will yield more rules concerning what should be disclosed, at least some of which arguably are, or in time become, inefficient. Because judicial rulemaking is reactive, it can look to see if the act or omission actually caused the injury. Thus, judicial rulemaking gives "better" rules in terms of avoiding unnecessary or wrong rules. Judicial rulemaking, however, also gives fewer rules. Having fewer rules means not only eliminating the unnecessary ones, but also eliminating many needed or efficient rules which are never formulated because the issues are not presented to the courts.67 Starting with an administrative regulatory system with pre-review, the point at which reliance on judicial rulemaking has its greatest weaknesses, and then moving toward less review once a culture of disclosure has been established is a better approach. This has been the experience of the corporate disclosure system, where review requirements have been loosened selectively over time.68

66. The increase would be the result of many violations going unlitigated because of the high transaction costs of litigating small claims and because of the difficulty in discovering and proving fault. See infra text accompanying notes 71-78.

67. Administrative rulemaking occurs in an environment of more uncertainty than judicial adjudication which involves essentially bi-polar situations where one party wins and one loses concerning a specific set of facts. Because of the greater uncertainty and because agencies attempt to enact rules regulating broader ranges of conduct, administrative rules adopted ex ante likely will turn out to be wrong or inefficient. De Long, Informal Rulemaking and the Intergration of Law and Policy, 65 Va. L. Rev. 257, 346 (1979); see also Pierce, supra note 63, at 1308-11 (discussing and comparing agency determination of causation with that of the courts).

Professors Ehrlich and Posner suggest that a reduction of standards to more precise rules results in both overinclusion and underinclusion of the conduct to be regulated and that the problem is more serious the greater the uncertainty with respect to the conduct to be regulated. Ehrlich & Posner, supra note 63, at 268-71, 272-74. Agency rulemaking, therefore, operating with more uncertainty, likely will produce more overinclusive rules which deter not only the prohibited activity, but also other lawful and socially desirable activity. But see Breyer, Analyzing Regulatory Failure: Mismatches, Less Restrictive Alternatives, and Reform, 92 Harv. L. Rev. 549, 579-80 (1979) (suggesting that even if disclosure rules result in "too much, or the wrong information," unlike substantive regulatory standards, the producer's flexibility and the consumer's choice are not significantly impeded).

68. The evolution of the registration forms required by the SEC, culminating in the adoption of integrated disclosure in 1982, illustrates the process of loosening regulatory requirements over
C. Assuring Compliance

Preventing the violation of an efficient rule is desirable. As noted earlier, victims of a violation are not always compensated fully and, even when they are compensated fully, the compensation cannot cure the resulting misallocation of resources or the frustration of the process of timely adjustment to new fiscal realities. Administrative review of proposed disclosures can prevent violations. The relevant question for evaluating the compliance gains from including such a review in a system of disclosure is how many of the violations that would be prevented in advance by review would not otherwise have been deterred anyway by the threat of ex post private actions for damages or agency enforcement proceedings. Examination of this question requires consideration of: (1) the historical experience with corporate issuers under the Securities Act; (2) the behavioral tendencies of municipal issuers; (3) the structure of the process of private litigation; (4) the process of administrative enforcement of municipal violations that do occur; and (5) the enforcement role of the private bar. The third and fourth considerations also are relevant to the issue discussed above, concerning whether a lack of administrative review would generate sufficiently more litigation for courts to be able to establish in a timely fashion a set of rules that would constitute a comprehensive, uniform set of disclosure standards obviating the need for administrative rulemaking.

1. The Historical Experience with Corporate Disclosure

The mandatory disclosure system for corporate issuers includes an administrative review process and, as shown above, the number of cases brought under section 11 of the Securities Act is very small. One might conclude that the compliance gains from administrative review are significant: the small number of cases is the result of a small number of violations and the small number of violations is the result of the review process. Further reflection, however, suggests that neither causal connection is certain. Violations do not necessarily generate time. See L. Loss, supra note 22, at 149-50 (describing four stages in the SEC's maturation process, moving from non-differentiated, strict, and duplicative requirements in the form of registration statements and prospectuses, to the forms used today that broadly permit incorporation by reference of material from a registrant's Exchange Act reports). The SEC's adjustments of its letter of comment procedures evidence the same loosening process.

The loosening of requirements also may be, in part, a reflection of a changed political climate toward regulation (i.e. a part of the deregulation reform movement). See M. DERTHICK & P. QUIRK, THE POLITICS OF DEREGULATION 58-95, 241-58 (1985) (discussing the forces at work within the independent regulating agencies which propelled the regulators to deregulate in the late nineteen seventies and eighties). The authors conclude that the "independent" status of the regulatory agencies "rendered them more than ordinarily vulnerable to presidential efforts at reform," because the executive branch, using its line agencies with rival expertise, could freely criticize the independent agencies.

The fact that agency regulators are more responsive to changes in the political environment than are judicial rulemakers is, contrary to the original notions of keeping "politics" out of the independent regulatory agencies, a positive factor in evaluating the rulemaking process, because agency regulators are more accountable. Cranston, supra note 63, at 19; Breyer, supra note 67, at 583; cf. Posner, THEORIES OF ECONOMIC REGULATION, 5 BELL J. ECON., 335, 351 (1974) (arguing that the freedom of courts from political interest group pressures makes them better regulators and more likely to decide issues on efficiency grounds).
cases and, even if the number of violations is low, the low number could be explained as the result of the *in terrorem* effect of the Securities Act liability provisions. Worth noting, however, is that Professor Loss, a leading commentator in securities law, gives most of the credit to the review process, stating that "probably the greatest single deterrent to section 11 actions has been the Commission's careful examination of registration statements."  

2. **Behavior of Municipal Issuers in Response to Litigation Risks**

Municipal issuers' past behavior suggests that they will not adhere willingly to mandatory uniform standards simply out of fear of later adverse consequences. They will not flout the law's mandates, but absent a review process, minimal compliance is the most one can expect. Situations where there are countervailing pressures to disclose are common, and the short-time horizon of politicians, combined with the tendency to identify strongly with organizational goals, will cause municipal issuers to risk possible future sanctions for nondisclosure in return for the immediate perceived gains from noncompliance.  

3. **The Process of Private Securities Litigation**

The experience with corporate securities litigation, combined with particular characteristics of the municipal securities market, also suggests that reliance on liability rules alone would be an inferior enforcement mechanism. As is true in the corporate securities market, for many municipal securities investors injured by the failure of an issuer to comply with disclosure regulations, the individual injury is likely to be too small to justify a lawsuit. To the extent that these claims are not brought, the issuer does not have the incentive to avoid the social harm of nondisclosure. Class actions under Rule 23 of the Federal Rules of Civil Procedure (utilized in both the New York City and WPPSS litigations) offers an imperfect source for aggregating small individual claims. Of particular

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69. 3 L. Loss, *supra* note 21, at 1690.

70. A politician who identifies with a particular program or project will tend to measure the organization's performance in terms of the degree to which the politician's goals are reached, without regard to efficiency concerns. H. Simon, *Administrative Behavior* 212 (3d ed. 1976). Since the future sanctions for non-disclosure may well occur after the politician's term in office or at least after re-election, the politician will discount the negative effects of such sanctions. See Gellis, *supra* note 8, at ____. Moreover, the gains from full disclosure also may not be felt during the current politician's term in office in that there will be a lag between the time of the issuer's first full disclosure statement and its effect on borrowing costs. This lag occurs because the market needs time to determine that a particular issuer's behavior pattern demonstrates an intention to provide full disclosure as a general matter. Because the gain is not of advantage to current government managers and the costs are felt in the future, there is little incentive to disclose. Moreover, the economic literature on enforcement of rules suggests that when legal rules are uncertain regarding the probability of punishment, risk averse persons overcomply, but for risk preferring persons, uncertainty strengthens the incentive to undercomply. Craswell & Calfee, *Deterrence and Uncertain Legal Standards*, 2 J. L. Econ. & Org. 279, 280 (1986). While bureaucrats generally are risk averse, their superiors, in particular politicians, generally are less risk averse.

concern in analyzing the efficiency of the incentives provided by a system of liability rules is the criticism that the plaintiff's attorney in class actions has incentives to, and because of the peculiar relationship between client and attorney, is able to, enter into premature settlements for too little money. Thus, the full costs of the injuries are not borne by the wrongdoers and deterrence is incomplete. Also important to the question of the efficacy of private enforcement through class actions is the evidence that class actions tend to be linked to the level of visibility of the underlying wrong. Plaintiffs' attorneys have been found more likely to ride the coattails of a public enforcement proceeding than to engage in costly efforts to seek out less visible violations.

These problems associated with class actions may be aggravated in the municipal securities market. Typically, individual municipal securities investors, who today are the major purchasers of newly issued securities (approximately 80% as of 1984, and as of 1986, individual investors owned over 35% of the outstanding debt of state and local governments), hold their investments until maturity. The pattern of municipal defaults in the post-World War II period


72. The plaintiff's attorney in class actions sometimes has been described as a "bounty hunter" or "mercenary law enforcer," undertaking private enforcement of laws for monetary reward. Coffee, Rescuing the Private Attorney General: Why the Model of the Lawyer as Bounty Hunter is not Working, 42 Md. L. REV. 215, 218 (1983); Garth, Nagel & Plager, The Institution of the Private Attorney General, supra note 71, at ___. Because the lawyer's incentive for undertaking the litigation is the contingent fee, the lawyer will engage in tradeoffs, not always to the client's advantage, which protect his recovery. For example, studies show that fee awards decline proportionally as the recovery increases. This fact, Professor Coffee argues, means lawyers will be less willing to invest time and money as the size of the action increases, creating a problem of underfunding and an incentive to settle prematurely as compared to the client's interest in settling for the maximum amount. Coffee, supra note 71, at 686-90. Similarly, the recent study by Professors Garth, Nagel, and Plager found that lawyers traded injunctive relief for monetary awards. Garth, Nagel & Plager, The Institution of the Private Attorney General, supra note 71, at ___. Because in a class action litigation client control is virtually nonexistent over such important matters as whether to litigate, the amount spent on litigation, and timing and amount of settlement, the attorney, in Professor Coffee's words, is an "independent entrepreneur" rather than an agent, as is typically the case in other client-attorney relationships. Coffee, supra note 71, at 681-82; See generally Dam, Class Actions: Efficiency, Compensation, Deterrence, and Conflict of Interest, 4 J. LEGAL STUD. 47, 61-66 (1975) (examining the major choices an attorney must face in administering a class action).

73. Kennedy, Securities Class and Derivative Actions in the United States District Court for the Northern District of Texas: An Empirical Study, 14 HOUS. L. REV. 769, 807 (1977); Coffee, supra note 71, at 681-82 (1986). The recent study of class actions by Professors Garth, Nagel, and Plager also found private attorneys relying heavily on governmental investigations and limiting their activities to "no research" lawsuits. Garth, Nagel & Plager, The Institution of the Private Attorney General, supra note 71, at ___.

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is one in which there have been few, but spectacularly large, defaults.\textsuperscript{75} And while the nature of the municipal securities market and the financing of government services has undergone, and still is undergoing, significant changes that may result in an increased default rate in the future, the risk of ultimate nonpayment on municipal debt has traditionally been low, especially regarding general obligation bonds.\textsuperscript{76} These factors mean that lawsuits brought by individual investors are likely to be limited to the few very large defaults.

Furthermore, in cases not involving actual default, the municipal securities market presents even higher search costs for anyone who wishes to bring lawsuits for noncompliance with statutory standards than does the corporate securities market because of the range of issuers, the different kinds of municipal securities in the market, and at least initially, if there is no administrative review, the continued use by municipal issuers of different forms of accounting procedures.\textsuperscript{77} The task of uncovering and successfully litigating the issue of adequate disclosure of any one issuer's disclosure document would be formidable. Moreover, the thinness of a secondary market—municipal bonds generally are illiquid and secondary trading is limited—means that it would be more difficult to assess damages in terms of changes in market value for the securities sold in violation of the disclosure rules.\textsuperscript{78}

4. Ex Post Enforcement by an Administrative Agency

The problems with relying on private damage actions to deter violations clearly suggest the desirability of giving an administrative agency the power to

\textsuperscript{75} See Gellis, supra note 8, at \underline{\underline{____}} & nn. 27-30, (discussing the default rate and repayment record of municipal issuers). A relatively recent survey by the Advisory Commission on Intergovernmental Relations of defaults during the period 1972-83 found 36 defaults on general purpose debt (eleven of which were general obligation debt) and 82 defaults on private purpose debt. Most of the defaults were small, with three significantly large exceptions: (1) In New York City, at the time of the fiscal crisis in 1975, the city had $4.5 billion in short-term notes outstanding and $14 billion in long-term debt; $1.5 billion of short-term notes were subject to a state imposed moratorium on payment (ultimately held to be unconstitutional under the New York State Constitution in Flushing Nat. Bank v. Mun. Assistance Corp., 40 N.Y.2d 731, 739, 358 N.E.2d 848, 852 (1976)); (2) Cleveland defaulted on $15 million in bond anticipation notes and had overdue accounts of $36 million; (3) WPPSS defaulted on $2.25 billion of revenue bonds. Advisory Commission on Intergovernmental Relations, \textit{Bankruptcy, Defaults and Other Local Government Financial Emergencies} 21-22 (1985).

\textsuperscript{76} Permanent losses on principal and interest for the period 1945-1965 were less than .01% of debt outstanding in 1965. J. Petersen, supra note 28, at 111. Permanent losses on the $13.5 billion of municipal bonds in default in 1932 amounted to approximately $200 million. W. Smith, THE APPRAISAL OF MUNICIPAL CREDIT RISK 244 (1978); see Gellis, supra note 8, at \underline{\underline{____}} (discussing the reasons for the general obligation bonds' good credit record).

\textsuperscript{77} In a 1983 report on the municipal bond market, the General Accounting Office found that there were one and one-half million outstanding issues representing approximately $2,000,000,000, in contrast to 6000 outstanding corporate issues. U.S. General Accounting Office, TRENDS AND CHANGES IN THE MUNICIPAL BOND MARKET AS THEY RELATE TO FINANCING STATE AND LOCAL PUBLIC INFRASTRUCTURE, Sept. 12, 1983, at 2 [hereinafter GAO Report]. The rating agencies classify municipal debt into as many as 14 subclasses. See Gellis, supra note 8, at \underline{\underline{____}}.

\textsuperscript{78} See infra notes 165-83 and accompanying text regarding the nature of the secondary market for municipal securities.
seek sanctions in response to violations that do occur. But such public enforcement proceedings do not constitute an adequate alternative to private damage suits for ferreting out violators, except in the case of the largest defaults. As a general matter, reliance on public proceedings as the prime means of enforcement is subject to the direct political restraints of budget resources and indirect political pressures regarding how those resources are directed.\textsuperscript{79} Recognition of these limitations in the past has formed the basis for the encouragement of implied private rights of action.\textsuperscript{80} States and local governments would no more appreciate being sued vigorously by a federal agency for noncompliance than they would being subjected to prior review. Whatever scheme ultimately is adopted, political concern for state sovereignty probably will mean that a federal agency would not resort to formal public enforcement proceedings except in egregious cases.\textsuperscript{81} Because of the limits on \textit{ex post} public enforcement, it cannot substitute for private claims not brought because of incentive problems. In fact, as discussed above, such limitations actually reduce the number of private claims.

5. \textit{Enforcement Role of the Private Bar}

A review process has some other advantages that are important to assure compliance by issuers and underwriters, particularly where the system of mandatory disclosure is new or undergoes change. By providing an opportunity for dialogue between the regulators and counsel for the issuers and underwriters, and by providing for job movement between the two worlds, the system is likely to become self-enforcing in a way that would be difficult to duplicate under a system dependent on liability provisions, where counsel's role is limited solely to representing clients sued for violating the rules. The corporate securities disclosure bar has developed a positive identification with the functions of disclosure that stands apart from the customary identification with the client's interest.\textsuperscript{82} Some commentators have criticized that identification, to the effect that the securities bar, in essence, has been "captured" by the SEC because of its financial interests in the continuation of a system of mandatory disclosure

\textsuperscript{79} See Dam, \textit{supra} note 72, at 66-69 (discussing public enforcement as an alternative to the class action device). Dam notes that relying solely on public enforcement may result in suboptimal enforcement because of budget restraints and political decisions regarding the rate of enforcement. \textit{See also} Landes & Posner, \textit{The Private Enforcement of Law}, 4 \textit{J. LEGAL STUD.} 1, 36-40 (1975) (noting that while private enforcement is more vigorous than a public monopoly, it is also less likely to result in "discretionary nonenforcement" when confronted with innocent behavior inadvertently covered by overinclusive rules, and suggesting possible solutions).

\textsuperscript{80} J.I. Case Co. v. Borak, 377 U.S. 426, 432 (1964) (noting that the SEC could not alone provide for enforcement of the proxy rules given the overwhelming burden of reviewing and examining all the proxy statements filed each year).

\textsuperscript{81} Despite findings in its lengthy report on the transactions in New York City securities which would have supported an agency action under § 17 of the Securities Act, the SEC did not bring enforcement proceedings against the City. The SEC has been investigating the WPPSS default since 1984, and has been subjected to some pressure recently from Rep. Dingell, Chairman of the House Energy and Commerce Committee, to "vigorously enforce the federal securities laws." The Bond Buyer, Mar. 3, 1987, at 1, 6.

\textsuperscript{82} N. Wolfson, \textit{The Modern Corporation} 115-16 (1984). While recognizing that the securities bar as a whole is dedicated professionally to the public goals of the federal securities laws, Professor Wolfson argues that whether as regulator within the agency or as interpreter of regulation for clients, lawyers maximize their utility by seeking increased regulation. \textit{Id.} at 115.
for corporate issuers. Yet to prevent the development of identification by members of the bar with the goals of disclosure—considering the many positive attributes of that identification—and to correct problems in the rulemaking process that arise from too close an identification, would be akin to "throwing the baby out with the bath water." Looking more closely at the rulemaking processes in order to develop ways in which negotiations can occur between the regulators and the regulated, which restores balance to the process, is a better way to resolve this problem of vested interests than is eliminating regulatory input at the stage at which it can produce the most benefits.

6. Conclusion

A review of the preceding considerations suggests that a system of administrative review is likely to result in substantial compliance gains. The discussions concerning the processes of private and public securities litigation also suggest that to give an administrative agency an ex post enforcement role would be desirable, but that such a role should supplement, not substitute for, a review role.

D. Federalism Concerns

Mandatory disclosure standards for state and local governments when they issue securities inevitably would intrude on their affairs. With the reversal of National League of Cities v. Usery, little question remains concerning the

83. Id.; see also H. Kripke, THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE 22-23 (1979) (delivering a vehement attack on the relationship between the SEC and the securities bar and characterizing the relationship as one in which lawyers do not challenge SEC pronouncements on disclosure practice for fear of "making waves"). Kripke relies on an earlier article, Jenkins, Such Good Friends: The SEC and the Securities Lawyers, Wash. Monthly, Feb. 1978, at 53, which reported that lawyers surrendered their clients to SEC enforcement actions to avoid SEC "blacklisting."

84. For example, substantive rulemaking by the agency charged with administering a mandatory disclosure law for municipal securities could provide for direct negotiation with representatives of issuers and underwriters, rather than the current "notice and comment" practice with its more formal adjudicative procedures. See infra notes 92-93 and accompanying text; Stewart, Regulation, Innovation, and Administrative Law: A Conceptual Framework, 69 Calif. L. Rev. 1259, 1328-53 (1981). Professor Stewart argues for an informal negotiation process "between the agency, regulated firms and other interested groups" as a means of reducing delay, costs, and undue constraints in rulemaking, and, thus, promoting innovation. Id. at 1341. To avoid the problem of either inability to reach consensus or standards based on the lowest common denominator, he argues that the agency should retain ultimate authority. "[N]egotiation would not imply mandatory consensus but instead connote a process more informal and open and less dominated by litigation. It would also imply that agencies will enjoy more discretion and power." Id. at 1344; see generally Note, Rethinking Regulation: Negotiation as an Alternative to Traditional Rulemaking, 94 Harv. L. Rev. 1871, 1874-75 (1981) (discussing the advantages and disadvantages of the negotiation process in informal rulemaking).

85. 426 U.S. 833 (1976). National League of Cities held that the tenth amendment was an independent check on Congress' commerce clause power to regulate certain activities of the states and their political subdivisions. Id. at 852. Justice Rehnquist's majority opinion was unclear regarding what state activities were so protected. The opinion talked about traditional state functions, essential functions and attributes of sovereignty. Id. at 843-52. Arguably, the ability to engage in capital financing would have been considered basic to the government's ability to provide public services and, therefore, such activity would fall within the ambit of National League of Cities. Subsequent
The constitutionality of this intrusion even if it involves administrative rulemaking and review of proposed disclosure.\textsuperscript{86}

The intrusion also can be justified on policy grounds. At least two of the social functions of disclosure—investor protection and efficient allocation of resources—represent national goals in what is today a national market. It is unrealistic to expect the states to impose strict requirements on themselves or on their own political subdivisions in order to protect investors in a national market or to prevent the misallocation of funds to their own agents. The third goal of disclosure, assisting adjustments to new fiscal realities, is in one sense local. This goal, however, also has a quality like the \textit{Baker v. Carr},\textsuperscript{87} one-man-one-vote decision, in that a federal intrusion is justified because it sets up procedures to help states and localities better govern themselves in circumstances in which they are not capable of setting up such procedures on their own. Also, it should be noted that New York City’s nondisclosure-related failure to make such timely adjustments had national implications when the city faced the consequences of its acts.\textsuperscript{88}

Nevertheless, concern for the preservation of federalism continues to be an important value held by many participants in our political system, which suggests that the intrusion should be minimized to the extent possible consistent with attaining the goals of the system. The foregoing concern is important both in terms of structuring the role of the administrative agency in rulemaking and in reviewing proposed disclosures.

cases developed a three (or four) prong test to determine whether the regulated state activity was within the protected class—three requirements concerning the nature of the activity under challenge, and a fourth which incorporated a balancing test, weighing state and national interests. Hodel \textit{v. Virginia Surface Mining & Reclamation Assoc.}, 452 U.S. 264, 287-88 (1981). \textit{See id.} at 856 (Blackmun, J., concurring) (providing the origin of the balancing test). In Garcia \textit{v. San Antonio Metro. Transit Auth.}, 469 U.S. 528, 556-57 (1985), the Supreme Court overruled \textit{National League of Cities} finding that the rule of \textit{National League of Cities} and the tests refined from that case had proven to be unworkable and placed the judiciary in the position of choosing policies, a role properly belonging to Congress.

86. The \textit{Garcia} interpretation of the requirements of the tenth amendment rests on the states’ ability to use the political processes within Congress to protect their interests. \textit{Garcia}, 469 U.S. at 551-54.

87. 369 U.S. 186 (1962). In \textit{Baker v. Carr} the Supreme Court held that the judiciary could review a question of a state’s apportionment, reversing the lower court’s holding that, although there was a meritorious claim of fourteenth amendment violations, the suit presented a nonjusticiable “political question.” \textit{Id.} at 237. In the absence of judicial intrusion, the State of Tennessee’s legislative apportionment scheme prevented any change in the system, continuing the inequities in voting power. \textit{Id.} at 192-95. In the apportionment decisions, “the court cogently repaired a crucial void in American democratic society.” J. \textit{CHOPER, JUDICIAL REVIEW AND THE NATIONAL POLITICAL PROCESS} 102 (1980). In the present context, because of the very nature of representative government in a complex society in which bureaucracies carry out the public programs voted upon by the legislature, neither citizens nor the individual legislators will expend the requisite time and money to acquire the necessary information to effectively monitor the fiscal management of government. \textit{See Gellis, supra} note 8, at ___.

88. New York City’s default had two immediate effects: first, it created turmoil in the market which affected all issuers; second, it resulted in higher borrowing costs for other northern industrial cities. Petersen, Doty, Forbes & Bourque, \textit{supra} note 27, at 1177-78; Cook, \textit{Determinants of Individual Tax-Exempt Bond Yields: A Survey of the Evidence}, \textit{ECON. REV.}, May-June 1982, at 14, 26-27. The WPPSS default also has negatively affected interest costs for other municipal issuers. One study estimates that the WPPSS default resulted in $700 million in additional interest costs for municipal issuers in 1985. The Bond Buyer, May 30, 1986, at 4.
1. Rulemaking

As suggested above, establishing a system with uniform, comprehensive disclosure standards, capable of responding to changing circumstances, would be impossible unless the administrative agency has rulemaking powers. But the concerns of federalism argue that the statute must be as specific as possible. Such an approach provides the states with a forum—the Congress—for negotiating the terms of the regulation which forum is likely to be more sympathetic to their sovereignty than would an administrative agency. Because of their own roles as legislators and because of on-going relationships with the state and local government officials from their own individual states, members of Congress more readily identify with the political need of these governments to be able to freely structure and deliver public services to their constituencies. Thus, Congress is a more appropriate forum for weighing that need against the need for disclosure.

A number of other ways exist in which a regulatory scheme could minimize the extent of federal interference. First, the statute should specify areas of disclosure for each of the major types of municipal securities: general obligation bonds, government purpose revenue bonds, and “private purpose” revenue bonds. Some guidance is available from the ten years of experience with the Guidelines regarding what kinds of information is currently being disclosed, and the adequacy of the information for each group. The statute can be fairly specific, provided the agency has the power to grant exemptions when a provision is not applicable to a particular issuer or issue and to enact rules requiring additional disclosure to deal with new developments. In the latter case, rulemaking in the area of

89. See supra notes 60-68 and accompanying text.

90. Members of Congress are likely to have political experience at the state or local level and clearly rely on the political machinery at the state and local levels for grass roots support for election to the national level. Of the fifty newly elected members of the House of Representatives of the 100th Congress, half had served in their state legislatures, one had been governor, and seven had been either local legislators or executives. Seven of the thirteen newly elected senators had held elected positions at the state or local level, including three former governors. 44 Cong. Q. 2815-21, 2845-53 (Nov. 8, 1986).

Related to the receptiveness of individual congressmen to state concerns because of their similar political experiences and frame of reference, is Congress' place within the federalist framework of the Constitution as the political body at the national level in which states' interests are represented. The premise of the Supreme Court decision in Garcia v. San Antonio Metro. Transit Auth., 469 U.S. 528 (1985), defining the reach of the tenth amendment as a limit on Congress' power under the Commerce Clause, is the states' capability to protect their sovereignty against federal government intrusions through their state delegations in Congress. See supra notes 85-86. Noting the states' success in obtaining various forms of federal assistance and in tailoring legislation to their needs, the Court found that there are “built-in restraints that our system provides through state participation in federal government action,” such that “the political process ensures that laws that unduly burden the States will not be promulgated.” Garcia, 469 U.S. at 556. This view of the federalist scheme of the Constitution is essentially an adoption of Professor Wechsler's conception of federalism. Wechsler, The Political Safeguards of Federalism: The Role of the States in the Composition and Selection of the National Government, 54 Colum. L. Rev. 543, 547 (1954). As Professor Wechsler put it, “[t]o the extent that federalist values have real significance they must give rise to local sensitivity to central intervention; to the extent that such local sensitivity exists, it cannot fail to find reflection in the Congress.” Id.; see also J. Choper, supra note 87, at 171-90 (discussing the scope of national power relative to the states and the dispensability of judicial review).

91. See supra note 7.
substantive disclosure—other than accounting rules—could be fashioned to require some kind of formal participation by the GFOA and the MSRB, the two organizations which, as the respective representatives of municipal issuers and underwriters, are concerned actively with the functioning of the municipal securities market.\textsuperscript{92} Past experience suggests that the agency should be given sole responsibility for the formulation of accounting rules.\textsuperscript{93}

Furthermore, to the extent that the statute does not provide the kind of specificity needed for uniform, comprehensive standards, the federalism concerns of municipal issuers are in one way enhanced by including administrative rulemaking within the system. Absence of administrative rulemaking invites judicial rulemaking. The influence of municipal issuers is likely to be more easily brought to bear on an administrative agency than on a judicial rulemaker.

2. Administrative Review

In consideration of the agency's review function, a statutory scheme which decentralizes the review process, at least for issues under a certain size (e.g. $10 million), by providing for regional filings would help to minimize undue interference. Regional agency officials would have more familiarity with the demographics of the area, the major issuers, and the political environment in their region, so that their review would be more focused. At the same time, smaller issuers, in particular, are likely to feel less threatened by a regional review process and, hence, more likely to defend against what they consider to be unwarranted intrusions. A third advantage of decentralization for small issues is the reduced time it would take to get through the review process. Confirmation of this advantage comes from recent experience with corporate regional filings on Form S-18 for certain issues not in excess of $7.5 million, where the average time in registration is shorter for regional filings than for filings made at the SEC’s central office in Washington.\textsuperscript{94} Because the delay which results from any

\textsuperscript{92} By providing for direct participation by those persons to be regulated, the system should be more open to innovation in disclosure standards and be more responsive to particular issuer needs. See supra note 84.

\textsuperscript{93} See sources cited supra note 36, with respect to the long history of failed efforts to achieve consensus and uniformity in the area of accounting practices. See also J. Seligman, \textit{The Transformation of Wall Street} 551-54 (1982) (describing the corporate accounting practices prior to the creation of the Financial Accounting Standards Board (FASB) as being characterized by a similar problem of non-uniformity).

With the establishment of the FASB, the SEC has allowed the FASB to be the standard-setter, content to act as stimulator or gadfly. \textit{Id.} at 555. This secondary role of the SEC has been subject to criticism. See H. Krippke, supra note 83, at 211, 224, 278. Professor Krippke argues that the SEC, at crucial points, abdicated its responsibility to the FASB. \textit{Id.} In a similar vein, Professor John C. Burton has written that the FASB is a reactive body in which users' interests are "woefully underrepresented" which requires the SEC to exercise "compensating political power on the side of the users." Burton, \textit{What Lies Ahead for SEC Financial Reporting}, Legal Times, Oct. 8, 1984, at A2, A10.

\textsuperscript{94} The Form S-18 registration statement was adopted in 1979. 17 C.F.R. § 239.28 (1986). Studies of the use of Form S-18, one in 1981 by the Directorate of Economic and Policy Analysis of the SEC, and a 1985 study conducted by the SEC and Financial Reporting Institute, School of Accounting, University of Southern California, have found the time in registration shorter with regional filings than with central filings in Washington. Directorate of Economic and Policy Analysis, U.S. Securities and Exchange Commission, \textit{Form S-18: A Monitoring Report on the First Eighteen
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pre-filing is by itself an intrusion into the municipal issuer’s freedom to engage in the financing of government services, a process which shortens the time in review lessens the negative impact of the process.

There also could be procedures that would reduce or eliminate review altogether for the issuance of securities. Expedited treatment of certain insured issues could be provided, permitting issuers to weigh the costs of insurance against the costs of a more extensive review. As in the Securities Act, an exemption should exist for limited offerings, discussed below, for those issuers who wish to avoid the review process altogether.

Admittedly, no matter how tightly drawn the statute, it cannot eliminate all possibility of overzealous inquiry on the part of the reviewer without, at the same time, eliminating the review process. Should such excesses occur in more than isolated instances, one must rely on the political process to curb them. States and local governments in the past have not been shrinking violets when it comes to protesting a pattern of unjustified interference in what they consider to be their sovereignty.

3. Inappropriateness of the State Regulation Exemption

An inappropriate way to reduce federal intrusiveness is to offer some sort of exemption for issues subject to state disclosure regulation. The Williams bill, for example, would have provided a blanket exemption for municipal issues when “the disclosure with respect to which has been approved, after hearing, as adequate for the protection of investors by a state governmental authority (other than the issuer).” As an initial matter, few states provide for systematic disclosure review of the offering statements of their political subdivisions.

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Months of its Use, at 38 (Mar. 1981); J. MANEGOLD, AN EMPIRICAL ANALYSIS OF THE NEW ISSUES SECURITIES MARKET: THE EFFECTS OF THE FORM S-18 REGISTRATION STATEMENT 17-20 (1985). The time in registration for S-18 registrants at the central office was the same for registrants using Form S-1 (the most basic and most onerous registration statement form in terms of amount of information required) as it was for the Form S-18 statements. The Form S-1 statements studied were those of issuers also qualified to use Form S-18. Id.; see H. BLOOMENTHAL, supra note 21, § 6.10, at 124-26 (providing a brief synopsis of the requirements of Form S-18).

95. The average insurance premium is about 12 basis points. Kidwell, Sorensen & Wachowicz, Jr., Municipal Bond Insurance, 8 Mun. Fin. J. 21, 27 (1987). The SEC has discussed whether to eliminate registration requirements for insured corporate bond issues. The Bond Buyer, Mar. 24, 1987, at 4. The findings of the disclosure practices of municipal issuers using credit enhancements, however, suggest that an exemption from registration altogether may be inappropriate at this time. See sources cited supra note 37.


97. Williams Bill, supra note 52, § 13A(c)(1).

98. A handful of states require local governments to get state approval for bond issues. While the approval process in these states is designed to promote better fiscal management by reviewing the locality’s tax and debt structure and project feasibility, all of which is to the public and investors’ benefit, none specifically reviews the official statement in terms of disclosure of information. 2 D. GELFAND, supra note 29, § 11:10. In a 1984 article, the then director of Merrill Lynch’s municipal securities division specifically pointed out that the area of the municipal securities market most in need of improvement was state regulation of disclosure standards. The states, in his opinion, were not providing adequate review of disclosure documents. Rousseau, Municipal Disclosure Developments, 192 N.Y.L.J., Dec. 10, 1984, at 37, 41.
the extent legislation like that contemplated by the Williams Bill is made a part of the federal scheme and results in more states imposing such regulatory control, the problem is intensified, rather than reduced. One would have fifty states, each with its own regulatory scheme, using different standards and applying differing enforcement efforts. Uniformity would be nearly impossible.

E. The Costs of Administrative Review

Of the possible roles that an administrative agency might play in a system of mandatory municipal disclosure, the role of reviewing proposed disclosures raises a special concern of costs that merits further discussion. A system of municipal disclosure utilizing administrative review is bound to involve certain costs that would not be present in a system that relies solely on ex post enforcement mechanisms, even if we assume the same standards of disclosure for each system. The agency will require a staff to engage in the review. The issuer will incur expenses because of the time required of its lawyers and officials to negotiate with the agency and to prepare the additional documentation that the agency requests. Analyzing the importance of these costs requires consideration of several questions as they relate both to the agency and the issuer. At the time the issue is being registered, how much does administrative review add to the aggregate costs of issuance and how can these costs be minimized? Does administrative review result in savings later after the securities are issued? Are there compensating benefits in the form of a higher level of compliance with the standards?

1. Agency Costs

The only way to get a sense of the costs of maintaining a staff to review proposed municipal disclosure is to look at the history of the corporate disclosure system. The SEC's division of corporation finance, which, among other responsibilities, reviews registrations for public issues of corporate securities, employs 285 persons and has a budget of approximately $18 million. In 1985 there were 4805 registered public offerings of corporate securities.

At first blush, a municipal disclosure system would involve greater costs because the size of the job would be larger. Because most states and local governments finance their activities through public offerings, rather than private loan arrangements, the number of new municipal issues generally exceeds the number of new corporate issues. For the ten year period 1975-1985, the annual number of new municipal issues has fluctuated between 7000 and 8000 about


102. The Bond Buyer 1985 Municipal Statbook 11 (1985). In 1985, there were 11,078 issues (using The Bond Buyer data). Id. This was an unusually high number, as issuers flooded the market in anticipation of the new tax law.
twice the annual number of corporate registration statements filed during that period. In all likelihood, however, the institution of a mandatory disclosure system with an administrative review process would reduce the number of public offerings. Because there are economies of scale in going through the registration process, issuers, particularly smaller ones, may enter the market less often but for larger amounts. In addition, more states would be encouraged to form bond banks for their local governments so that a number of small financings could be grouped together in one offering, thus requiring only one review. A private placement exemption, which in some form is likely to be a part of the system, would reduce further the number of issuers, as some issuers would turn to private offerings. If an exemption for small issues is provided, the number of offerings that would need to be reviewed would be reduced further.

The agency's costs of review are not only a function of the number of issues to be reviewed but also of the procedures followed in the process. The experience in the corporate system again is helpful because the cost of mandatory corporate disclosure has been the subject of much debate and has focused attention on the SEC and its procedures. The SEC, in response to criticisms that its rules did not reflect current economic theory of how the capital markets operate, has instituted a number of changes, both in its disclosure requirements and, importantly for the purposes of this discussion, in its review procedures to respond to the concern over costs of regulation.

103. SEC ANNUAL REPORT, supra note 100, at 122, table 25.
104. The concept of the bond bank is to provide a mechanism by which small local governmental units can pool their obligations to reach wider markets and lower borrowing costs. See 2 D. GELFAND, supra note 29, § 11:36 (describing the typical bond bank statute). One report by John Nuveen & Co., investment bankers, indicated that bond banks result in upgraded ratings for issuers and substantial cuts in marketing costs. The Bond Buyer, Aug. 29, 1986, at 4.
105. See infra text accompanying notes 151-57.
106. See infra text accompanying notes 158-64.
107. One of the first to argue that securities disclosure regulation was more costly than the benefits it produced was Professor George Stigler. Stigler, Public Regulation of the Securities Market, 37 J. BUS. 117 (1964). His cause was joined forcefully by Professor George Benston in a series of articles and books on the subject. See, e.g., Benston, The Costs and Benefits of Government-Required Disclosure: SEC and FTC Requirements: An Appraisal, in CORPORATIONS AT THE CROSSROADS: GOVERNANCE AND REFORM 37 (D. DeMott ed. 1980). Other attacks on the need for mandatory disclosure have come from proponents of the agency theory of the firm with respect to the production of information, the efficient market hypothesis with respect to the distribution of information in the market, and the portfolio theory with respect to investor's ability to diversify the risk of noninformation. See supra notes 26, 42 and infra note 171. The 1977 Report of the SEC's Advisory Committee on Corporate Disclosure was undertaken in part in response to some of this criticism. See generally Seligman, The Historical Need for a Mandatory Corporate Disclosure, 9 J. CORP. L. 1, 2-9 (1983) (reviewing the debate concerning the need for the current mandatory disclosure scheme for corporate issuers). See also H. KRIPKE, supra note 83, at 32-36 (providing a critical analysis of the SEC's response to economic theory).
108. In particular, the adoption of integrated disclosure in 1982, which permits incorporation by reference to the registrant's Exchange Act filings, Adoption of Integrated Disclosure System, Securities Act Release No. 6383, [1982 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 72,328 (Mar. 3, 1982), and rule 415 which allows shelf registration by Form S-3 issuers, Shelf Registration, Securities Act Release No. 6499, [1983 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 83,449 (Nov. 17, 1983), are based on the efficient market hypothesis that once information is publicly available the market prices immediately adjust to incorporate that information. Thus, there need not be the widespread dissemination of information through a prospectus as required by the Securities Act. Fox, Shelf Registration, Integrated Disclosure, and Underwriter Due Diligence: An Economic Analysis,
could be incorporated in an administrative process for municipal disclosure. For example, many of the large issuers in the municipal securities market are frequent issuers of similar types of issues. Apart from the initial costs of instituting a mandatory disclosure system, which would require equal review of all registration statements filed, a procedure comparable to expedited review could be used for frequent issuers of substantial size. Similarly, certain insured issues could be given minimal review. For the small issuers, as will be discussed in more detail in part IV, a system permitting regional filings with perhaps different disclosure requirements would ameliorate the agency costs involved in registration. Expedited review also reduces issuer's costs.

Even after accounting for the factors just discussed that make the amount less than it appears to be initially and recognizing the inevitably rough nature of the calculations, the costs to the agency of reviewing proposed disclosures may still look substantial in absolute dollar terms. This absolute dollar value, however, is minuscule relative to the aggregate amount of newly issued municipal long-term securities ($136.98 billion in 1986). This dollar amount represents an expenditure for a procedure that the preceding discussion of uniform comprehensive standards, dynamic considerations, and compliance argues has important positive effects with respect to this very large amount of securities. Among other things, that discussion suggests that agency review would result in a higher rate of compliance than a system which relies solely on *ex post* enforcement. Avoiding violations improves the efficiency with which resources are allocated, aids issuers in adjusting to new fiscal realities, and, where there are insufficient funds to compensate the victims, aids investor protection as well. As an example, the WPPSS default of $2.25 billion represents a situation where enormous resources were wasted on a never to be finished project and where investors are unlikely to receive much in the way of compensation. The ill-fated project was funded by a series of bond offerings over a period of several years. A review of the deficiencies in the accompanying WPPSS offering statements suggests that the underlying problems which eventually led to the termination of the project would have been revealed fairly early on by the kind of review process suggested here. Consequently, much of the waste of resources and investor loss that occurred would have been avoided. The savings could

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70 Va. L. Rev. 1005, 1008 (1984). The adoption of Regulation D, in particular rules 504 and 505 with respect to small issues, and Form S-18, is a response to criticisms of the cost burden of registration, especially on small businesses. J.W. Hicks, **LIMITED OFFERING EXEMPTIONS: REGULATION D** at 5 (1986).


110. Construction of the two nuclear power plants numbers four and five to which the WPPSS bonds related was abandoned in 1984 and the take-or-pay contracts which were to provide a form of guarantee of payment of debt service by the participants in the projects have been held enforceable. Chemical Bank v. Washington Public Power Supply System, 99 Wash. 2d 772, 798-99, 666 P.2d 329, 342-43 (1983). Bondholders presently are litigating claims against WPPSS for violations of federal and state securities laws.

111. Fifteen public offerings were made between 1977 and 1981 for WPPSS Plants four and five. Gleckman, *WPPSS: From Dream to Default*, in **CREDIT MARKETS** 1, 18 (Jan. 1984).

have funded an agency review staff budget of $20 million for 110 years.113

Also to be noted is that the extent to which a review procedure prevents violations, it reduces subsequent litigation and hence the costs to the government and the public of pursuing and administering such suits through the courts. Thus, expenditures at the time of registration will be counterbalanced not only by the benefits of improved disclosure but also by the savings from a reduced need for ex post enforcement.

2. Issuer Costs

In theory, a rational issuer facing the threat of ex post enforcement and the same standards of disclosure should prepare its disclosure document with the same care and incur the same costs in terms of lawyers and staff time, whether or not it is subject to a review of its proposed disclosures. In practice, an issuer subject to review will probably incur more costs. In part this is because the issuer is not likely to act fully rationally with respect to a mere threat of liability at some point in the future.114 To the extent that the review process induces the issuer to act in its own interest and avoid the possibility of having to incur the costs of defending an action against it, both the issuer and society gain from the avoidance of violation. Another part of the issuer's extra costs may be the result of the defects in the process of ex post enforcement that lead the issuer rationally to calculate, when there is no administrative review, that the odds of a successful action against it for a violation are not sufficient to deter it.115 Here, at least society benefits from the issuer's extra costs that avoid the violation when there is review. The remainder of the issuer's extra costs will be the result of the need to negotiate with reviewers and provide documentation and amended filings where the standards of disclosure do not in fact require them. Given the fact that there are, within the political system, mechanisms for raising concerns about agency behavior and that state and local governments are staffed with persons particularly adept at using those mechanisms, these unjustified costs should not become excessive as a general matter.

A mandatory system of municipal disclosure with administrative review is also likely to have an impact on the costs issuers must incur to pay the

113. The savings, of course, does not take into account issuer costs of compliance. Some of the problems that beset the WPPSS projects numbers four and five related to very basic questions about the viability of the two nuclear power plants under construction. First, the assessment of the need for the plants appears to have been based on erroneous and overly optimistic estimates of future electric consumption in the area to be served despite the existence of other studies to the contrary. Second, there was a legal question about the enforceability of the “take or pay” contracts that, in essence, provided bondholders with a guarantee of payment even if the plants were terminated or electric usage was less than estimated. It is not possible to say with certainty that a review process accompanied by a rigorous due diligence investigation would have revealed these facts, but, absent wilful fraud on the part of WPPSS, it is more than likely that it would have.

It should be noted that investors in the WPPSS projects four and five bonds appear not to have been totally unaware that the bonds were risky because they demanded higher than normal interest rates. Yet, had investors been aware of the factors outlined above, it is unlikely that any commercially feasible interest rate would have been high enough to attract them to purchase the bonds.

114. See supra note 70 and accompanying text (reviewing expected municipal issuers' responses to possible litigation).

115. See supra notes 71-81 and accompanying text.
underwriters of their issues. Assuming the system imposed liability on underwriters for negligence in the preparation of the disclosure documents, underwriter fees will increase, whether or not there is an administrative review, both because underwriters will perceive a greater liability risk and because they will incur costs engaging in due diligence. Some commentators, however, argue that a system which does not provide an opportunity for administrative review will not produce the same amount of due diligence on the part of underwriters despite the same statutory risk of liability. Underwriters behave in this irrational fashion because they tend to ignore the long term risk of liability and focus instead on the short term risk of loss of business opportunities. Reduced due diligence may lower the price underwriters charge for their services, and hence issuer costs, for two reasons: underwriter costs will be lower and more intense competition among underwriters is possible. The first factor, however, is likely to work only in the short run since underwriters will eventually realize the increased legal risks of less due diligence and pass the costs of these risks on to the issuers. Savings from both factors come at the societal expense of a less informed securities market.

Related to the question of underwriter competition and costs is the question of what would be the effect of a system of administrative review on the issuer practice of choosing an underwriter on the basis of competitive bidding. Understanding the significance of this question requires a brief aside about the role of competitive bidding in the municipal securities industry.

At one time nearly all municipal bond offerings were competitively bid because of the prevalence of general obligation bond financings that, under many state laws, are required to be competitively bid. As with other public

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117. Fox, supra note 108, at 1030.

118. One of the arguments made in support of Rule 415 which allows registration by Form S-3 issuers of securities to be sold in the future, avoiding the delay of registration at the time of actual issuance, is the increased competition that will occur among underwriters to syndicate those securities, and the reduced cost to issuers that results from competition. Banoff, Regulatory Subsidies, Efficient Markets, and Shelf Registration: An Analysis of Rule 415, 70 VA. L. REV. 135, 152-53 (1984). Form S-3 is the short-form registration statement which permits the issuer to incorporate by reference its Exchange Act filings. Securities Act Release No. 6383, 24 SEC Docket 1262 (1982).

119. Competitive bidding is a form of underwriting distribution where the issuer advertises for bids on the securities to be offered. On the announced date for opening bids, the issuer selects the syndicate of underwriters providing the lowest effective interest cost to the issuer. See generally A. RABINOWITZ, MUNICIPAL BOND FINANCE AND ADMINISTRATION (1969) (discussing the competitive bidding process).

120. All but one state requires competitive bidding for general obligation bonds. GAO Report, supra note 77, at 17. See also 2 D. GELFAND, supra note 29, § 11:27. Most state laws, on the other hand, permit negotiated sales of revenue bonds. Id. With the enormous growth of revenue bonds in the last twenty years, the number of competitively bid issues has declined dramatically. In 1985, 2945 out of 4300 general obligation bonds were competitively bid while only 620 out of 5018 revenue bonds issues were competitively bid. Public Securities Association, Municipal Market Developments, Table 5A (Issued in 1986 tabulating 1985 data). In 1970, 17% of the bonds issued were sold through negotiated underwritings. GAO Report, supra note 77, at 17. In 1985 the percentage was 83%, and in 1986, based on preliminary figures, it was 75%. The decrease in 1986 probably is attributable to the decline in the number of revenue bond sales from about 72% of the market in 1985 to 61% of the market in 1986. The Bond Buyer, Jan. 2, 1987, at 17.
contracts, competitive bidding for underwriting contracts is thought to prevent conflicts of interest and result in lower costs to the issuers. Yet with the shift to greater reliance on revenue bonds came greater use of negotiated underwritings, so that the latest figures show, as of 1986, over 75% of the aggregate dollar volume of long term bonds were sold through negotiated underwritings. Given that the studies comparing the costs of competitively bid underwritings with that of negotiated underwritings support the contention that underwriting costs are less with competitive bidding, one might ask what accounts for the dominance today of negotiated bidding? It could be the result of improper relationships between issuers and their investment bankers. More likely, negotiated underwritings are perceived by the issuers as offering valuable services not available with competitive bidding even when separate financial advisors are employed in the pre-bidding stage. This would seem to be particularly true today, with the growing complexity of the market requiring more sophisticated financial planning and involvement by the underwriters at the initial stages of "packaging." Nonetheless, competitive bidding is still a significant part of the general obligation bond market and, if under the new tax law the use of general obligation bond financings increases as against revenue bonds, there should be an increase in the number of competitively bid municipal bonds. Thus, knowledge regarding the effects of a mandatory system of municipal disclosure, both with and without administrative review, on competitive bidding is still important.

A statutory scheme without review would allow the process of competitive bidding to continue essentially unchanged. Faced with the increased threat of

121. A. RABINOWITZ, supra, note 119, at 55.
123. See Kidwell & Sorensen, Interest Rate Differences between Competitive and Negotiated Municipal Offerings, in 1 THE MUNICIPAL BOND HANDBOOK, supra note 39, at 412, 418, which reviews the literature with respect to interest cost differentials for competitive and negotiated sales. The various studies, including the authors' own study, support the finding that negotiated bond issues sell for a "higher net interest cost than comparable competitively sold bond issues." Id. at 418.
124. In a recent article on this subject, observers of the market, such as John E. Petersen, Research Director of the GFOA, suggest that "politics" (i.e. conflict of interests) may be a reason why small, uncomplicated issues are sold through negotiated underwritings. The Bond Buyer, Apr. 30, 1987, Public Securities Association Special Edition, at 19. All seem to agree that the larger, more complex financings are unsuitable for competitive bidding. Id.
125. Municipal issuers using competitive bidding often will employ an investment banking firm or other financial consultant to assist them in determining what to market (i.e. the terms of the securities) and when to market — advice normally provided by the underwriters in a negotiated underwriting. Kidwell & Sorensen, Investment Banking and the Underwriting of New Municipal Issues, in 1 MUNICIPAL BOND HANDBOOK, supra note 39, at 169, 174.
126. The Bond Buyer, supra note 124, at 19. Issuers today do not fear being treated unfairly in a negotiated underwriting because competition among securities firms is high and negotiated sales are more responsive to changes in supply and demand. Lamb & Schott, Jr., Price Efficiency of Competitive Bidding on New Issues in the Municipal Securities Market, 8 MUN. FIN. J. 9, 14-15 (1987).
127. Approximately 45% of the general obligation bond issues for 1985 were competitively bid. While state laws generally require competitive bidding, see sources cited supra note 120, there are a number of exceptions permitted, such as failure to receive two or more bids or sales to other governmental entities. 2 D. GELFAND, supra note 29, § 11:28.
128. See sources cited supra note 120 (discussing statistics showing a decrease in the number of revenue bond issues for 1986).
liability that mandatory municipal disclosure would impose, underwriters would respond in one of three ways. One response would be to increase fees to cover the new risk, since competitive bidding by its terms does not afford an opportunity for a traditional due diligence investigation by underwriters. Second, in situations where the costs of investigation of the issuer would be less than what underwriters would charge for the unknown risk, one would expect a tendency to switch to negotiated underwritings. Where that switch does not happen, one would expect some accommodation within the competitive bidding process for a modified form of due diligence, perhaps the appointment of independent counsel for the underwriters, as was the practice for many years in the corporate securities market with respect to competitively bid public offerings by public utilities.

A possible third response would be to shift the risk to the issuers by having the issuers agree to indemnify the underwriters in the event of liability. The value of such indemnification would depend on the credit worthiness of the issuer and the estimation of the chances that a court would find such indemnification to be enforceable, and not void as against public policy.

The likely outcome, in practice, is that the first alternative—higher fees to cover increased risks—would prevail, except in instances where underwriters are already aware of credit difficulties—for example, New York City in the late seventies—in which case there would be either a switch to negotiated underwriting.

129. The typical procedure for a public sale (i.e. competitive bidding) is for a notice to be published advertising the sale and requesting the submission of bids. The time interval between notice and the opening of the bids is usually a week. The issuer's official statement is available for prospective bidders to review during this period. Allotments are made and bonds sold within hours of the selection of the winning bid. Thus, there is no time to sit down with the issuer and ask questions about the information in the official statement or anything else. Kidwell & Sorensen, Investment Banking and Underwriting of New Municipal Issues, in 1 THE MUNICIPAL BOND HANDBOOK, supra note 39, at 169, 173-77; 2 D. GELFAND, supra note 29, § 11:29; Lamb & Schott, Jr., supra note 126, at 15.

130. Rule 50, adopted in 1941 under the Public Utility Holding Company Act of 1935, required public utility holding companies and their subsidiaries to use competitive bidding when they sold securities. 17 C.F.R. § 250.50 (1987). The rule in essence was recently superceded by the SEC's allowing utilities to use rule 415, with respect to shelf registrations. Holding Co. Act Rel. 22,623, 26 SEC Docket 39 (1972). Because public offerings by these companies were to be registered under the Securities Act before sale in the same manner as any other public issuance of securities by a corporate issuer, and such filing occurred before the selection of the winning bid, the practice developed of the issuer selecting an independent counsel to represent the yet unknown underwriters in the preparation of the disclosure documents. N. WOLFSON, CONFLICTS OF INTEREST: INVESTMENT BANKING 14 (1976) Greene, Investment Bankers: Determining the Responsibilities of Underwriters Distributing Securities Within an Integrated Disclosure System, NO. DAME L. W. 755, 792 (1981); Henkel, The Auction Block for Securities, 36 VA. L. REV. 701, 714-15 (1950).

131. Current corporate practice is for the issuer to agree in its underwriting agreement to indemnify the underwriters for material misstatements in the prospectus and the registration statement other than in information supplied by the underwriters. The SEC has long taken the position that provisions with respect to issuer indemnification of officers and directors are unenforceable as being against public policy because such provisions weaken the in terrorem effect of section 11 liability under the Securities Act. 3 L. Loss, supra note 21, at 1834-35. This position has not been extended, however, to the cross indemnification agreements between issuer and underwriters. Id. Nevertheless, the question still is open whether such provisions under any particular fact pattern will be upheld in court. See e.g., Globus v. Law Research Serv., Inc., 418 F.2d 1276, 1288 (2d Cir. 1969) (court upheld the district court's refusal to allow indemnification of an underwriter by the issuer where the underwriter had actual knowledge of the misstatements).
or the requirement of independent disclosure counsel. Arguably, issuers, in turn, will respond by providing the information mandated as fully as possible in order to reduce these costs. Yet, as I argued in my prior article, public officials, as a general matter, may not be as sensitive to costs as their counterparts in the private sector. They may be willing to pay higher borrowing costs in return for minimal disclosure. Also, the extent to which an issuer is forthcoming is not always fully apparent to an underwriter, and the time it may take for an issuer to develop a reputation in this regard, and hence for its behavior to affect its costs one way or the other, may be considerable.

An administrative review process, on the other hand, does not fit easily with competitive bidding because the identity of the underwriting syndicate is not known until a very short period before the sale of securities to the public. The solution worked out by the SEC in rule 50 under the Public Utility Holding Corporation Act was for the issuer to appoint independent disclosure counsel who represented the yet unknown underwriters in the registration process. This arrangement was less than ideal in terms of optimal disclosure. Problems of counsel identification with the issuer and routinized disclosure were common complaints. One commentator suggested as an alternative that underwriting teams be used to perform due diligence in order to avoid the inherent conflict of interest when issuers choose the investigating counsel. With either solution, the likely result is that, once representatives of the underwriters are required to be participants in the preparation of the disclosure document, one of the positive features of competitive bidding from the issuer’s perspective will be lost, and issuers will turn to negotiated underwritings.

In the end, it is not possible to prove in ledger fashion that the proposed disclosure regulation, or for that matter any other proposed regulation, will yield greater benefits than costs. Estimating the benefits and costs of a regulation not yet in existence is inevitably speculative. To require definitive proof that benefits exceed costs in almost every instance would doom regulatory initiative at the outset. This Article has demonstrated the existence of a serious problem and has explored as fully as possible the general magnitude of the costs of curing it by regulation. It remains for later empirical study once a system of regulation is in place to measure more definitively whether predicted benefits have materialized and at what cost.

F. The Appropriate Administrative Agency

If, as suggested here, the mandatory system of municipal disclosure involves an administrative agency, what agency should that be? At least three options come to mind: the SEC, a newly created agency, and the MSRB.

132. The underwriters insisted on New York City having special disclosure counsel for its securities offerings in addition to the traditional bond counsel.
133. Because the full impact of higher borrowing costs are felt in the future beyond the politician’s term in office, those costs may be discounted. See Gellis, supra note 8, at ___.
134. See sources cited supra note 129; see also 1976 Hearings, supra note 30, at 126 (testimony of Richard Kezer, President, Dealer Bank Association, arguing that due diligence and competitive bidding were incompatible because of the timing problems and the search costs).
135. See sources cited supra note 130.
136. N. Wolfson, supra note 130, at 14-15; Greene, supra note 130, at 792.
137. N. Wolfson, supra note 130, at 15.
The advantages of using the SEC are obvious. It has fifty years of experience in regulating securities disclosure. Furthermore, while opponents will argue as they did in 1976 that it lacks specific experience with municipal financial matters, it is the agency that is charged with investigation of municipal securities fraud under the Securities Act and the Exchange Act, suggesting that the agency's understanding of disclosure is capable of a broader application. Moreover, the SEC also is responsible for approving the rules of the MSRB concerning regulation of municipal brokers/dealers.

The disadvantage of placing regulatory authority with the SEC is the difficulty of having one agency administering two different disclosure schemes, particularly in terms of the regulatory behavior of the administrators. Concern with this problem is the main argument for creating a new agency. The need for regulation of municipal disclosure is fired less by the need for protection against securities fraud, and more by the need for efficient allocation of resources and better fiscal management of public sector expenditures. Any regulatory approach must be mindful of both state sovereignty concerns and of the role played by politicians in government operations. Politicians are not the functional equivalent of corporate management, and their relationship with, and public communications to, their citizens are not solely those of agent and principal. Therefore, the kind of regulatory scheme envisioned here, while incorporating a review process, nevertheless contemplates a fairly structured statute. One can imagine that the SEC, even with distinct branches, might have difficulty adjusting to a narrower approach to its functions. Having a new agency would avoid these problems. It would, however, create other problems, such as the duplication of effort in the general area of securities disclosure and fragmentation of regulatory authority, unless the SEC were to be divested of its powers with respect to municipal securities fraud and regulation of municipal brokers/dealers. In addition, start-up costs would be higher.

Between the SEC and a new agency, either choice is justifiable, but the SEC may be marginally preferable. It makes sense to utilize the existing expertise within the SEC while keeping securities regulation under one umbrella agency. The third option, placing the regulatory powers with the MSRB, which presently exercises the only day to day regulatory authority in the municipal securities

138. See, e.g., 1976 Hearings, supra note 30, at 143, 147 (statement of the Securities Industries Association, contesting the Williams bill provisions which vested regulatory authority with the SEC); see also id. at 240-41 (testimony of Richard Smith, Chairman, Subcommittee on Municipal and Governmental Obligations of the ABA Committee on Federal Regulation of Securities, suggesting that given the fact that the SEC does not have expertise in municipal finance comparable to its expertise in corporate finance, in the interest of federalism, a national council composed of state and local officials appointed by the President be used to set uniform (but non-mandatory) disclosure standards).


140. A disclosure scheme for municipal issuers must make allowances for statements, arguably fraudulent, made by politicians to their public, as distinguished from statements specifically for investor consumption. Similarly, pre-offering activities by municipal issuers cannot be overly restricted to prevent officials from performing their political leadership responsibilities. Note, Federal Securities Fraud Liability and Municipal Issuers: Implications of the National League of Cities v. Usery, 77 COLUM. L. REV. 1065, 1070-76 (1977).
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market, should be rejected. Created in 1975 in response to abusive practices by municipal brokers and dealers in dealing with their customers, the MSRB incorporates the notion of self-regulation, parallel to the regulatory scheme for corporate securities brokers/dealers. The make-up of the MSRB is weighted decidedly toward the municipal securities underwriters with five broker-dealer representatives, five bank representatives, and five “public” representatives, at least one of whom is to represent investors, and one of whom is to represent issuers. Therefore, the MSRB rules would not be viewed by issuers as impartial. Moreover, underwriters as a group are likely to seek to minimize their own exposure to liability by limiting the disclosure requirements. In fact, from its inception, the MSRB has spoken out against any mandatory disclosure regulation, including the Williams bill. Thus, the MSRB is an inhospitable place to vest regulatory authority for mandatory disclosure.

IV. Exemptions

Municipal issuers, like corporate issuers, should have an alternative to the registered public offering. At the extreme, there is no interest in capturing the individual loan negotiated face to face between a municipal borrower and a lender within the mandatory disclosure rules. Such a lender should be able to obtain, through negotiations, all the disclosure required for its decision. On the other hand, as discussed in more detail below, when there is sufficiently more than one purchaser of an issuer’s securities, without mandated disclosure, there does not exist adequate incentives for any participant, even an underwriter, to seek out and make available to the other participants the same amount of information that a single large lender would obtain from the issuer.

An exemption for situations where no such incentive problem exists because of the nature of the purchasers and their relatively small number would provide a useful mechanism for re-channeling some of the municipal securities offerings which are currently done as public offerings into private placements. This would both assist the operational efficiency of the review process and provide issuers with a possible lower cost alternative to a registered public offering. Consideration

141. Doty & Petersen, supra note 31, at 343-44.
143. 1976 Hearings, supra note 30, at 390-97 (statement of the Municipal Securities Rulemaking Board). In recent hearings on a proposal to include regulation of government securities dealers within the jurisdiction of the MSRB (which would have been renamed the Public Securities Rulemaking Board), the MSRB strongly opposed the proposed deletion of the Tower Amendment, § 15B (d), which prohibits the Board from requiring issuers to furnish information to the Board or to any purchaser. 1985 Hearings, supra note 74, at 69-72 (statement of Donald J. Robinson, Chairman, Municipal Securities Rulemaking Board). In an abrupt policy shift, the MSRB in August 1987 indicated that the Board is now supportive of mandatory disclosure rules. The Bond Buyer, Aug. 25, 1987, at 1.
144. Another alternative has been suggested in the past as a middle course between a regulatory agency and the current system of voluntary affirmative disclosure. This alternative is to have a “national council” which would issue the appropriate guidelines for disclosure. See, e.g., 1976 Hearings, supra note 30, at 240 (testimony of Richard B. Smith, Chairman, Subcommittee on Municipal and Governmental Obligations of the ABA Committee on Federal Regulation of Securities). Difficulties in deciding who should be represented on the council and how members would be appointed is but one reason to reject this approach. More importantly, such an approach is unlikely to be effective in producing full disclosure by municipal issuers.
also should be given to the desirability of an exemption, or at least reduced registration requirements for small issuers, because agency and issuer costs of achieving the goals of mandated disclosure are, on a per dollar of capital raised basis, higher than with larger issues.\textsuperscript{145} The transaction exemptions for limited offerings by corporate issuers that exist today are convoluted and in some places redundant. They represent efforts, over time, of both Congress and the SEC to provide, consistent with the purposes of the Securities Act, relief to issuers for issues which are sold to a limited number of persons or which are small in aggregate amount.\textsuperscript{146} The current exemptions contained in section 4(2),\textsuperscript{147} section 3(b),\textsuperscript{148} section 4(6),\textsuperscript{149} and in Regulation D\textsuperscript{150} are instructive and provide a structural framework for coming to terms with similar exemptions for the municipal securities market. These exemptions, however, should not be accepted carte blanche.

A. Private Placement Exemption

The private placement exemption for municipal issuers should be a simplified one, extending to issues unlimited in amount, but limited as to both the nature of investors and the total number of investors. All investors to whom municipal

\textsuperscript{145} Recognition of the greater burden placed on small corporate issuers by the registration requirements of the Securities Act is reflected in the adoption of the Small Business Investment Incentive Act of 1980, the adoption of Form S-18, and the promulgation of Regulation D in 1982. See generally J.W. Hicks, supra note 108, § 1.02, at 2-6 (1986) (discussing Congress' concern for small business as a part of the background to the enactment of Regulation D).

\textsuperscript{146} The primary statutory transaction exemption from the registration requirements of the Securities Act is § 4(2), or the "private placement" exemption, which exempts "transactions by an issuer not involving a public offering." Until the adoption of rule 146 in 1974, issuers relied on SEC and court determinations of "when the exemption would not be available." Carney, Exemptions from Securities Registration for Small Issuers: Shifting from Full Disclosure: The Private Offering Exemption, Rule 146 and an End to Access for Small Issuers, 10 LAND & WATER L. REV. 507, 516 (1975). Rule 146 was an attempt to provide a "safe harbor" by specifying specific criteria for a private offering. It was replaced in 1982 with rule 506 of Regulation D that broadly exempts sales of unlimited amounts to unlimited numbers of "accredited persons" and a maximum of 35 non-accredited, but otherwise sophisticated, persons. In addition to rule 506, rule 504 exempts offers and sales by certain issuers non-reporting companies and non-investment companies of up to $500,000 in securities to an unlimited number of persons, and rule 505 exempts offers and sales of up to $5 million within a twelve-month period to unlimited accredited persons and 35 non-accredited persons by non-investment company issuers. Regulation D does not eliminate the availability of an exemption under § 4(2). See generally 7C J.W. HICKS, EXEMPTED TRANSACTIONS UNDER THE SECURITIES ACT OF 1933, § 11 (1987) (analyzing the interpretation of § 4(2) and the interrelationship between § 4(2) and rule 506); J.W. HICKS, supra note 108, at 38-333 (analyzing rules 501 through 506 (Regulation D)).

In addition to § 4(2) and Regulation D, § 4(6) of the Securities Act provides an exemption for the issuance of securities of up to $5 million, offered and sold to accredited investors, and generally allows in § 3(b) for the SEC to exempt securities under that section in the aggregate amount of $5 million. J. HICKS, supra note 108, at 4. Rule 505, adopted pursuant to § 3(b) of the Securities Act (the small offerings exemption), is limited in the aggregate sales amount to $5 million in a twelve-month period. Rule 506, adopted pursuant to § 4(2) exemption, is unlimited in the amount of sales. See N. WOLFSON, supra note 82, at 129-35 (providing a brief, critical review of the SEC's approach to exemptions from § 5 for small issuers and small financings).

\textsuperscript{150} 17 C.F.R. §§ 230, 501-06 (1986).
securities can be sold in a private placement should be "accredited," borrowing loosely from terminology of the Securities Act.\footnote{151} Rule 506 of Regulation D, which covers private placements of corporate issuers, allows sales to unlimited numbers of accredited persons and, in addition, to 35 non-accredited persons, conditioned upon such non-accredited persons being financially sophisticated and receiving prescribed disclosure information.\footnote{152} There is little reason, however, to permit private placement sales of municipal securities to non-accredited persons. Such persons are not likely to be needed to implement a successful private placement of municipal securities, given that the traditional investors in municipal securities have been commercial banks, insurance companies, and wealthy individuals. To allow private placement sales of municipal securities to unaccredited persons unnecessarily introduces problems of deciding on the level of disclosure to be required and monitoring compliance.

A limitation on the number of investors as suggested is a departure from the corporate securities case law interpreting section 4(2) and from rules 505 and 506 of Regulation D which impose no limit on the number of qualified or accredited purchasers.\footnote{153} For example, an offering to two hundred individuals, each with a net worth of $1 million, qualifies as a limited offering under rule 506.\footnote{154} Yet, at some point, no matter how capable each of these individual investors is at fending for himself and withstanding losses, the amount of information disclosed, which may or may not be sufficient for investor protection, will fall short of what is required for the other functions of disclosure. With a large number of investors, no single investor has the incentive to expend resources to obtain information, but will seek to free ride on the benefits of disclosure presumably secured by the other investors.\footnote{155} The earlier years of the municipal securities market, which were characterized by public offerings to investors who were either financial institutions or wealthy individuals, show that when there are a large number of investors, their financial sophistication is not enough to produce adequate information.

Limited offerings of corporate securities carry with them restrictions on the resale of the securities in order to prevent subsequent distribution without

\footnote{151} The amendment of the Securities Act in 1980, adding § 4(6), introduced the term "accredited person" which is an attempt to define the types of investors not in need of the Act's protection because of their financial sophistication and wealth. Section 2(15) specifically includes certain institutional investors, such as banks, insurance companies, registered investment companies, and employee benefit plans, as accredited persons. \footnote{152} \footnote{153} \footnote{154} \footnote{155} See generally \footnote{152} J.W. Hicks, supra note 146, § 11.08 (discussing the nature of the purchasers required for rule 506 and a comparison with rule 146, the earlier safe harbor limited offering rule, with respect to investors and the issuer's obligations to determine their sophistication). \footnote{153} \footnote{154} \footnote{155} Section 4(2), as interpreted by the SEC and the Supreme Court, focuses on the number of offerees as opposed to purchasers. Rule 506 is a departure from § 4(2) in that it looks at purchasers. Regarding the number of offerees one could have and still qualify for a "private placement" under § 4(2), the Supreme Court has held that there is "no warrant for superimposing quantity limit on private offerings . . . ." SEC v. Ralston Purina, 346 U.S. 119, 125 (1953). \footnote{154} \footnote{155} The rule 501 definition of "accredited investor" includes "any natural person whose individual net worth or joint net worth with that person's spouse, at the time of his purchase exceeds $1,000,000." 17 C.F.R. 230.501(a)(6) (1986). \footnote{155} See Easterbrook & Fischel, Voting in Corporate Law, 26 J. L. & Econ. 395 (1983) (making an analogous argument regarding the behavior of shareholders in voting).
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registration. Under rule 144, the purchaser must hold the securities for at least two years before any sales can be made in order to establish "investment intent," and subsequent sales are limited in amount and in the manner of sale.156 Under the limited offering exemption outlined above for municipal securities, some restriction on resale similarly would be needed to avoid end-runs around the registration process. Investors should be required to hold the securities for a period of time before resale to the public in over-the-counter trades. Other limited offerings to accredited investors should be permitted.157

B. Small Issue Exemption

The Securities Act has no blanket small issue exemption not tied to sales to accredited persons. Can a blanket small issue exemption be justified for the municipal securities market? In 1985 there were 4379 issues of less than $5 million.158 While these issues represented 45% of the total number of issues, they only constituted 4.17% of the dollar volume of long-term bonds issued.159 Thus, an exemption for issues of $5 million or less, covering the total amount issued by any issuer within a twelve-month period, would not in the aggregate hamper seriously the goals of mandatory disclosure. Moreover, the 1986 Tax Reform Act provides that the "small issue government purpose securities" (securities of issuers of not more than $10 million for that taxable year) receive special treatment because commercial banks are allowed to continue to deduct the carrying costs of such securities.160 This means that bank investors, relative to individual investors, will be particularly attracted to small issues. Local commercial banks are likely to remain the major purchasers of small issue municipals.161

For middle size issues within the $5 to 10 million range, the possibility of more relaxed financial reporting standards should be explored in order to reduce the cost burden of disclosure on these smaller issuers. The rationale again would

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157. Allowing resales to a limited number of other accredited persons without requiring a holding period is consistent with the current practice of allowing private sales of restricted securities, the "Section 4(1 1/2)" exemption. 7C J.W. Hicks, supra note 146, § 10.06, at 10-659. In each case, the buyers are a class of investors capable of securing information for themselves. The proposed Federal Securities Code similarly would allow resales to institutional investors but would restrict other sales, such that for a period of three years, the total number of owners—other than institutional investors—could not exceed 35. Federal Securities Code, § 202(4)(b)(i)(II) (1980).

158. Public Securities Association, Municipal Market Developments, Table 6 (issued in 1986, tabulating data for 1985). The total number of issues in the Public Securities Association's database for long-term issues in 1985 was 9840.

159. The total dollar volume for 1985 according to the Public Securities Association was $209 billion. Id. at Table 5A.

160. I.R.C. § 265(b)(3)(B) & (C) (as amended by the Tax Reform Act of 1986). Prior to the 1986 Tax Reform Act, commercial banks were able to deduct the interest on indebtedness incurred to purchase all tax-exempt obligations. Because of the operation of § 291(a)(3), with respect to preference items, only 80% was deductible. The current deduction for securities of small issues is similarly limited to 80%. The exemption applies both to primary offerings and purchases in the secondary market.

161. See R. ROBINSON, POST-WAR MARKET FOR STATE AND LOCAL GOVERNMENT SECURITIES 81-89 (1959) (discussing the role that banks, particularly the smaller banks, have played as investors in the securities of small local government issuers).
be that the costs of full blown disclosure for issues of this size are particularly high on a per dollar raised basis, and the reduction in the benefits of disclosure as a result of relaxed standards would in the aggregate be relatively small. Form S-18, introduced in 1979 for corporate issuers of small size offerings (today, up to $7.5 million), provides a model of this approach with its less onerous financial reporting requirements. For example, financial statements need only be prepared in accordance with GAAP, whose requirements are less extensive than the requirements for Regulation S-X.\textsuperscript{162} In addition, only one year’s audited balance sheet is called for, rather than Form S-1’s requirement of balance sheets from two years,\textsuperscript{163} and Form S-18 permits regional filings.\textsuperscript{164} Whether or not a blanket small issue exemption is adopted ultimately, the Form S-18 model for regional filings should be incorporated in a regulatory scheme for municipal securities for issues up to $10 million. As indicated earlier, a regional filing scheme has advantages both in terms of the costs of registration and the perceptions of the smaller issuers who, given the number of local government units, will continue to constitute a large percentage of the issuers in the market.

V. Periodic Disclosure

This section of the Article will explore the extent to which periodic disclosure, along the lines of what is required of corporate issuers under the Exchange Act, is needed in the municipal securities market. The conclusion is that mandated periodic disclosure probably is not needed in order to effectuate the goals of disclosure as described in this Article.

A. Disclosure in the Corporate Sector

Most corporate issuers of any significance are required to provide periodic, on-going disclosure under section 13 of the Exchange Act.\textsuperscript{165} With the adoption of integrated disclosure in 1982,\textsuperscript{166} the SEC officially recognized that, for companies whose securities are traded regularly in the secondary market, it is this periodic disclosure that should be the focal point of the federal disclosure scheme.\textsuperscript{167} By providing relevant information that might not otherwise be forthcoming, and thereby increasing price accuracy in the secondary market, periodic disclosure facilitates the efficient allocation of resources in three ways. First, accurate share prices are important to the market for corporate control because accuracy helps ensure that poorly managed companies will be priced low and

\textsuperscript{163} Id.
\textsuperscript{164} Id.
\textsuperscript{165} The periodic reports under § 13 (the annual reports and the interim reports) are required of companies which either are registered under § 12(g) of the Exchange Act — issuers with a class of equity securities held of record by 500 or more shareholders and total assets exceeding $1 million (by rule increased to in excess of $3 million, rule 12g-1) or have a registered offering under the Securities Act (§ 15(d)).
\textsuperscript{167} Securities Act Release No. 6383, supra note 108, ¶ 72,328. See Nicholas, supra note 116, at 4-6 (providing a brief synopsis of the background to the SEC’s shift to integrated disclosure).
become targets for takeovers. Second, accurate share prices encourage efficient management decisions by making share price based compensation schemes act as effective incentives. Third, share prices in the secondary market are guides for other suppliers of capital. In addition, more accurate prices in the secondary market make investments in the corporate securities market less risky for individual investors in that, on average when they decide to liquidate their securities, the prices received are likely to be closer to the expected return. This additional factor, however, does not involve directly the allocation of resources and, because investors can diversify, the argument for disclosure in the secondary market is less persuasive.

B. Is Periodic Disclosure Needed for Municipal Issuers?

In determining whether periodic disclosure would be needed for municipal securities as well, the three functions served by municipal disclosure discussed at the beginning of the Article must be considered: efficient allocation of resources, investor protection, and the adjustment function in connection with the level of public services. A review of these functions suggests there is no need to require periodic disclosure of municipal issuers.

1. Efficient Allocation of Resources

The efficiency justifications for periodic disclosure by corporate issuers have little or no applicability to municipal issuers. The managements of municipal issuers are not chosen by the holders of their securities and so there is no market for municipal issuer control. Municipal issuers do not have equity securities that can be utilized in management compensation schemes to provide incentives. Finally, unlike corporations, the bulk of municipal capital not derived from taxes or fees is provided through the public issuance of securities. These issues would be covered by the disclosure plan discussed in the preceding parts.

2. Investor Protection

Very little is known about the workings of the secondary market for municipal securities. All municipal securities are traded over-the-counter. The annual trading volume is unknown, but estimates are that the size of the secondary market is approximately one to two times the size of the new issue municipal market.
In contrast, the size of the secondary market for corporate equity securities is about 82 times the size of the primary market. The most active traders in the secondary market are municipal securities dealers, both as market makers for particular securities and in connection with the investment management of their own inventories of municipal securities. Speculative trading, to the extent it exists, primarily is between institutional investors. Traditionally, individual investors have been infrequent traders, preferring to hold their securities until maturity. The institutional character of the secondary market is reflected in its custom of treating sales of less than $25,000 as "odd lot" transactions for retail investors and those less than $100,000 as odd lots for institutions. Marketing costs for odd lots can be as much as four points if the issue is inactive ($200 per $5000 par value) as compared with one half of one point ($25 per $5000 par value) for large block trades. There is some evidence that the large increase in individual ownership of outstanding state and local government debt, not including mutual funds, which has occurred in last five years has translated into more trading by individuals, in that brokers are reporting an increase in the number of odd lot transactions. This increase, however, probably represents, in large part, individuals trading in their securities in order to receive needed cash—for example, liquidation of savings—rather than in order to purchase other municipal securities.

The number of actively traded issues still appears to be relatively low. The Blue List of Current Municipal Offerings, which lists bonds available for sale with offering quotes, may list hundreds of issues available for sale in any particular week, but actively traded issues are, in fact, far more limited in number. For example, the Bond Buyers Futures Index, against which future contracts in municipal bonds are measured, is composed of forty long-term bond issues with a principal value of at least $50 million. When initiated, the index

173. The total value of shares traded in 1984 on the national and regional exchanges and in the over-the-counter market was $1 trillion compared with a total of $12.9 billion in new equity issues for 1984. SECURITIES INDUSTRY YEARBOOK 1985-86, at 619-23.

174. Staats, supra note 74, at 8.

175. Id. at 11. The reasons for this behavior probably are connected to the significance of the tax motivations in purchasing municipal securities (i.e., to obtain tax-exempt interest), coupled with the tax consequence of selling the bonds, which is to recognize gain on such sale. The recognition of gain, plus the high marketing costs, particularly for small sales of less well-known issuers, means that trading is not a profitable activity, except for the large and skillful investor. See sources cited infra note 179.


177. Id.; H. & S. RICHELSON, INCOME WITHOUT TAXES 199 (1985); see also Cook, supra note 188, at 30 (discussing the illiquidity of small issues in the secondary market); Staats, supra note 74, at 9 (same).


179. The major exception is "tax bond swapping." Investors swap bonds of similar characteristics in order to recognize tax losses. H. & S. RICHELSON, supra note 177, at 197-98; see Friedlander, Municipal Bond Swaps for Private Investors, in 1 THE MUNICIPAL BOND HANDBOOK, supra note 39, at 604. One commentator suggests that trading activity to take advantage of market conditions should be engaged in only by the "aggressive investor" with a "highly dynamic" portfolio strategy. Id. at 610. The implication is that trading is not the normal activity for individual investors.

included 75 issues, but was reduced to 40 because there were not 75 actively traded issues at any one time.\textsuperscript{181} The index is revised twice a month. An average of six to ten bonds are removed from the index and replaced with more actively traded issues.\textsuperscript{182} Furthermore, the trading in the secondary municipal securities market that does occur appears to be tied to the primary market; if municipal securities are actively traded at all, it will only be for a short period of time after the original issuance.\textsuperscript{183}

3. \textit{Adjustment Mechanism}

The remaining function for disclosure in the municipal securities market—to assist in the timely adjustment of the level of public services to reflect current economic realities—would be served by periodic disclosure. The pressure that public disclosure of negative information puts on municipal officials to make these adjustments does not come just from potential securities purchasers who, if the adjustments were not made, would insist on harsher terms or even refuse to purchase the issuer’s securities. The pressure also comes from other participants in the political process. To impose the additional burden of periodic disclosure on municipal issuers, however, absent a need on the part of the bondholders for such information seems inappropriate for a federal securities law. Certainly justifying such federal intrusion into the affairs of state and local governments would require an examination of issues outside the scope of this Article. Moreover, given that government issuers with significant amounts of outstanding debt tend to be frequent issuers in the new issue market, relatively up-to-date information for those issuers generally would be available even without periodic disclosure.

VI. \textit{Civil Liability}

Regulation of the issuance of corporate securities includes the express imposition of civil liabilities on the various participants in the issuance and distribution of securities for failure to comply with the provisions of the Securities Act. Section 11 is the central liability provision relating to false and misleading statements in the basic disclosure document in the process, the registration statement.\textsuperscript{184} It was designed as an \textit{in terrorem} remedy to encourage the careful preparation of the registration statement by requiring “a degree of competence as well as innocence.”\textsuperscript{185} The corporate issuer is liable absolutely under section 11 for any materially false or misleading statement. The other participants subject to section 11 liability (officers, directors, underwriters, and experts) are liable as well, unless they can establish that, after a reasonable investigation, they had

\textsuperscript{181} Id.
\textsuperscript{182} Id.
\textsuperscript{183} Id.
\textsuperscript{185} H.R. REP. NO. 85, 73d Cong., 1st Sess. 9 (1933); see 3 L. Loss, supra note 21, at 1730 (discussing Congress’ rationale for the different burdens of investigation placed on various participants in the registration process).
Mandatory Disclosure for Municipal Securities

reasonable grounds to believe and did believe that the registration statement contained no materially false or misleading statements.\textsuperscript{186}

In contrast to the corporate securities model, commentators on the issue of liability for false and misleading statements in connection with the issuance of municipal securities generally have argued against the imposition of liability on the issuer or on the issuer’s officials or underwriters unless they have been shown to have engaged in intentional fraud. The Williams bill, reflecting this view, had no liability provisions, relying for its enforcement on the provisions of the existing securities laws to protect investors against fraudulent conduct.\textsuperscript{187}

This part explores the arguments of these commentators and concludes that the better system is to pattern the liability provisions of a municipal disclosure system largely or in whole after the corporate model. For purposes of this discussion of civil liability under a mandatory disclosure scheme for municipal issuers, the discussion is confined to the issue of “section 11” type liability, that is, liability for misstatements in the disclosure document.

\textbf{A. Issuer Liability}

\textit{1. The Burden on Taxpayers}

The argument for limiting issuer liability to intentional fraud starts with the observation that if the issuer were liable for false or misleading statements made negligently, it would face a significantly greater risk of having a damage award rendered against it. If the issuer were absolutely liable, the risks would be increased even more. The cost of any such award would be borne ultimately by the issuer’s taxpayers in the form of higher taxes or reduced services. Because the taxpayers are innocent of wrongdoing, it is unfair to impose on them the extra risks associated with a stricter standard of liability.

The issue of how unfair it really is to impose these risks upon taxpayers can be understood as a symptom of the more general problem of when should the acts of an agent of a legally created artificial person, such as a corporation or a government, make that person liable. This problem is complex because it involves the interaction of a legal regime nominally external to the artificial person, one which by its terms purports to apply to the person as a single entity, and the set of legal relationships among real individuals making up that artificial person. Ultimately, our concern has to be with regulating the behavior of real individuals and with their welfare. In the case of the legal person called a corporation and the disclosure behavior of its officials when it issues securities,

\begin{itemize}
  \item \textsuperscript{186} 15 U.S.C. § 77K(b) (1982).
  \item \textsuperscript{187} The only provision relating to liability was a limitation on underwriters total liability “in or as a consequence of any suit for damages” to the total price at which the issue was sold by it to the public. Williams bill, \textit{supra} note 52, § 13A(g). Commentators were critical of the Williams bill for not dealing more specifically with the liability issue. See, \textit{e.g.}, Note, \textit{Federal Regulation of Municipal Securities: Disclosure Requirements and Dual Sovereignty}, 86 \textit{Yale L.J.} 919, 932 (1977); Comment, \textit{supra} note 57, at 1286-88. Underwriters, in particular, sought to lessen their exposure under rule 10b-5 because of the incompatibility of due diligence and competitive bidding. See, \textit{e.g.}, 1976 \textit{Hearings}, \textit{supra} note 30, at 127, 130-31 (testimony of Richard Kezer, President, Dealer Bank Association).
\end{itemize}
Congress decided to impose liability on the issuer in more situations than just intentional fraud. Congress probably was motivated in this decision in part by the feeling that the issuer benefited from the false or misleading statement, whether intentional or not, and that the officials making the statement, if liable themselves, are not likely to have sufficient resources to compensate the victims. Intention is difficult for the plaintiff to establish even when it exists. These factors, at least, should be equally applicable to municipal issuers. Congress undoubtedly also understood that the real individuals who ultimately would bear the resulting costs imposed on the corporation would be its shareholders. Thus, the proposal that municipal issuers should be treated more leniently than corporate issuers must rest ultimately on arguments that taxpayers are significantly different from shareholders in ways that justify such a difference in legal regime.

One argument that taxpayers are different from shareholders is that taxpayers do not accept voluntarily the risk of having to bear the costs of their government’s liability. Existing shareholders, when they choose to invest their savings in any given corporation, know that they are accepting a risk that their return on investment might be reduced or eliminated if management unintentionally or negligently makes a false or misleading statement in connection with a subsequent issuance of new securities. The shareholder also knows the maximum extent of his losses: the cost of his investment. The problem with this argument is that it exaggerates the voluntariness of shareholders’ choices. Since the Securities Act provisions imposing liability on an issuer for false or misleading statements apply to all corporations that issue securities publicly, any corporate investment by a saver involves the risk that he will lose financially if its management makes such a statement. Therefore, assuming we wish savings to be invested in productive projects that are best undertaken in the corporate form of business, the saver cannot avoid this risk.

Another argument is that taxpayers are different from shareholders in that shareholders have more control over the issuer’s officials. Thus, the increased threat to shareholder welfare from broad corporate issuer liability is more effective in restraining officers from securities law violations than would be the increased threat to taxpayer welfare that would result from imposing broad liability on municipal issuers. The first thing to note in response to this argument is that, in terms of restraining official behavior by the threat of electoral loss, taxpayers are likely to be more, not less, effective than shareholders. Government officials often fail to win re-election following a securities law liability award. Thus, there would be a potent political weapon to use against an incumbent. In contrast, corporate officials are almost never replaced by a shareholder vote unless there is at least some concentration of share ownership.

A more sophisticated and persuasive case that shareholders have more control over corporate officials than do taxpayers over governmental officials can be made based on the agency or contractual theory of corporations. This theory suggests that a number of forces exist to keep management behavior in line with shareholder interests. One force is the mechanisms used to monitor man-

189. The seminal article setting forth the agency theory of the firm is Jensen & Meckling, supra note 42.
agement performance that management implements and promises to maintain in order to receive financing at lower costs. A second force is the market for managerial labor which rewards managers who act in the shareholder’s best interests. A third force is the threat of hostile takeover: mismanagement by the incumbents leads to a low share price, which, in turn, permits a more adept management group to purchase a sufficient number of widely held shares at a bargain price in order to aggregate in its hands the voting power to transfer control to itself. In comparison, as argued in detail in a previous article, none of these forces works well for keeping government officials in line. Government officials are much less likely to implement and maintain mechanisms to monitor their own performance even if such monitoring mechanisms would lower their financing costs. There is no labor market for government officials. Furthermore, there is no equivalent threat of hostile takeover: taxpayers cannot move from one community to another with the same ease as shareholders can sell and buy shares. An individual taxpayer cannot purchase the votes of others to wrest control from the current management, and changes of control can legally occur only at specified times.

The problem with this more sophisticated argument is that it relies on the relative lack of effective controls on government officials, which is one of the key problems that mandatory municipal disclosure is intended to combat. If, as argued below, effective compliance by issuers with mandatory disclosure is unlikely without broad issuer liability for misstatements, it would be ironic to have the effort to improve taxpayer control over government decisions through mandatory disclosure essentially vitiated because of a lack of taxpayer control over the government’s compliance with disclosure regulations.

This last point suggests that the question of whether taxpayers are sufficiently different from shareholders to make it unfair for them to have to bear the burden of the increased risk of damage awards arising from broad issuer liability is too narrow an approach for analyzing the effect of such broad liability on taxpayer welfare. A more fruitful analysis would be to focus as well on the benefits derived by taxpayers from a liability system imposing a higher standard of care. A system of rules which does not penalize disclosure failures absent a showing of intentional fraud loses much of its deterrent effect. The only way citizens can hold officials accountable is if they receive information regarding officials’ deeds and misdeeds. Fear that citizens will remember on election day the consequences of a liability award arising out of the government’s failure to comply with the securities laws is an incentive for officials to act in a careful and prudent fashion in their disclosures. The need for these incentives is related to the need for mandatory disclosure. As previously argued, politicians and bureaucrats are subject to strong pressures not to disclose information. These

190. Id. at 325-26.
193. See Gellis, supra note 8, at ___ (analyzing the incentive structure of the agency theory as applied to government management).
194. Id. at ___. Citizens, however, can more easily change management at election time than can shareholders in widely-held, management controlled corporations other than in takeover situations.
pressures are not counterbalanced by effective controls from legislators or citizens. Mandatory disclosure provides a mechanism for monitoring fiscal management of governmental issuers, and the existence of broad liability for noncompliance makes that mechanism more effective.

In comparing the gains to taxpayers from improved disclosure with the losses from bearing the higher risk of damages in a broad liability system, it should be noted that the poorer disclosure which would result from limiting issuer liability to intentional fraud will increase financing costs, and those costs also will be borne by taxpayers. Investors, without recourse for unintentional disclosure failures, will demand compensation in the form of higher interest costs for the increased possibility of default associated with the purchase of municipal securities. They may demand compensation as well for the increased volatility of return that will result from poorer disclosure, even though the portfolio theory maintains that such risks can be diversified away. The evidence indicates that investors in the municipal securities market tend not to diversify. Moreover, greater inaccuracy in pricing resulting from poorer disclosure will increase the costs of financing paid by some communities. While other communities will enjoy the benefits of lower costs because of inaccurate prices, the less efficient allocation of resources means that losses are likely to outweigh gains. Another cost of poor disclosure is the pain experienced by communities that must make sharp, unplanned adjustments in their services because of a delay in their realization of changed fiscal circumstances.

2. Increased Litigation

Another argument for limiting issuer liability to intentional fraud is that broader liability will "open the floodgates," and municipal issuers will be in court continuously to defend against securities cases. There is also an underlying assumption that issuers more often than not will lose in litigation. The claim of increasing litigation is in part based on a perception that the huge amounts of money involved in public financings will attract a large number of lawsuits based on relatively flimsy claims. Similar predictions were made initially by corporations opposing the broad liability provisions of section 11 of the Securities

196. The lack of diversification is due, in part, to the state tax exemption on interest paid on the securities of their own political subdivisions, which leads individuals to concentrate in the securities of issuers in their state of residence. Hendershott & Kidwell, The Impact of Relative Security Supplies, 10 J. MONEY, CREDIT & BANKING 337, 339 (1978); see also De Jong, supra note 74, at 458, 474-75 (suggesting that a portfolio which includes tax-exempt securities presents more difficult problems of diversification than one of corporate securities alone because one must avoid having corporate stocks and municipal bonds which are subject to the same "economic process" (e.g., holding Chrysler stock and municipal bonds of Michigan issuers)).
197. New York City's fiscal crisis, with its day-after-day cliff hangers concerning the city's possible bankruptcy, is a good example of a situation that would have been "less cataclysmic" had there been adequate disclosure of the city's true financial picture earlier. C. MORRIS, THE COST OF GOOD INTENTIONS 12 (1980).
198. This assumption may arise from the perception that juries view governments as deep pockets. See, e.g., Lindsey, Surge in Lawsuits Strains Budgets of Many Cities, Chicago Daily Law Bulletin, May 14, 1985, at 1, 9.
Act, but they were not borne out in practice.\textsuperscript{199} The empirical evidence available suggests the opposite: large corporations are not bedeviled continuously by securities lawsuits.\textsuperscript{200}

This general line of argument also is based in part on the proposition that governments in general are particularly attractive targets of litigation where legislation permits suits against them, and that they have particularly low success rates. State and local government liability under section 1983 civil rights actions\textsuperscript{201} and under the antitrust laws have given rise to similar kinds of concerns. Again, the available empirical evidence suggests that these concerns are unfounded. For example, a recent empirical study of section 1983 constitutional tort cases brought in the Central District of California found that there has not been an uncontrolled mushrooming of cases in the federal courts under section 1983 and that, at every level of adjudication, constitutional tort plaintiffs have a significantly lower success rate than do non-civil rights plaintiffs.\textsuperscript{202} Based on the population located in the Central District of California (which includes the Los Angeles metropolitan area), it is estimated that taxpayers paid about 20 cents per person for all section 1983 cases in 1980 through 1981 (judgment awards plus settlements), which represented less than .02\% of local government revenues.\textsuperscript{203} Similarly, while the \textit{Community Communications, Inc. v. Boulder}\textsuperscript{204} Supreme Court decision in 1982 was viewed by local governments as exposing them to an onslaught of lawsuits, a 1984 list of antitrust suits brought against local governments shows these fears to be unfounded.\textsuperscript{205} The survey showed there were 158 suits nationwide in various stages of litigation.\textsuperscript{206} In most cases, defendant local governments had been successful either in having the cases dismissed or in obtaining judgments in their favor.\textsuperscript{207} Only two of the reported cases resulted in jury awards for plaintiffs, and seventeen cases were settled.\textsuperscript{208}

\begin{footnotesize}
\begin{itemize}
  \item \textsuperscript{199} 3 L. Loss, \textit{supra} note 21, at 1721. Section 11 had been perceived as the "bete noir" which would stifle legitimate financing. \textit{Id}. Similarly, Folk notes that "section 11 in its original form terrified the investment community." Folk, \textit{supra} note 184, at 18. Amendments were added in 1934 to mollify the investment banking community, but, in general, the amendments were not substantive. \textit{Id}.; see also Greene, \textit{supra} note 130, at 755, 768 (stating that the apprehensions of the investment community concerning the civil liability standards of the Securities Act brought about amendments to §§ 11 and 13 of the Act).
  \item \textsuperscript{200} See sources cited \textit{supra} note 65 (indicating the extremely small number of § 11 suits since 1933). In terms of suits against corporations by shareholders, the evidence also suggests that derivative lawsuits are relatively few in number. One study of the incidence of shareholder suits, using a sample of 190 firms (80 of the "largest firms" and 110 "random firms"), found that, on average, a firm would be involved in a disputed issue once every 17.5 years. Jones, \textit{An Empirical Examination of the Incidence of Shareholder Derivative and Class Action Lawsuits 1971-1978}, 60 B.U.L. REV. 306, 313 (1980).
  \item \textsuperscript{201} 42 U.S.C. § 1983 (1982).
  \item \textsuperscript{202} Eisenberg & Schwab, \textit{The Reality of Constitutional Tort Litigation 63} (Sept. 17, 1986) (unpublished manuscript).
  \item \textsuperscript{203} \textit{Id}. at 77.
  \item \textsuperscript{204} 455 U.S. 40 (1982).
  \item \textsuperscript{205} National Institute of Municipal Officers (NIMLO), \textit{Survey of Antitrust Suits Against Municipalities} (Oct. 1984). The survey listed pending suits, classified by the type of local government power involved (e.g. licensing powers or various zoning powers).
  \item \textsuperscript{206} \textit{Id}.
  \item \textsuperscript{207} \textit{Id}.
  \item \textsuperscript{208} \textit{Id}. Two developments in the antitrust area might have influenced the number of cases, although both occurred subsequent to the NIMLO survey. The first was the enactment in October
\end{itemize}
\end{footnotesize}
3. **Absolute Liability versus a Negligence Standard of Care**

Corporate issuers are liable absolutely for material misstatements in their registration statements under section 11(a) of the Securities Act. The only defenses available are that (i) the plaintiff knew of the misstatement, (ii) the plaintiff is unable to prove reliance upon the misleading statements when an earnings statement concerning a twelve month period after the effective date of the registration statement has been generally released, and (iii) plaintiff's damages resulted in whole or in part from factors other than the misstatement. For the other persons subject to section 11 liability, the standard of care is one of negligence. There are at least two possible reasons for this difference in duties imposed by Congress. First, the suggestion has been made that the degree of liability for the persons listed in section 11 reflects the proximity of the person to the preparation of the registration statement, its ability to control the content, and the degree to which investors rely on such person's authority. Thus, the issuer is held to a higher standard than the underwriter and the underwriter is held to a higher standard than the expert, except as to the "expertised" portion.

Second, absolute liability for issuers is one part of the *in terrorem* effect desired by Congress. Combined with shifting the burdens of proof and the elimination of reliance as an element of a cause of action, section 11 is designed to prevent misleading statements and omissions from being made in the first instance, as well as to provide redress when they do occur. Congress likely was concerned that a negligence standard for issuers, even when shifting the burden of proof to the defendant, would undercut significantly the *in terrorem* effect of the section.

Whether absolute liability was imposed by Congress because of its desired *in terrorem* effect or because of a notion of moral responsibility for statements made by issuers to solicit funds from the public, in economic terms, absolute liability is a restitution remedy. Issuers are required to pay in damages the gain made by virtue of the failure to disclose. Thus, an issuer which makes an...
innocent misstatement concerning the possibility of some damaging event but faces the prospect of paying damages if the event occurs, *ex ante*, in no worse position than if it fully complied with the Securities Act initially. The lower borrowing costs resulting from the misstatement should, on an expected basis, equal the expected cost of having to pay the damages.

All of these reasons for absolute liability for issuers apply with equal force to municipal issuers. To require proof of negligence on the part of municipal issuers would reduce the *in terrorem* effect of a disclosure statute because the threat of potential suits is lessened. Moreover, in situations where negligence is not shown or the suit is not brought because of the uncertainty of recovery, taxpayers obtain a windfall gain at the expense of investors.

**B. Underwriters**

In the evolution of corporate disclosure under the Securities Act, the role of underwriters in performing their "due diligence" duties imposed under the civil liability provisions of section 11 has been vital to the disclosure process. Underwriters are participants in the drafting of the registration statement, who are independent of the issuer, with their own exposure to liability unless they can prove that they acted in a non-negligent manner, and with their own reputations at stake as financial intermediaries between issuers and investors. Consequently, underwriters have strong incentives to ask difficult questions and to probe for full disclosure. Observers of the process of drafting a registration statement agree that underwriters do, through their investigations, hone the issuer's initial statements into a much more valuable disclosure document.

Underwriters of municipal securities have argued that, under any mandatory disclosure scheme, they ought to be entitled to rely on the statements of municipal issuers, provided such reliance was reasonable. Their concern is the inability of underwriters in competitively bid offerings to conduct sufficiently thorough investigations of the issuer to assure themselves of the availability of the due diligence defense. Whatever the merit of this argument at a time when competitive bidding predominated the market, with competitive bidding representing only 36% of today's public offerings and just 16% of the dollar volume,
there is no reason to eliminate, or to create defenses sufficiently broad so as to undercut, what has proven to be the single most effective tool for promoting disclosure by corporate issuers. As discussed earlier in connection with the costs of a review process, there exists a model for underwriters to use in competitively bid offerings to conduct due diligence reviews. To the extent that system does not remove all of the disadvantages under which underwriters are placed in competitively bid situations, they are better handled through a court determination of reasonableness in the particular circumstances.

C. Individual Liability for Issuer's Officials

Under what circumstances should the top officials of a municipal issuer be liable for any materially false or misleading statements made by the issuer in its securities disclosures? One approach again is to follow the corporate securities model. As presented above, the Securities Act requires the principal officers of a corporate issuer and its directors to prove they were not negligent based on a reasonable investigation in order to avoid liability for false or misleading statements made in connection with the sale of securities. This section concludes that the corporate model should be followed, but consideration should be given to reforms called for in the corporate system by some commentators. These commentators are concerned over officers' and directors' exposure to potentially enormous liabilities with respect to the issuance of corporate securities and have called for limits on the total amount of recovery against a negligent officer or director who does not benefit personally from the violation. Limits on liability are justified as being more fair in terms of the individual's economic situation, as not making individuals unduly risk averse in their decisionmaking, as reducing insurance costs for corporate issuers, and as resulting in more equitable court decisions, once courts are not faced with draconian remedies. Commentators agree that the amount of liability needs to be sufficiently high so that the duty of care standard serves its underlying purpose, and where the issuer is judgment proof, to ensure that lawyers will undertake securities class actions on a contingent fee basis.

The conclusion concerning the individual liability of top municipal officials is controversial. Most commentators addressing the question of the breadth of individual liability in a municipal disclosure system advocate limiting liability to acts of intentional fraud. Such commentators have voiced three principle

221. See sources cited supra note 130.
222. See supra notes 185-86 and accompanying text.
223. See 2 Federal Securities Code § 1708(c)(2) (1980) (limiting the liability of individual defendants for negligent misrepresentations contained in a registration statement to $100,000); PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS § 7.17 (Tent. Draft No. 6, 1986).
224. PRINCIPLES OF CORPORATE GOVERNANCE: ANALYSIS AND RECOMMENDATIONS, supra note 223, § 7.17.
225. Id.; see 2 FEDERAL SECURITIES CODE § 1708(c)(2), commentary at 731 (1980).
226. Seligman, supra note 188, at 669; see 1976 Hearings, supra note 30, at 393-94 (statement of the Municipal Securities Rulemaking Board); Note, Municipal Securities, 60 Minn. L. Rev. 567, 592-93 (1976); Note, supra note 187, at 943; cf. Doty & Peterson, supra note 31, at 386-89 (advocating a system of liability that distinguishes between issuer's officials participating in the offering and those who are nonparticipants, by imposing a negligence standard of care on the former and a gross negligence or recklessness standard of care on the latter).
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Concerns: first, government employees will become risk averse to the public's detriment; second, the government will be less able to attract good people into government service; third, top officials exposed to liability may not be able to control other persons within the political body or bureaucracy on whom they depend for information.227

Professor Schuck, addressing tort liability of government officials generally, expands on the concern about making government officials too risk averse. He argues that individual official liability should be abandoned and that government liability should be embraced as a general matter in public tort law, as suggested here in connection with the issuance of securities.228 Professor Schuck's focus with respect to official liability, however, is on the "street level bureaucrats," the persons who are responsible for the actual delivery of public services, such as the police officer, social worker, or teacher. The consequence of imposing liability on these people is to make people who tend to be risk averse even more so. It makes them even more bureaucratic, so that the goal of "vigorous official decisionmaking" is impeded.229

While not a rare event for some governments, conducting a public offering of debt securities is still an event that is not equivalent to the day-to-day government operations of the police department, the parks department, or the school system. The event generally is sufficiently significant to involve top level officials. Such officials are not the "street-level bureaucrats" who provide basic services to the public. Further, the activity in which these officials are engaged is narrow. While a full appreciation of what the securities laws require to be disclosed may be beyond the understanding of an official versed in securities law practice, the parameters of what is required can be comprehended. Even today, without mandatory disclosure rules, issuers are advised to some extent by bond counsel in the preparation of the offering statement. Under a mandatory disclosure scheme, lawyers likely would be intimately involved in the process. Requiring the issuer's officials to be careful and diligent does not seem to be an unacceptable burden to impose on such officials, because, as to financial officers in particular, they presumably are elected or appointed on the basis of their ability to provide good fiscal management. To expect "honesty, care and compliance" of our corporate officials under the Securities Act230 and not of our governmental officials would be an odd anomaly.231

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227. See, e.g., Comment, supra note 57, at 1288.
229. Id. at 55-57, 59-81. For Schuck, official liability as the norm of the public tort system has two negative results: first, the effect on the decisionmaking process when officials are "over-deterred"; and second, the system's "resort to crude immunity rules and other risk-shifting techniques . . . [which] reduce compensation, deterrence and other remedial values . . . without really eliminating the threat to vigorous decisionmaking that the remedy inevitably poses." Id. at 56. Analogous to the argument in this Article for issuer liability as a means of providing taxpayers with an effective monitoring device of government management, Schuck argues that the weakness of control mechanisms over employee conduct in the public sector "enhances the importance of tort remedies that effectively compensate, as governmental liability can and official liability cannot." Id. at 57. See also, Cass, Damage Suits Against Public Officers, 129 U. PA. L. REV. 1110 (1981) (analyzing when liability for public officials will improve incentives for optimal behavior). Professor Cass, in general, agrees with Professor Schuck that one problem with liability rules for government officers is the likelihood of over deterrence which is not necessarily detected and therefore goes uncorrected. Id. at 1171.
231. As two commentators state: "Municipal officials and employees should likewise be expected
Furthermore, because the officials who would be liable under a disclosure scheme similar to the Securities Act are top management, placing liability on them would have the positive effect of deterring violations without the negative consequences described by Professor Schuck. People who become politicians and rise to the top positions of chief executive or chief financial officer typically are not very risk averse. Given all the other risks in a political career, one's desire to be a governor or mayor will not be dampened significantly by the fear of liability if one is found negligent in connection with the issuance of securities.

By imposing liability, officials are encouraged to make efforts to control their subordinates and to communicate a need for disclosure. To the extent there are inherent limits on the amount of control which officials can exert because of the size of the organization or due to the inability to threaten the dismissal of uncooperative subordinates, officials are not without liability defenses. As long as the officials conducted a reasonable investigation, and had reasonable grounds to believe the information stated, they would not be held liable.

D. Common Law Sovereign Immunity Concerns

This Article argues that the interests of society are not served by a system of mandatory disclosure rules that will neither deter negligent behavior nor compensate injured investors. A system of liability should be implemented similar to section 11 of the Securities Act with due diligence defenses available to the issuer's principal officers and the underwriters. By imposing liability on the governmental entity, as well as on its officials, this scheme represents a departure from the traditional notions of public tort liability by accepting the doctrine of respondeat superior. It may well be that in the period when the concepts of sovereign immunity developed, the areas of governmental activity were limited so that the number of times members of society went uncompensated for governmental wrongs were few. This has not been true of our society for a long time and the recognition of the more activist state by the courts and state legislatures was reflected in the steady erosion in the late 1950s and 1960s of the doctrine of sovereign immunity at the state and local governmental levels.

The pattern of municipal financing since World War II also mirrors the activist state, both in terms of the amount of debt issued each year to fund governmental activities and the innumerable forms of debt issued to match the wide-range of activities and entities engaged in providing public services. At the same time, as the market is growing more sophisticated in the types of financing, municipal issuers are appealing to a wider audience of less sophisticated investors to exercise care to insure the accuracy and sufficiency of disclosures. If they do not do so, no one will." Doty & Petersen, supra note 31, at 389.

232. P. SCHUCK, supra note 228, at 34; see Jaffee, Suits Against Governments and Officers: Damage Actions, 77 HARV. L. REV. 1 (1963) (reviewing the history of the English common public tort law system).

233. See Gellis, supra note 8, at ____ n.5 (providing statistics as to the growth of the municipal securities market in the post-World War II period).
investors to sell their securities. Fairness dictates that these governments bear the cost of their tortious conduct to the same extent as corporate issuers of securities.

E. Constitutional Concerns

A federal statutory scheme that opens state and local governments to civil liabilities raises federal constitutional questions that also come under "sovereign immunity." These questions arise under both the tenth amendment and eleventh amendment. The issue of the demands of federalism was discussed earlier in this Article, and to the extent that the Garcia decision remains the last word from the Supreme Court, the lifting of sovereign immunity by a federal statute would not raise problems under the tenth amendment.

The eleventh amendment has been interpreted by the Supreme Court to preclude suits for damages in federal courts by private individuals against the states. This interpretation would not create a problem for imposing a system of civil liability on state political subdivisions such as cities, counties, school districts, and special districts because the amendment has been construed narrowly to exclude local governmental units from its coverage. A problem may arise in applying this system to the states themselves and to their agencies when they issue securities. The sovereign immunity of the states extended by the eleventh amendment, however, is not absolute. Sovereign immunity of states does not apply to suits for damages brought by another state or by the federal government. Furthermore, the immunity can be lifted under certain circumstances. States can consent to be sued, and Congress, acting under section 5 of the

234. See sources cited supra note 1, for statistics regarding the size of today's municipal market and the extent of individual investment in that market. Evidence from the New York City default and WPSS default suggests that the securities of large issuers in particular are individually-held. See Gellis, supra note 8, at ___ and the notes thereto. Municipal issuers, limited by the 1986 Tax Reform Act in the amount and kind of "private purpose" activities that can be financed with tax-exempt bonds, are turning to taxable bonds to fund such activities (e.g. industrial revenue bonds and pollution control bonds). Without the tax-exempt feature, these bonds undoubtedly will be marketed to individuals who otherwise might not have been interested in the lower yield tax exempt municipal bonds.

235. "The powers not delegated to the United States by the Constitution, nor prohibited by it to the States, are reserved to the States respectively, or to the people." U.S. Const. amend. X.

236. "The Judicial power of the United States shall not be construed to extend to any suit in law or equity, commenced or prosecuted against one of the United States by Citizens of another State, or by Citizens or Subjects of any Foreign State." U.S. Const. amend. XI.

237. See supra notes 86-97 and accompanying text.

238. Hans v. Louisiana, 134 U.S. 1 (1890), held that although not explicitly included, the eleventh amendment also precluded suits by citizens of the defendant state. Id. at 11; see J. NOWAK, R. ROTUNDA & J. YOUNG, CONSTITUTIONAL LAW, § 2.12, at 81-96 (providing a general discussion of the case law interpreting the scope of the eleventh amendment).

239. Lincoln County v. Luning, 133 U.S. 529, 530 (1890). The amendment protects the state and agencies of the states which are not "politically independent." J. NOWAK, R. ROTUNDA & J. YOUNG, supra note 238, § 2.12, at 86.


241. See J. NOWAK, R. ROTUNDA & J. YOUNG, supra note 238, § 2.13, at 90-91 (discussing when waiver by the state will be found). With respect to whether engaging in federally regulated activities constitutes an implied waiver by the state of its immunity to suit under the eleventh amendment, the authors conclude that "it is unlikely that an implied waiver will be found unless the state has taken actions which are admittedly subject to federal regulations and which are not essential state functions." Id. at 91.
The fourteenth amendment, can remove the immunity, provided it clearly states its intention to do so. Whether Congress, in enacting a statute pursuant to an article I power, such as the enactment of a federal disclosure statute under the commerce clause, can similarly lift the states' sovereign immunity under the eleventh amendment has not been resolved by the Supreme Court.

The debate concerning how the Court will or should answer the question is similar to the debate which surrounded the interpretation of the tenth amendment in National League of Cities and Garcia with respect to what the demands of federalism require and where in our system of government the power to strike the balance between the powers of the national government and the states should reside. For example, the Supreme Court has indicated a greater willingness to find an implied waiver of the eleventh amendment immunity where the state activity is proprietary in nature rather than governmental. In National League of Cities and its progeny, the focus was on distinguishing, for tenth amendment purposes, between the traditional, essential governmental functions entitled to protection from federal intrusion and those non-essential functions that were not entitled to protection.

Professors Nowak and Tribe, in their articles on the eleventh amendment, view the eleventh amendment as a limitation on the judiciary's power under article III and not as a limitation on Congress' power to determine national policies under article I. Professor Nowak's argument is similar to that espoused


243. Parden v. Terminal Ry. Co., 377 U.S. 184 (1964). Parden involved a suit against the State of Alabama by employees of a state-owned and operated railroad pursuant to the Federal Employee's Liability Act for damages for injuries. The Court implied a waiver from the voluntary act of the State in entering into a federally regulated proprietary activity. This case is consistent with cases under the tenth amendment involving state-run railroads where the Court has declined to consider such activity governmental. See, e.g., United Transportation Union v. Long Island R.R., 455 U.S. 678, 686 (1982); United States v. California, 297 U.S. 175 (1936) (specifically noted in Justice Rehnquist's opinion in National League of Cities, n.18, as not constituting an integral part of a state's governmental activities).

Subsequent cases where implied waivers were not found, Employees of the Dep't of Pub. Health and Welfare v. Missouri Dep't of Pub. Health and Welfare, 411 U.S. 279 (1973) [hereinafter Employees] and Edelman v. Jordan, 415 U.S. 651 (1974), involved legislation which affected activities more "governmental" in nature. For example, Employees involved application of the Fair Labor Standards Act to the states, the same legislation involved in National League of Cities and later Garcia. See Nowak, The Scope of Congressional Power to Create Causes of Action Against State Governments and the History of the Eleventh and Fourteenth Amendments, 75 COLUM. L. REV. 1413, 1416-22, 1451-53 (1975) (considering these three cases and the role of the governmental or proprietary distinction in deciding the question of implied waiver). This division is reinforced by the concern embodied in the eleventh amendment for protecting the public treasury. Thus, proprietary activities which are profit making are not viewed as deserving of the protection of the eleventh amendment as the not-for-profit governmental activities. See Brown, State Sovereignty under the Burger Court-How the Eleventh Amendment Survived the Death of the Tenth: Some Broader Implications of Atascadero State Hospital v. Scanlon, 74 GEO. L.J. 363, 371 (1985) (discussing the importance of the concern for the public treasury in the development of the law on the eleventh amendment).

by the majority in Garcia. Congress is the most appropriate forum for deciding the balance between the two levels of government. States that are unhappy with where the balance is struck have the political clout in Congress for redress.245

The reasoning of Garcia logically supports a court’s finding that Congress can lift the immunity so long as it does so clearly and affirmatively in order to assure the court that the concerns of federalism have been considered and weighed. The 5-4 Garcia decision, with Justice Rehnquist’s statement that Garcia may not be the last word on the tenth amendment,246 makes it doubtful that, despite the logic, the Court willingly would take a further step in cutting into state sovereignty.247 While the Court may be reluctant to broaden Congress’ authority to remove the eleventh amendment immunity, the nature of the remedies called for in a statute concerning disclosure provide a possible middle course for the Court. The remedies consist of restitution. The traditional argument for providing immunity—the protection of the state treasury against unexpected damage awards—is less compelling.248

VII. CONCLUSION

The exemption for securities of state and local governments from the federal securities laws has been reviewed only once by Congress, in 1976, in the wake of the New York City default. While there was little interest in simply removing the exemption, there was support in Congress, the SEC, and among underwriters, for some form of mandatory affirmative disclosure regulation. Much of the commentary on what kind of mandatory disclosure regulation ought to have been adopted focused on the differences between the corporate and municipal

245. Nowak, supra note 243, at 1441-42. The underpinnings of Professor Nowak’s thesis, like those of the Garcia opinion, are Professor Wechsler’s theory that the states are able to protect their interests at the national level through the political processes set up in the Constitution. See generally Wechsler, supra note 90, at 547 (stating that the equality of state representation in the Senate guarantees states, even with small populations, an ability to influence national policy provided there is popular interest within a states’ polity to do so).


247. In Atascadero State Hosp. v. Scanlon, 473 U.S. 234 (1985), the majority, consisting of the four Garcia dissenters plus Justice White, held that a suit for damages against the state under § 504 of the Rehabilitation Act of 1973 could not be maintained since Congress had not clearly manifested its intent to change the “fundamental constitutional balance between the Federal Government and the States . . . .” Id. at 238. Justices Brennan and Blackman in their dissents argued that the decision rested on erroneous doctrine as to the nature of federalism. Id. at 3150, 3154, 3179; see Brown, supra note 243, at 389-93 (attempting to reconcile the Atascadero and Garcia cases). Brown argues that the requirement of an explicit statement by Congress to abrogate the eleventh amendment is a means of assuring that Congress, in enacting legislation, “does its job” to consider the states’ interest, and enables the Court to determine whether the processes have been followed. Id. at 390-93.

248. The Supreme Court decisions on the eleventh amendment have limited its reach to suits for damages which put the public treasury at risk. Thus, suits for prospective, injunctive relief can be maintained. Edelman v. Jordan, 415 U.S. 651, 665 (1974). Doty and Petersen argue that Edelman leaves open the possibility that some form of equitable restitution under a § 11 type liability might be permitted. Doty & Petersen, supra note 31, at 356. However, there is broad language in the Edelman case which seems to treat even equitable restitution relief as within the immunity if the damage remedy is paid from state funds and “measured in terms of a monetary loss resulting from a past breach of a legal duty on the part of the defendant’s state officials.” Edelman, 415 U.S. at 668.
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securities market regarding credit risk and the nature of investors and on the significant tenth amendment problems posed by National League of Cities.249 All of these factors, it was claimed, argued for a minimalist approach to regulation. The focus on these factors is reflected in the Williams Bill. In recognition of the dearth of information then made available by municipal issuers, the Williams Bill set forth standards regarding what information was to be disclosed. The Williams Bill, however, did not provide a mechanism for review or for enforcement, and it broadly permitted states to replace federal regulation with their own.

The approach of the Williams Bill was too narrow. It looked only at the investor protection purpose served by disclosure and, against the need for protection, it weighed a concern for state sovereignty. Additional, equally important, societal functions exist for disclosure in the municipal securities market: the efficient allocation of resources and the provision of an adjustment mechanism for the level of public expenditures to reflect current taxing capacity. The purpose of this Article has been to look anew at the issue of a mandatory municipal securities disclosure system with all three goals in mind in order to answer the key questions of what securities and transactions will be covered by the rules and how compliance with the rules will be secured.

The focus of a municipal securities disclosure law should be on the primary issuance of securities. Based on the limited information available concerning the secondary market in municipal securities, none of the amount of securities traded, the purposes for trading, or the kinds of investors who typically buy and sell in the secondary market, justifies regulation of the market beyond the currently existing regulation of brokers and dealers.

With respect to regulation of the primary market, the areas of most controversy involve ex ante and ex post enforcement devices, and as part of that debate, the role of an administrative agency. If substantial compliance with a uniform, comprehensive set of standards that reflects legislative purposes is to be achieved relatively quickly, there needs to be an administrative agency that makes rules and reviews issuers' proposed disclosures. The nature of the market as one with few, but generally quite large, defaults, coupled with the problem of most individual claims being small, suggest that the number of cases generated would be small in any given year. A system that has no administrative rulemaking and relies instead on the accumulation of judicial precedent would thus take a long time to develop uniform, comprehensive standards. A system consisting of administrative rulemaking would be better, but the absence of administrative review of proposed disclosures would deprive the rulemakers of a rich source of information and the system as a whole of a valuable ex ante enforcement device. The paucity of cases would make the threat of litigation insufficient by itself to obtain substantial compliance.

Prior review, however, is not sufficiently effective alone to assure compliance. Injured investors should be able to recover damages against issuers, their principal officers, and underwriters. This Article takes issue with those who would limit the liability of municipal issuers and their officials to acts of intentional fraud. This Article suggests that the municipal disclosure system should follow the

249. See sources cited supra note 53.
Securities Act model on civil liability except that a ceiling on recoveries against negligent officials should be adopted.

The argument that a Securities Act type of civil liability scheme would impose undue burdens on taxpayers is not sustainable for a number of reasons. Shareholders and taxpayers are not sufficiently distinguishable to suggest that what is an acceptable burden on one is an undue burden on the other. Furthermore, the higher level of care in a Securities Act type scheme provides a stronger incentive for full disclosure. The benefit of such disclosure insures taxpayers both increased control over the activities of its government managers and lower average borrowing costs. A damage remedy against the issuer for a false or misleading statement rectifies the fact that the issuer and its taxpayers obtained proceeds at a lower cost than they would have but for the statement, no matter how innocently made. It is not the equivalent of a damage remedy for the negligence of the government in providing a particular service, in that in the latter case, the treasury, with the exception of savings from not being sufficiently careful, has not been enriched by the negligent act in question.

The preparation of an offering statement by the issuer's officials should not be viewed as the same kind of activity as the direct provision of government services to the public for purposes of deciding whether there should be liability for negligent as well as intentional acts. These officials generally are the top officials, performing a discrete task to which they typically are advised by counsel concerning what the law requires.

Municipal securities disclosure has received little serious attention by either lawmakers or commentators on the municipal securities market. Since 1933, the market has experienced radical changes in its structure and has grown to enormous size. There has been a reluctance to recognize these changes and to apply more sophisticated economic and political theories now available to analyze the issues involved. The theoretical and empirical case that municipal issuers do not provide voluntarily sufficient disclosure of information is strong. In the wake of two defaults in a decade, each larger than any default by a private issuer, the time has come to recognize the problem of inadequate disclosure and to put into place the kind of effective mandatory disclosure scheme outlined in this Article.