Municipal Bondage: The Undisclosed Disclosure Obligations on Municipal Securities Issuers

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Abstract

The municipal securities market has recently become the target of increased regulatory scrutiny. Once considered a "sleepy market," the market is now burdened by new regulations, increased oversight, and heightened enforcement, which place direct disclosure obligations on municipal securities issuers. As such, the clear provisions of the 1975 Tower Amendment, which limit regulation of the municipal securities market to anti-fraud actions, have been cut off at all corners.

This Article examines the fundamental discord between regulating the municipal securities market with the same structure and intensity as the corporate securities market. This Article proposes limiting the reach of federal regulatory bodies on the municipal securities market because of the harmful and unnecessary impacts caused by overbroad regulatory actions. To subdue these harms, this Article ultimately suggests that registration and disclosure requirements place undue burdens on municipal issuers and their counterparts, and that regulatory bodies should be limited to controlling municipal securities through anti-fraud actions.

I. Introduction

There are at least 3.67 trillion reasons why the municipal securities market shines brightly on the United States Securities and Exchange Commission's ("SEC")

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regulatory radar.[1] California,[2] Detroit,[3] and Puerto Rico[4] all provide notorious cases-in-point for why public investments may no longer be such a safe bet, and why the fiscal stability of governments deserves intensified scrutiny in the regulatory realm. And intense it has become. In the last five years, the municipal securities market has found itself the target of an unprecedented amount of new regulations, strict oversight, and heightened enforcement actions.

This Article is about those increased regulatory burdens on the municipal securities market, why those burdens are undue because of municipal securities' dissonance from traditional corporate securities, and the need to better harmonize regulation with reality. This Article offers the first-ever sustained examination of the recent regulatory burdens on the municipal securities market, highlights the serious flaws in the traditional approaches to financial regulation as applied to the municipal securities market, and ultimately proposes and explains why the market should, as originally crafted under the federal securities laws and sustained through the 1975 Tower Amendment, be limited to regulation through anti-fraud actions.

Part II of this Article provides a bedrock for understanding the municipal securities market. Part III explores the developing concerns related to the municipal securities market. Part IV identifies the increased measures that have been taken to resolve those concerns, specifically the imposition of disclosure obligations on municipal securities issuers, which violates the Tower Amendment. Part V turns from problem to solution, proposing that only anti-fraud actions should be used to regulate the municipal securities market because the municipal securities market differs from the corporate securities market in five fundamental ways. This Article then ends with a brief conclusion that echoes the important call for a regulatory watchdog, rather than a disclosure-dependent megalomaniac, for municipal securities.

II. The Muni Market

Once considered a "sleepy market,"[5] the municipal securities market is now valued at over $3.67 trillion.[6] The municipal securities market consists of both a

1. As of the fourth quarter of 2013, approximately $3.67 trillion of municipal bonds were outstanding. BD. OF GOVERNORS, FED. RESERVE BD., FINANCIAL ACCOUNTS OF THE UNITED STATES – FLOW OF FUNDS, BALANCE SHEETS, AND INTEGRATED MACROECONOMIC ACCOUNTS tbl. L.211 (2013), *available at* http://www.federalreserve.gov/releases/z1/current/z1.pdf.

2. *See* Rich Smith, *How Safe Are Your Muni Bonds? Not Very, Warns Warren Buffett*, DAILY FIN. (July 9, 2012, 4:45 PM), http://www.dailyfinance.com/2012/07/19/warren-buffett-muni-bond-default-crisis-warning/ (discussing California's bankruptcies).

3. *See* Carla Fried, *Municipal Bonds, Stung Again*, N.Y. TIMES (Oct. 5, 2013), http://www.nytimes.com/2013/10/06/business/mutfund/municipal-bonds-stung-again.html?_r=0 (discussing Detroit's July 2013 declaration of bankruptcy).

4. *See* Stephen J. Lubben, *Answer to Puerto Rico's Debt Woes? It's Complicated*, N.Y. TIMES (Feb. 6, 2014, 2:31 PM), http://www.economist.com/news/finance-and-economics/21588364-heavily-indebted-island-weighs-americas-municipal-bond-market-puerto-pobre (analyzing Puerto Rico's debt crisis).

5. Christopher Cox, *Speech by SEC Chairman: Integrity in the Municipal Market*, U.S. SEC. & EXCH. COMM'N (July 18, 2007), *available at* http:// www.sec.gov/news/speech/2007/spch071807cc.htm.

6. BD. OF GOVERNORS, *supra* note 1.

primary market and a secondary market.[7] This Part provides a background of the municipal securities market by defining municipal securities, identifying the market's participants, mapping the market's regulatory history, and revealing the problems created by the conception of Rule 15c2-12.

A. What Is A Municipal Security?

The rudimentary definition of a municipal security is the direct debt obligation issued by a state or local government.[8] Beyond that definition, municipal securities, or "munis",[9] incorporate an abundant variety of characteristics. These securities typically diverge in two primary aspects: 1) purpose and 2) form.

1. Purpose

Municipal securities employ varying purposes. In general, municipal securities provide the necessary financial means for "building and maintaining" our nation's infrastructure.[10] Government entities issue municipal securities to finance important public projects, including the construction of schools, hospitals, and highways.[11] Furthermore, the securities are used to meet the everyday financing needs of municipalities.[12]

2. Form

Municipal securities come in many forms. A common thread among most municipal securities is that they are tax-exempt,[13] an appealing feature for many investors. Other features and forms are not so similar. The greatest distinction involves separating two types of bonds that are classified as either general obligation bonds or revenue bonds.[14] The difference between these two types of bonds deals with repayment structures. Repayment on general obligation bonds is made from the issuer's general tax revenue; thus, the debt is secured by the issuer's full faith and credit, along with the government's taxing power.[15] Conversely, revenue bonds are repaid by revenues generated from the public projects themselves or from special taxes (sales, gasoline, etc.).[16]

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7. *See* U.S. SEC. & EXCH. COMM'N, REPORT ON THE MUNICIPAL SECURITIES MARKET 1 (2012), *available at* http://www.sec.gov/news/studies/2012/munireport073112.pdf [hereinafter MUNICIPAL REPORT].
8. Securities Exchange Act of 1934 § 3(a)(29), 15 U.S.C. § 78c(a)(29) (2006).
9. *Investing Basics: Municipal Bonds: What Are Municipal Bonds?*, INVESTOR.GOV, http://www.investor.gov/investing-basics/investment-products/municipal-bonds#.VKmqWivF-AV (last visited Apr. 1, 2015).
10. MUNICIPAL REPORT, *supra* note 7.
11. *Id.* at 5.
12. *Id.*
13. *Id.* at 11.
14. *Id.* at 7.
15. *Id.*
16. *Id.*

The securities can also have different maturities.[17] Municipal securities that have maturities of less than one year are typically referred to as municipal "notes."[18] Conversely, municipal "bonds" typically hold maturities greater than a year.[19] Another distinction comes in the area of interest rates. Interest rates on municipal securities can either involve a predetermined fixed rate or a variable rate that adjusts in accordance with market conditions.

In all, several factors determine the overall makeup of municipal securities. The securities share certain characteristics with corporate securities, but are truly unique in other respects.

B. Market Participants

An essential ingredient for understanding any market, and how to regulate it, involves knowing its players. The municipal securities market consists of four core groups of participants: 1) issuers, 2) underwriters, 3) advisors, and 4) investors.

1. Issuers

It is estimated that there are over "55,000 issuers of municipal securities in the United States."[20] Towns, cities, counties, and states commonly issue municipal bonds, but issuers also include a broad span of government entities such as hospitals and universities.[21]

2. Underwriters

Along with the issuing governmental entities, underwriters play a vital role in bringing municipal securities to market. Underwriters act as intermediaries between the municipal securities issuer and the investors during a primary offering.[22] In most primary offerings, a syndicate—or group of underwriters—purchases the securities directly from the governmental entity and then resells the securities to investors.[23] These syndicates may consist of large banks or small firms.[24] Also, with each underwriting arrangement, the issuer pays the underwriter a fee for selling the securities, which is determined on a case-by-case basis with each particular offering.[25]

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17. JUDY WESALO TEMEL, BOND MARKET ASS'N, THE FUNDAMENTALS OF MUNICIPAL BONDS 248 (5th ed. 2001).

18. MUN. SEC. RULEMAKING BD., GLOSSARY OF MUNICIPAL SECURITIES TERMS, Note (2d. ed. 2004), *available at* http://emma.msrb.org/EducationCenter/Glossary.aspx [hereinafter MSRB GLOSSARY].

19. *Id.*, Bond.

20. *How the Market Works*, MUN. SEC. RULEMAKING BD., http://www.msrb.org/Municipal-Bond-Market/How-the-Market-Works.aspx (last visited Apr. 1, 2015).

21. *See Investor Bulletin: Focus on Municipal Bonds*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/investor/alerts/municipal.htm (last visited Apr. 1, 2015).

22. *See* MUNICIPAL REPORT, *supra* note 7, at 15 (discussing the role of the underwriter); *see also* Securities Act of 1933 § 2(a)(11), 15 U.S.C. § 77b(a)(11) (2006) (defining "underwriter").

23. LARRY D. SODERQUIST & THERESA A. GALBADON, SECURITIES REGULATION 26 (5th ed. 2003).

24. *Id.*

25. MUNICIPAL REPORT, *supra* note 7, at 15.

3. Municipal Advisors

Another important player in bringing municipal securities to market is a municipal advisor. Government issuers will often employ a municipal advisor to provide counseling services regarding how to structure the issuance.[26] General financial advisors, consultants, or legal counsel can take on this role of a municipal advisor. The advisors often assist issuers in determining their financing needs and may help to determine how to acquire the necessary capital. Advisors may also act as liaisons in connecting underwriters with the issuers.[27] In some instances, financial firms may act as both underwriters and municipal advisors for the issuance.[28]

4. Investors

On the other side of the participant equation are municipal securities investors. In its early days, institutional investors dominated the municipal securities market.[29] Institutional investors include large banks, pension funds, and hedge funds.[30] However, the Tax Reform Act of 1986 significantly reduced the tax benefits associated with securities when the securities are purchased by large institutional investors.[31] As a result, retail investors make up nearly seventy-five percent of municipal securities investors today.[32] Retail investors include individual "household" investors and small organizations.[33] Thus, several participants play significant roles in establishing the municipal securities market.

C. Regulatory Background

There are two monumental periods of legislation that shaped the regulatory background of the municipal securities market: 1) the Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act") (collectively, "Federal Securities Laws"); and 2) the Securities Act Amendments of 1975 ("1975 Amendments").

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26. *See* Kenneth N. Daniels & Jayaraman Vijayakumar, *The Role and Impact of Financial Advisors in the Market For Municipal Bonds*, 30 J. FIN. SERVS. RES. 43, 43 (2006) ("Significantly more and more issuers of municipal bonds use the services of financial advisors during the bond issuance process.").

27. TEMEL, *supra* note 17, at 11.

28. *Id.*

29. *Id.* at 150.

30. JOHN C. COFFEE, JR. & HILLARY A. SALE, SECURITIES REGULATION 41 (11th ed. 2009).

31. *See* STAFF OF THE JOINT COMM. ON TAXATION, GENERAL EXPLANATION OF THE TAX REFORM ACT OF 1986 558–66 (1987), *available at* http://www.jct.gov/jcs-10-87.pdf.

32. MUNICIPAL REPORT, *supra* note 7.

33. MSRB GLOSSARY, *supra* note 18, Retail Customer.

1. Federal Securities Laws

The Federal Securities Laws laid the initial regulatory groundwork for the municipal securities market. When originally enacted, Section 3(a)(2) of the Securities Act exempted municipal securities and their issuers from registration, disclosure, and periodic reporting requirements.[34] The only federal regulations that pertained to municipal securities transactions were the Federal Securities Laws' antifraud provisions—Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act, and Rule 10b-5.[35] These antifraud provisions prohibit any person from making a false or misleading statement of material fact, or from omitting any material fact, in connection with the offer, purchase, or sale of any security—municipal securities included.[36]

This "hands off" approach[37] to securities regulation was justified for several economic and policy reasons. First, Congress feared that registration and disclosure requirements would place undue economic burdens on municipal securities issuers.[38] Congress found that certain costs on underwriters, such as capital requirements, investigatory duties, and other due diligence obligations, would spread to issuers and hinder their ability to raise capital.[39] Similarly, disclosure obligations would cause issuers to bear increased costs to obtain independent audit reports, legal representation, or otherwise afford necessary costs of compliance.[40]

Second, the exemption found credence with policy considerations.[41] The municipal securities market generally enjoyed high levels of investor confidence. The market had low rates of default. The market was primarily composed of sophisticated investors. There was a favorable absence of any evidence of sales or trading abuse (comparable to that found in the corporate securities markets), and Congress was especially suspect of possible constitutional problems with imposing federal regulations on municipalities.[42] Based on these justifications, this regulatory approach went undisturbed for nearly forty years.

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34. *See* 15 U.S.C. § 77c(a)(2) (2006) ("[15 U.S.C. §§ 77a-77aa] shall not apply to . . . [a]ny security issued or guaranteed by the United States or any territory thereof, or by the District of Columbia, or by any State of the United States, or by any political subdivision of a State or Territory, or by any public instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States.").

35. *See* Securities Act of 1933 § 17(a), 15 U.S.C. § 77q(a) (2006); Securities Exchange Act of 1934 § 10(b), § 15(c), 15 U.S.C §§ 78j(b), 78o(c) (2006); Rules 10b-5, 15c-2, 17 C.F.R. §§ 240.10b-5, 240.15cl-2 (2006).

36. *See, e.g.*, 17 C.F.R. § 240.10b-5 (2006).

37 . Ema Clark, *The Dodd-Frank Act and Municipal Securities Regulation*, 30 REV. BANKING & FIN. L. 494, 498 (2011).

38. *See Stock Exchange Practices: Hearings on S.R. 84, S.R.56 & S.R. 97 Before the Senate Comm. on Banking and Currency*, 73d Cong., 2d Sess. (1934); *Hearings on H.R. 7852 & H.R. 8720 Before the House Comm. on Interstate and Foreign Commerce*, 73d Cong., 2d Sess. (1934).

39. *Id.*

40. *Id.*

41. H.R. REP. NO. 73-8 (1933); *Hearings on S. 873 before the Senate Comm. on Banking and Currency*, 73d Cong., 1st Sess. (1933).

42. *Id.*

2. 1975 Amendments

In the early 1970s, the municipal securities market began to increase in both size and volume of transactions.[43] The market began to see increased entries of retail investors, growing evidence of sale and trading abuses, and a lack of investor confidence.[44] During this time, the SEC instituted several anti-fraud actions involving municipal securities dealers.[45] Then came the crisis. In March 1975, New York City nearly defaulted on municipal bonds valued at $600 billion, which would have been the largest municipal default in history.[46] After this event, Congress concluded that "[e]xpanding the protections generally available under the federal securities laws to investors in municipal securities is . . . appropriate."[47]

On June 4, 1975, Congress initiated a series of amendments to the Federal Securities Laws.[48] The three most important aspects of these amendments were: a) the creation of the Municipal Securities Rulemaking Board ("MSRB"); b) new registration requirements for municipal securities underwriters; and c) the Tower Amendment.

a. The MSRB

Pursuant to the 1975 Amendments, Congress established the MSRB as the primary rulemaking authority for the municipal securities marketplace.[49] As a self-regulatory organization, the MSRB was charged with establishing rules for those involved in underwriting, advising, trading, or selling municipal securities.[50] Subject to oversight by the SEC, the MSRB was granted the authority to issue guidance and create rules establishing fair practices and procedures amongst the participants in the municipal securities market. However, the MSRB does not have enforcement power. Instead, Congress divided municipal enforcement responsibilities among multiple regulatory agencies.[51] Currently, in addition to the SEC, the Financial Industry Regulatory Authority ("FINRA") and several banking agencies (e.g., the FDIC) all play a role in the enforcement of MSRB rules.[52] The MSRB works to

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43. *See* MUNICIPAL REPORT, *supra* note 7, at ii (discussing the motivations behind the 1975 Amendments).

44. *See id*; *see also* S. REP. NO. 94-75, at 3–4 (1975).

45. OFFICE OF MUN. SEC., U.S. SEC & EXCH. COMM'N, CASES AND MATERIALS 19–23 (1999) *available at* http://www.sec.gov/pdf/mbondcs.pdf (summarizing several enforcement actions involving municipal securities dealers in the late 1970s).

46. Christine Sgarlata Chung, *Municipal Securities: The Crisis of State and Local Government Indebtedness, Systemic Costs of Low Default Rates, and Opportunities For Reform*, 34 CARDOZO L. REV. 1455, 1502 (2013).

47. S. REP. NO. 94-75, at 3 (1975); *see also* Ann Judith Gellis, *Mandatory Disclosure For Municipal Securities: A Reevaluation*, 36 BUFF. L. REV. 15, 17–18 (1987) ("[T]he decision not to require disclosure of information by municipal issuers went unquestioned [until the New York City bond crisis].").

48. Securities Acts Amendments of 1975, Pub. L. No. 94-29, § 13, 89 Stat. 97, 132 (codified as amended at 15 U.S.C. § 78o-4(b)(1) (2006)).

49. *See* S. REP. NO. 75-94, at 48 (1975).

50. *See* § 13, 89 Stat. at 132.

51. *See* Securities Exchange Act of 1934 § 15B(c)(5) (1934).

52. *See id.* § 15B(c)(7).

facilitate the enforcement efforts of these agencies through regulatory coordination and enforcement support programs.[53]

b. Registration Requirements

The 1975 Amendments also created registration requirements for participants in the secondary market. Firms transacting in municipal securities in the secondary market were required to register with the SEC as broker-dealers.[54] Additionally, banks dealing with municipal securities in this market were required to register as municipal securities dealers.[55] Congress gave the SEC broad rulemaking and enforcement authority over these broker-dealers and municipal securities dealers.[56] Outside of initial registration, however, there were no ongoing disclosure requirements imposed on these parties.

c. Tower Amendment

A key provision of the 1975 Amendments is the so-called Tower Amendment. Congress established the Tower Amendment in deference to, and furtherance of, the disclosure-exempt status of municipal securities as required by Section 3(a)(2) of the Securities Act.[57]

The Tower Amendment contains two provisions that expressly restrict federal regulation pertaining to municipal securities issuers—whether directly or indirectly. The first provision restricts municipal securities regulation in primary market issuances:

> Neither the [SEC] nor the [MSRB] is authorized under this chapter, by rule or regulation, to require any issuer of municipal securities, directly or indirectly through a purchaser or prospective purchaser of securities from the issuer, to file with the [SEC] or the [MSRB] prior to the sale of such securities by the issuer any application, report, or document in connection with the issuance, sale, or distribution of such securities.[58]

The second provision restricts federal regulation of municipal securities in the secondary market:

> The [MSRB] is not authorized under this chapter to require any issuer of municipal securities, directly or indirectly through a municipal securities broker, municipal securities dealer, municipal advisor, or otherwise, to furnish to the [MSRB] or to a purchaser or a prospective purchaser of such securities any application, report,

53. *See* MUNICIPAL REPORT, *supra* note 7, at 34–35.

54. *See* Securities Acts Amendments of 1975, Pub. L. No. 94-29, § 13, 89 Stat. 97, 132 (codified as amended at 15 U.S.C. § 78o-4(b)(1) (2006)).

55. *See id.*

56. *See, e.g.*, Securities Exchange Act of 1934 §§ 15(c)(1), 15(c)(2); 17(a); 17(b), 15B(c)(1), 21(a)(1).

57. *See* § 13, 89 Stat. at 132.

58. *Id.* § 78o-4(d)(1).

> documents, or information with respect to such issuer: Provided, however, that the [MSRB] may require municipal securities brokers and municipal securities dealers or municipal advisors to furnish to the [MSRB] or purchasers or prospective purchasers of municipal securities applications, reports, documents, and information with respect to the issuer thereof which is generally available from a source other than such issuer. Nothing in this paragraph shall be construed to impair or limit the power of the [SEC] under any provision of this chapter.[59]

These provisions of the Tower Amendment clearly illustrated Congress's approval and desire to keep municipal securities issuers free from registration and disclosure requirements. No act of Congress has ever repealed Section 3(a)(2) of the Securities Act or the Tower Amendment.

D. Rule 15c2-12

With the Tower Amendment in place, the issue of municipal securities disclosure was not questioned for fourteen years. Then, in 1989, the Washington Public Power Supply System ("WPPSS") (which is, ironically, pronounced "whoops"[60]) defaulted on $2.25 billion of municipal revenue bonds.[61] Upon investigating this catastrophe, the SEC developed new concerns about the financial reporting and disclosure aspects of the municipal securities market.[62] But, with Section 3(a)(2) and the Tower Amendment in the back of their minds, neither Congress nor the SEC wanted to impose direct disclosure requirements upon municipal securities issuers. Instead, the SEC decided to target municipal securities and exercised its authority under Section 15(c)(2) of the Exchange Act, which enables the SEC to adopt rules to deter fraud and manipulation in the municipal securities market.[63] On June 28, 1989, the SEC adopted Rule 15c2-12.[64]

When initially adopted, Rule 15c2-12 required underwriters who participated in primary offerings of municipal securities to obtain, review, and distribute to investors copies of the issuer's official statement.[65] Official statements are a type of disclosure document that bear a striking resemblance to a prospectus in the corporate securities context.[66] In connection with Rule 15c2-12, the SEC issued a companion

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59. *Id.* § 78o-4(d)(2).
60. Cox, *supra* note 5.
61. *See* 17 C.F.R. § 240.15c2-12 (1995); *see also* Municipal Securities Disclosure, Exchange Act Release No. 26,985, 54 Fed. Reg. 28,799 (July 10, 1989) (final rule).
62. *See generally* DIV. OF ENFORCEMENT, U.S. SEC. & EXCH. COMM'N, STAFF REPORT ON THE INVESTIGATION IN THE MATTER OF TRANSACTIONS IN WASHINGTON PUBLIC POWER SUPPLY SYSTEM SECURITIES (1988), *available at* http://3197d6d14b5f19f2f4405e13d29c4c016cf96cbbfd197c579b45.r81.cf1.rackcdn.com/collection/papers/1980/1988_0901_SEC_WPPSS.pdf.
63. The SEC adopted Rule 15c2-12 under Section 15(c)(2) of the Exchange Act. Municipal Securities Disclosure, Exchange Act Release No. 26,985, 54 Fed. Reg. 28,799 (July 10, 1989) (final rule).
64. *Id.*
65. 17 C.F.R. § 240.15c2-12 (2012); *see also* Municipal Securities Disclosure, Exchange Act Release No. 26,985, 54 Fed. Reg. 28,799 (July 10, 1989) (final rule).
66. Tesia Nicole Stanley, *Narrowing the Disclosure Gap: Is EMMA EDGAR For the Municipal Securities Market?*, 7 J.L. ECON. & POL'Y 91, 102 (2010).

statement that discussed certain due diligence obligations of municipal underwriters and their responsibility to review the municipal issuer's official statement.[67] As such, the first makings of municipal securities disclosure obligations took form by way of this "back-door" primary offering scheme.

In less than five years, the SEC was able to expand its Rule 15c-12 authority to post-offering disclosures. In 1994, Orange County California declared bankruptcy after the county lost over $1.5 billion through high-risk investments in bonds.[68] Shortly thereafter, the SEC enacted amendments to Rule 15c2-12.[69] The amendments prohibited underwriters from participating in a municipal securities offering unless the underwriter could "reasonably determine" that the issuer would disclose specified annual information and notices of certain events.[70]

After this chain of events, the greatest undisclosed truth in the municipal securities market was that issuers were now subject to disclosure requirements. The Tower Amendment clearly stated that issuers could not be regulated with disclosure obligations either directly or indirectly, yet Rule 15c2-12 effectively placed these burdens on issuers because they could not (practically) sell their securities without underwriters, and underwriters could not (legally) sell the securities without seeing disclosure documents from the issuer. However, whatever were the claims of dichotomy or abuse of authority that could be pegged on the SEC's creation of Rule 15c2-12, these claims were never asserted because Rule 15c2-12 was never enforced.[71] Whether issuers complied with the rule or not, there was never a concern that Rule 15c2-12 held much weight.

III. Regulatory Concerns

This Part discusses the new concerns that have recently eclipsed the municipal securities market and the bases for increasing the scope and intensity of disclosure obligations in the market. Within the last five years, the composition and outlook of the municipal securities market has met unchartered levels of turbulence. In the wake of a global recession,[72] investment concerns abounded in virtually every industry. In a CNN interview on December 18, 2009, superstar investment banking analyst Meredith Whitney enflamed the public's concerns toward municipal

67. *See* Municipal Securities Disclosure, Exchange Act Release No. 26,100, 53 Fed. Reg. 37,778 (Sept. 22, 1988) (proposing Rule 15c2-12).

68. *See generally* Report of Investigation in the Matter of County of Orange, California as It Relates to the Conduct of the Members of the Board of Supervisors, Exchange Act Release No. 36,761 (Jan. 24, 1996), *available at* http://www.sec.gov/litigation/admin/3436761.txt (discussing the potential default of Orange County).

69. Municipal Securities Disclosure, Exchange Act. Release No. 34,961, 59 Fed. Reg. 59,590 (Nov. 10, 1994).

70. 17 C.F.R. §§ 240.15c2-12 (2012).

71. William C. Rhodes, Teri M. Guarnaccia, & Tesia N. Stanley, *SEC Enforcement Division Encourages Self-Reporting by Municipal Issuers and Underwriters*, BALLARD SPAHR LLP (Mar. 11, 2014), http://www.ballardspahr.com/alertspublications/legalalerts/2014-03-11-sec-encourages-self-reporting-by-municipal-securities-issuers-underwriters.aspx.

72. *See generally* John C. Philo, *Local Government Fiscal Emergencies and the Disenfranchisement of Victims of the Global Recession*, 13 J.L. SOC'Y 71 (2011) (discussing the global recession that began in 2007 and its effect on local governments).

securities. Whitney said, "There's not a doubt in my mind that you will see a spate of municipal-bond defaults. . . . You could see 50 sizable defaults, 50 to 100 sizable defaults . . . This will amount to hundreds of billions of dollars' worth of defaults."[73] As hindsight would have it, Whitney was wrong.[74] Still, these concerns are not baseless.

In recent years, increasing problems have been observed in the municipal securities marketplace, including "pay to play" practices, conflicts of interest, and overly complex municipal securities instruments.

A. Pay-to-Play Problems

"Pay-to-play" describes a common practice in the municipal securities industry whereby dealers and underwriters provide political contributions to the campaigns of elected officials in order to solicit municipal bond business.[75] These contributions are specifically directed to the campaigns of elected officials who will in turn favor those firms that contributed to them when it is time to select dealers for municipal bond work.[76] Elected officials involved in the selection of dealers and underwriters for municipal securities business can range from a local council member to a state governor.[77] These influential contributions can be made to candidates running for an office or to incumbents already in such offices who are seeking re-election.

Dealers and underwriters personally benefit from the award of municipal bond business by the fees they generate through underwriting the bonds. These fees can mean big business in the $3.67 trillion market.[78] Therefore, it is understandable that the system of pay-to-play has historically had an important role in the municipal securities industry. The practice had become so common that Wall Street considered these large political contributions to be an ordinary cost of doing business in the municipal securities industry.[79] Those who did not play the game risked foregoing valuable municipal bond business, while those who did play were richly rewarded.[80] Many Wall Street executives condemned the practice but continued to pay-to-play because they feared that if they did not, then their competitors who continued to make contributions would have an inside track on the

73. Max Abelson & Michael McDonald, *Whitney Municipal-Bond Apocalypse Short on Specifics*, BLOOMBERG (Feb. 1, 2011, 10:46 AM), *available at* http://www.bloomberg.com/news/2011-02-01/whitney-municipal-bond-apocalypse-is-short-on-default-specifics.html.

74. *See, e.g.*, David Weidner, *Meredith Whitney Blew a Call—and Than Some,* WALL ST. J. (Sep. 27, 2012, 1:53 PM), *available at* http://online.wsj.com/news/articles/SB10000872396390444549204578021380172883800.

75. *See* Stephen J. Hedges & Warren Cohen, *The Politics of Money: How Underwriters of Municipal Bonds Win Their Business,* U.S. NEWS & WORLD REP. (Sep. 20, 1993), *available at* http://wjcohen.home.mindspring.com/usnclips/money.htm.

76. *Id.*

77. *See* Jerry Knight, *Cracking the "Club" That Controls the Muni Bond Market,* WASH. POST, Nov. 21, 1993, at H1.

78. *See* BD. OF GOVERNORS, *supra* note 1.

79. *See* Hedges & Cohen, *supra* note 75.

80. *See* Jube Shiver, Jr., *Big Muni Bond Firms Agree to Curb Political Contributions,* L.A. TIMES, Oct. 19, 1993, at D1.

municipal bond business.[81] Moreover, some Wall Street underwriters, who complained about the system in private, did not dare complain about it to federal officials out of fear that government issuers would blacklist them.[82]

B. Other Conflicts of Interest

The pay-to-play practice is one type of concern regarding potential conflicts of interest between elected officials and dealers and underwriters. Regulators have also been increasingly suspect of the influence that municipal advisors have on issuers and the amount of fees earned from arranging bond issuances. The importance of bond counsel is crucial in the municipal securities market because they assist issuers—government officials who may or may not have any financial competency—in the structuring of deals, thereby increasing the likelihood of a successful project. However, conflicts of interest arise when the advisors are not independent, and are somehow connected to the dealers or underwriters, therefore, having an incentive to manipulate the fees paid by issuers to the dealers or underwriters.[83] For instance, "a municipal advisor might advise an issuer to structure an offering in a particular way," even though that structure is not in the issuer's best interest because "the financial advisor may receive payments from a third party, such as the provider of a swap or guaranteed investment contract."[84]

Issues also arise in certain swap transactions. In these situations, the municipal advisor's pecuniary interest is dependent upon concluding the swap agreement.[85] Therefore, these arrangements may improperly incentivize municipal advisors to emphasize the benefits of the swaps and minimize their risks so that they can get the municipal security out the door as soon as possible.

C. Complex Instruments

Additional concerns have arisen regarding the growing complexity of municipal securities and whether municipal advisors sufficiently understand, and are qualified to advise, on these products. Historically, municipal securities were

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81. *Id.*

82. Constance Mitchell & Thomas T. Vogel, Jr., *Illegal Payments Mar the Muni Market,* WALL ST. J., May 5, 1993, at C1.

83. Tamar Frankel, *"Let Me Advise You How Much to Pay Me": Subverting Fiduciary Duties and Rules*, 28 MUN. FIN. J. 53, 54–55 (2007).

84. *See* Martha Mahan Haines, *Testimony Concerning Legislative Proposals to Improve the Efficiency and Oversight of Municipal Finance*, U.S. SEC. & EXCH. COMM'N (May 21, 2009), *available at* http://www.sec.gov/news/testimony/2009/ts052109mmh.htm.

85. *See* PA. DEP'T OF THE AUDITOR GEN., A SPECIAL INVESTIGATION OF THE BETHLEHEM AREA SCHOOL DISTRICT, LEHIGH/NORTHAMPTON COUNTIES: A CASE STUDY OF THE USE OF QUALIFIED INTEREST RATE MANAGEMENT AGREEMENTS ("SWAPS") BY LOCAL GOVERNMENT UNITS IN PENNSYLVANIA, WITH RECOMMENDATIONS 42–43 (2009), *available at* http://www.auditorgen.state.pa.us/Media/Default/Reports/invBASD111809.pdf (relating conclusions and recommendations regarding deceptive tactics of market advisors).

benign and basic.[86] Today, municipal securities can take the form of complex derivatives and other instruments that are incomprehensible to even highly trained investment advisors.[87] Specifically, regulators have grown increasingly concerned about the role of unregulated advisors in the sale of derivative products to municipalities, particularly interest rate swaps.[88] "[D]erivative products carry numerous embedded risks that may not be easily understood by less financially sophisticated issuers. Some such risks are interest rate risk, termination risk, and counterparty risk."[89] Even "[m]any sophisticated issuers face large swap termination fees due to changes in short-term interest rates."[90] These developing intricacies and convoluted structures open the door to abuse because problems with the securities may not be detectable, let alone understood. Each of the concerns raised in this section have the potential to lead to bankruptcy or risks of default for municipal securities issuers.

IV. Tearing Down the Tower

This Part discusses regulators' newfound appetite to impose regulatory burdens on the municipal securities market. The aftermath of the 2008-2009 global financial crisis and subsequent developing concerns associated with municipal securities have led regulators to zone in on the municipal securities market. Since 2009, there have been unprecedented amounts of regulatory movement focused on reforming the municipal marketplace. The most prevalent among these actions have been new regulations, increased oversight, and heightened enforcement.

A. New Disclosure Regulations

There have been several new regulations that have recently come into existence that require municipal securities issuers to provide disclosures to the SEC and the MSRB. The three most important regulations are: 1) the creation of the Electronic Municipal Market Access system ("EMMA"); 2) an amendment to Rule 15c2-12 requiring special event disclosures; and 3) the registration requirements for municipal advisors pursuant to the Dodd-Frank Wall Street Reform and Consumer Protect Act ("Dodd-Frank").

86. *See* MUNICIPAL REPORT, *supra* note 7, at 91–95 (discussing how municipal securities have interacted with, and been affected by, derivatives and swaps).

87. *See id.*

88. *See Enhancing Investor Protection and the Regulation of Securities Markets - Part II: Hearing Before the S. Comm. on Banking, Housing, and Urban Affairs*, 111th Cong. 178-79 (2009) (statement of Ronald A. Stack, Chair, MSRB), *available at* http:// www.gpo.gov/fdsys/pkg/CHRG-111shrg144/pdf/CHRG-111shrg144.pdf.

89. *Id.* at 178.

90. *Id.*

1. EMMA

On July 1, 2009, the SEC effected a new rule requiring municipal securities underwriters to "reasonably determine" that the municipal securities issuer provided disclosure documents to the MSRB by way of EMMA.[91] This rule's bottom line is that EMMA would be the sole repository for initial and continuing disclosure documents. In other words, EMMA became the equivalent of EDGAR[92] in the corporate securities marketplace—a standardized disclosure system that provides easy access to issuers' filings for investors and regulators alike.

2. Special Event Disclosures

In May 2010, the SEC adopted additional amendments to Rule 15c-12 requiring municipal securities dealers to provide special-event disclosures.[93] These amendments also eliminated the existing materiality requirements for certain reportable events.[94] The amendments expanded the number and type of reportable events[95] and imposed new time limits for reporting events.[96] The amendments also revised (and almost entirely eliminated) an exemption from Rule 15c2-12's continuing disclosure requirements for certain municipal securities, such as those with put features.[97] The SEC, in conjunction with these amendments, issued an interpretive guidance, which reminded underwriters of their obligations under the antifraud provisions, particularly in cases where a municipal issuer failed to comply with agreements to provide continuing disclosure documents.[98] The interpretive guidance also reminded issuers that they are "primarily responsible for the content of their disclosure documents, and may be held liable under the federal securities laws for misleading disclosure."[99]

Commenting on these developments, the SEC's staff has expressed the view that the SEC had reached the outer edges of its rule-making authority under Rule 15c2-12.[100] Still, the edges of authority seem to be continually expanding.

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91. DORSEY & WHITNEY LLP, IMPACT OF RECENT AMENDMENTS TO RULE 15C2-12 AND APPROVAL OF MSRB'S EMMA SYSTEM 1 http://www.dorsey.com/files/upload/rule15c2_12.pdf (last visited Apr. 1, 2015).

92. *See generally* Stanley, *supra* note 66 (comparing EMMA and EDGAR).

93. *See* Amendment to Municipal Securities Disclosure, Exchange Act Release No. 34-62184A, 75 Fed. Reg. 33,100 (May 26, 2010) (codified at 17 C.F.R. § 240.15c2-12).

94. *Id.* at 33,103.

95. *Id.*

96. *Id.* at 33,131.

97. *Id.* at 33,100.

98. *Id.*

99. *Id.*

100. *See, e.g.*, Press Release, *Disclosure and Accounting Practices in the Municipal Securities Market*, U.S. SEC. & EXCH. COMM'N 3-4 (2007), *available at* http:// www.sec.gov/news/press/2007/2007-148wp.pdf.

3. The Dodd-Frank Act

On October 1, 2012, Section 975 of Dodd-Frank became effective.[101] This section required municipal advisors to register with the SEC. Immediately following the passage of Dodd-Frank, the SEC adopted an interim rule to temporarily satisfy this requirement and created final rules for the requirement on September 23, 2013.[102] In January 2014, the SEC issued a stay on the final rule until July 2014. The reason for the stay was to provide additional time for market participants to address a number of issues regarding implementation of, and compliance with, the new rule.[103] The rule would require many participants to adapt their policies and procedures, develop supervisory practices and internal controls, adapt account and investment tracking systems, develop recordkeeping procedures, adapt business models and practices, educate personnel with respect to the new rule, and develop training programs to establish effective compliance with the rule.[104]

Additionally, Dodd-Frank significantly expanded the authority of the MSRB, allowing the MSRB to adopt rules regulating transactions in municipal securities by broker-dealers and municipal securities dealers.[105] Dodd-Frank enabled the MSRB to provide advice to, or on behalf of, municipal entities and their intermediaries, along with other municipal advisors[106] with respect to municipal financial products[107] or the issuance of municipal securities. Pursuant to the proposed SEC rule, the MSRB was also granted authority to solicit certain business on behalf of broker-dealers, municipal securities dealers, and municipal advisors from municipal entities and obligated persons.[108] Dodd-Frank also changed the composition of the membership on the MSRB to require a majority of public representatives.[109]

In sum, Dodd-Frank called for "the MSRB to write rules to regulate the advisers, but [the MSRB] can't do so until the SEC establishes who counts as a municipal adviser."[110] In effect, then, this new rule will allow the MSRB to impose any disclosure obligations on these parties.

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101. The Dodd-Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376, § 975 (2010) [hereinafter Dodd-Frank Act].

102. Temporary Registration of Municipal Advisors, Exchange Act Release No. 62824, 75 Fed. Reg. 54,465 (Sept. 1, 2010) (to be codified at 17 C.F.R. pt. 240, 249).

103. Temporary Stay on Final Rule on Registration of Municipal Advisors, Exchange Act Release No. 34-71288, 79 Fed. Reg. 2,777 (Jan. 13, 2014).

104. *See e.g.*, letter from Mike Nicholas, CEO, Bond Dealers of America, to Hon. Mary Jo White, Chair, U.S. Sec. & Exch. Comm'n, (Nov. 8, 2013), *available at* http://www.sec.gov/comments/s7-45-10/s74510-977.pdf.

105. MUNICIPAL REPORT, *supra* note 7, at 33–35.

106. 124 Stat. 1376 (2010).

107. *Id.*

108. *Id.*

109. *Id.*

110. Liz Farmer, *What Will the New Bosses at the SEC and MSRB Mean for Muni Bonds?*, GOVERNING (June 2013), http://www.governing.com/topics/finance/gov-new-bosses-sec-msrb-effects-on-muni-bonds-market.html.

B. Increased Oversight

The amount of oversight in the municipal securities marketplace has increased in the last five years. The three most important changes in this realm are: 1) the creation of the Municipal Securities and Public Pensions unit ("MSPP"); 2) a new SEC enforcement division called the Office of Municipal Securities ("OMS"); and (3) the introduction of the Municipalities Continuing Disclosure Initiative ("Initiative").

1. Municipal Securities and Public Pensions Unit

On January 13, 2010, the SEC announced the appointment of the MSPP.[111] This new "specialized unit" was created to target misconduct in the municipal securities market, with a specific focus on public pension funds. A specific mandate of the unit was to target "offering and disclosure fraud."[112] The MSPP has brought actions against bulge-bracket banks such as Goldman Sachs and Bank of America, and has also been involved in the cases "against the states of Illinois and New Jersey and the cities of Harrisburg, Pennsylvania; South Miami, Florida; and Miami, Florida."[113]

2. Office of Municipal Securities

In 2012, the SEC established the OMS as required by Dodd-Frank.[114] The OMS works to educate municipal securities issuers about risk management issues and SEC policies.[115] Additionally, the OMS "reviews and processes rule filings created by [the MSRB] and acts as the SEC's liaison with the [MSRB], FINRA, and a variety of industry groups on municipal securities issues."[116] The OMS director, John Cross, has emphasized that a key mission of the OMS is to increase disclosure obligations in the municipal securities market.[117]

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111. William F. Sullivan, Thomas A. Zaccarro, Morgan J. Miller, & Adam D. Schneir, *SEC Unveils Specialized Units and New Cooperation Standards*, PAULHASTINGS.COM 1 (Jan. 2010), *available at* http://www.paulhastings.com/Resources/Upload/Publications/1485.pdf.
112. *Id.*
113. Deede Weithorn, *State and Local Governments Face Tougher Enforcement of Federal Securities and Pension Regulations*, BERKOWITZ POLLACK BRANT (Aug. 8, 2013), http://www.bpbcpa.com/litigation-support/state-and-local-governments-face-tougher-enforcement-of-federal-securities-and-pension-regulations-by-deede-weithorn/.
114. *See Dodd-Frank Financial Reform Act Will Impact Municipal Securities Market*, MCGUIRE WOODS CONSULTING (July 22, 2010), https://www.mcguirewoods.com/Client-Resources/Alerts/2010/7/Dodd-Frank-Financial-Reform-Act-Will-Impact-Municipal-Securities-Market.aspx.
115. *Office of Municipal Securities*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/municipal#.U2QZ6q1dUs8 (last visited Apr. 1, 2015).
116. *Id.*
117. Farmer, *supra* note 110.

3. Self-Reporting Disclosure Violations

On March 10, 2014, the SEC announced the new "cooperation" Initiative.[118] The Initiative encourages municipal securities issuers to self-report Rule 15c2-12 disclosure violations to the SEC. According to the Initiative, the SEC will recommend "favorable settlement terms" to issuers if they self-report any violations involving materially inaccurate statements relating to "prior compliance with the continuing disclosure obligations specified in Rule 15c2-12."[119] While not strictly an oversight committee, the Initiative displays the SEC's paternalistic approach to the municipal securities market.

C. Heightened Enforcement

"Before 2013, despite reports of widespread issuer noncompliance with . . . disclosure obligations, the SEC had not brought a related enforcement action against an issuer or emphasized SEC Rule 15c2-12 in its enforcement actions against underwriters."[120] Two cases brought in 2013 reveal the SEC's new enforcement ideologies with respect to Rule 15c2-12 and municipal securities issuers: 1) West Clark, and 2) Wenatchee.

1. West Clark

In July 2013, the SEC set groundbreaking precedent by undertaking an enforcement action against Indiana's West Clark Community Schools District of Clark County, Indiana ("West Clark") and the school district's underwriter.[121] In December 2007, West Clark issued a $31 million municipal bond offering.[122] In its offering statement, the district affirmatively stated that it was in compliance with all continuing disclosure obligations related to its previous bond offerings.[123] The SEC found, however, that in March 2005, West Clark had issued a $52 million bond offering but had failed to file any initial disclosures, ongoing annual reports, or any notice of its failures to do so.[124]

In its 2007 bond offering, under the section titled "Compliance with Previous Undertakings" of its official statement, West Clark stated that it had "never failed to comply" with any disclosure obligations from its past offerings.[125] The SEC found that

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118. *See Municipalities Continuing Disclosure Cooperation Initiative*, U.S. SEC. & EXCH. COMM'N, http://www.sec.gov/divisions/enforce/municipalities-continuing-disclosure-cooperation-initiative.shtml (last visited Apr. 1, 2015).

119. *Id.*

120. Rhodes, Guarnaccia, & Stanley, *supra* note 71.

121. Press Release, *SEC Charges School District and Muni Bond Underwriter in Indiana with Defrauding Investors*, U.S. SEC. & EXCH. COMM'N (July 29, 2013), *available at* https://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539734122#.U2RDja1dUs8.

122. *Id.*

123. *Id.*

124. *Id.*

125. *Id.*

West Clark, including its school board president, had reviewed, approved, and authorized this disclosure.[126] Accordingly, the SEC charged West Clark with securities fraud on the basis of material misstatements in its official statement, stating that it "knew, or was reckless in not knowing," that it never made any of the required continuing disclosures.[127]

The terms upon which the case was settled between the SEC and West Clark reveal how the SEC treats an issuer's failure to disclose. The settlement required West Clark to ensure that it would provide timely and accurate disclosures in the future, that it would implement internal trainings for all personnel involved in the disclosure process, and that it would certify these trainings with the SEC.[128]

2. Wenatchee

The *West Clark* case does not stand alone. In November 2003, the SEC charged the Greater Wenatchee Regional Events Center Public Facilities District ("Wenatchee") "with misleading investors in a bond offering that financed the construction of a regional events center and ice hockey arena."[129] The SEC claimed that the issuer negligently misled investors because it failed to disclose certain information in its official statement.[130] Wenatchee stated that there had never been independent reviews of its financial projections, and the SEC found this statement to be false.[131] The SEC also found that Wenatchee had failed to inform investors that the city of Wenatchee's mayor had unduly influenced the financial projections.[132] Based on these actions, the SEC assessed a financial penalty against Wenatchee, marking the first case in history that the SEC assessed a financial penalty against a municipal securities issuer.[133]

The *West Clark* case and the *Wenatchee* case demonstrate that the SEC is now willing to utilize its enforcement power in failure to disclose cases—despite the Tower Amendment or any act of Congress that enables this power.

V. Proposal

Again, the greatest undisclosed truth in the municipal securities market is that municipal issuers are subject to disclosure requirements. Whatever uncertainties to this fact existed with the initial arrival of Rule 15c2-12—cloaked with a focus on underwriters rather than issuers—the events over the past five years have left no doubt as to this fact. The disclosure requirements in the municipal securities

126. *Id.*
127. *Id.*
128. *Id.*
129. Press Release, *SEC Charges Municipal Issuer in Washington's Wenatchee Valley Region For Misleading Investors*, U.S. SEC. & EXCH. COMM'N (Nov. 5, 2013), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370540262235#.U2J-SK1dUs8.
130. *Id.*
131. *Id.*
132. *Id.*
133. *Id.*

marketplace now mirror those of its corporate counterpart—official statements, periodical reporting, special event disclosures, a centralized filing repository—there is virtually no difference between the two markets. While the presentation of this Article suggests that disclosure obligations have gotten out of hand, the reality—established by the Tower Amendment—is that they never should have existed in the first place. Therefore, the ultimate issue in this Article is not whether these disclosure obligations exist, but whether they *should* exist. This Article's answer to that issue is a resounding "no".

Regulation of the municipal securities market should be limited to the only congressionally approved regulatory devices: anti-fraud actions. The attempt to regulate the municipal securities market with the same disclosure devices as the corporate securities market creates undue burdens on the market. These burdens are undue because the municipal securities market differs from the corporate securities market in five primary aspects: (i) the market has lower default rates; (ii) there is a lack of proven abuses in issuing municipal securities, and the anti-fraud provisions adequately handle those abuses; (iii) municipal securities investors are different, if not more sophisticated; (iv) there is uncertainty whether a constitutional basis exists for the federal regulation of state and local governments; and (v) increased disclosure costs fall on taxpayers, rather than shareholders.

A. Safer Bets

Defaults on municipal bonds are rare. Even the riskiest municipal bonds have extremely low default rates—lower on average than AAA-rated corporate bonds.[134] "Municipal securities are considered to be second only to Treasuries in risk level as an investment instrument."[135] In 2013, the most recent year reported, Moody's concluded that the default rate for investment grade municipal debt was .03%, compared to 1.4% for investment grade corporate debt.[136] This data means that corporate debt is 46.67 times more likely to default than municipal debt. Moreover, the ultimate recovery for municipal bonds was just under 64% for the period 1970-2013, compared to 43.8% for corporate senior bonds over the same period.[137] Director of the SEC's new Office of Municipal Securities, John Cross, admitted, "Many would

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134. *See* MOODY'S INVESTORS SERV., MAPPING OF MOODY'S U.S. MUNICIPAL BOND RATING SCALE TO MOODY'S CORPORATE RATING SCALE AND ASSIGNMENT OF CORPORATE EQUIVALENT RATINGS TO MUNICIPAL OBLIGATIONS 2 (2006), *available at* https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBM_PBM97921.

135. 2014 FACTS: STATE AND MUNICIPAL BANKRUPTCY, MUNICIPAL BONDS, STATE AND LOCAL PENSIONS, GOVN'T FINANCE OFFICERS ASS'N 2, *available at* http://www.nasra.org/files/JointPublications/FactsYouShouldKnow.pdf (last visited Dec. 31, 2014).

136. *Compare* MOODY'S INVESTORS SERV., SPECIAL COMMENT: US MUNICIPAL BOND DEFAULTS AND RECOVERIES, 1970–2013 1 (May 7, 2014) *available at* https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBM_PBM170048 [hereinafter SPECIAL COMMENT: US MUNICIPAL BOND DEFAULTS], *with* MOODY'S INVESTORS SERVICES, SPECIAL COMMENT: ANNUAL DEFAULT STUDY: CORPORATE DEFAULT AND RECOVERY RATES, 1920–2013 1 (Feb. 28, 2014), *available at* https://www.moodys.com/researchdocumentcontentpage.aspx?docid=PBC_165331 [hereinafter SPECIAL COMMENT: ANNUAL DEFAULT STUDY].

137. *Compare* SPECIAL COMMENT: US MUNICIPAL BOND DEFAULTS, *supra* note 136, *with* SPECIAL COMMENT: ANNUAL DEFAULT STUDY, *supra* note 136, at 2.

say, 'There's nothing broken here. What are you trying to fix?' And there's some truth to that," noting that defaults have been limited mostly to small sectors of the market.[138]

In terms of outlook, Anne Van Praagh, a Moody's Managing Director said, "Even recently increased default activity remains well within levels predicted by our present municipal rating distributions . . . [and] risks are tilted to the downside going forward."[139]

Low rates of default were an important justification for exempting municipal securities from registration and reporting requirements with the passage of Section 3(a)(2) and the Tower Amendment.[140] Given the proof that the municipal securities still substantially differ from corporate securities in this aspect, this justification should remain in effect today.

B. Lack of Abuse

In general, the municipal securities market has a relatively low level of abuse.[141] Moreover, the Tower Amendment does not prohibit the SEC from regulating the municipal securities market through antifraud provisions, and the MSRB has the authority to define what activities are subject to those provisions. In this respect, the MSRB has been able to create rules, outside the disclosure context, that specifically deal with the regulatory concerns discussed in Part III. For example, the MSRB's Rule G-37 provides the SEC with enforcement authority where there have been pay-to-play violations.[142] Similarly, the SEC, FINRA, and other regulatory bodies have authority under the MSRB rules to target conflicts of interest and issues with unqualified municipal advisors.[143]

Over the last ten years, the SEC has increasingly exercised this authority and has issued many enforcement actions to regulate the conduct of issuers, bond counsel, and other market participants.[144] The following three cases show that the anti-fraud provisions sufficiently capture any wrongdoing that does exist: 1) Harrisburg; 2) South Miami; and 3) Victorville.

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138. Farmer, *supra* note 110.

139. Global Credit Res., *Announcement: Municipal Bond Defaults have Increased since Financial Crisis, But Numbers Remain Low*, MOODY'S INVESTORS SERV., INC. (May 7, 2013), https://www.moodys.com/research/Moodys-Municipal-bond-defaults-have-increased-since-financial-crisis-but--PR_272561.

140. H.R. REP. NO. 73-8 (1933); *Hearings on S. 873 Before the Senate Comm. on Banking and Currency*, 73d Cong., 1st Sess. (1933).

141. S. REP. NO. 94-75 (1975); *see also* Chung, *supra* note 46, at 1501 (discussing the lack of abuse).

142. MUNICIPAL REPORT, *supra* note 7, at 102.

143. *Id.* at 43.

144. *See id.* at 31.

1. Harrisburg

On May 6, 2013, the SEC charged the city of Harrisburg, Pennsylvania with securities fraud.[145] The SEC found that, from 2007 to 2011, the city made material misstatements and omissions in several non-disclosure filings, such as the 2009 city budget, State of the City address, and mid-year fiscal report.[146] According to the SEC's order, Harrisburg was nearly bankrupt and under state receivership mainly because of a $260 million revenue bond for an energy facility.[147] In 2008, Moody's downgraded the city's general obligation bonds to a Baa1 rating, citing Harrisburg's guarantee of the energy facility's bond as the primary reason.[148] Despite this downgrade, Harrisburg stated in its 2009 budget, and on the city's website that its general obligation bonds were still being rated AAA.[149]

The SEC also found that Harrisburg's Comprehensive Annual Financial Report ("CAFR") for the year 2007, which was not filed on EMMA until late 2009, omitted $4 million in guarantee payments that the city had paid on the energy facility bond.[150] Accordingly, the SEC charged Harrisburg with Section 10(b) and Rule 10b-5 anti-fraud violations.[151] Significantly, the violating statements were not made in the city's formal disclosure filings, but in general public statements and reports.

2. South Miami

On May 22, 2013, the SEC charged the city of South Miami, Florida with defrauding investors with false claims of tax exemptions for its bonds.[152] The city had issued a bond to construct a parking structure in its downtown commercial district.[153] The structure included both a parking facility (that would be financed by the bond) and a private retail facility.[154] The SEC found that in 2002 and 2006, the city borrowed over $12 million in two conduit bond offerings through the Florida Municipal Loan Council ("FMLC"), which enabled the city to borrow the funds at advantageous tax-exempt rates.[155]

The SEC found that a municipal advisor had warned city officials that the tax-exempt status of the bonds would be lost if any of the bond proceeds were used to

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145. Press Release, *SEC Charges City of Harrisburg For Fraudulent Public Statements*, U.S. SEC. & EXCH. COMM'N (Mar. 6, 2013), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171514194#.U2RKjK1dUs8.
146. *Id.*
147. *Id.*
148. *Id.*
149. *Id.*
150. *Id.*
151. *Id.*
152. Press Release, *SEC Charges City of South Miami with Defrauding Investors About Tax-Exempt Status of Municipal Bonds*, U.S. SEC. & EXCH. COMM'N (May 22, 2013), *available at* http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171514424#.U2RNaq1dUs8.
153. *Id.*
154. *Id.*
155. *Id.*

finance the retail portion of the structure.[156] The SEC also found that although city officials at the time understood this constraint, subsequent city officials were unaware of counsel's advice.[157] Therefore, when the city revised the lease with the developer in 2005 to give the developer primary control over the entire project—both the retail portion and the public parking garage—the tax-exempt status of the bonds was lost.[158]

In 2006, the city sought to raise an additional $5.5 million to complete the garage project, but it still did not disclose to the FMLC that it had significantly revised the project lease or that it had lent the developer the $2.5 million from the proceeds of the 2002 bond offering.[159] The SEC found that, in several documents submitted to the FMLC, South Miami misrepresented that its participation in the 2006 bond offering complied with the requirements for the exemption and FMLC, relying on the city's representations, incorrectly offered and sold the 2006 bonds as exempt from federal income tax.[160] The SEC charged South Miami with fraud under Section 17(a) and reached a settlement with the city that cost the beach town nearly $1.4 million.[161]

3. Victorville

On April 29, 2013, the SEC charged the city of Victorville, California and its bond underwriter with securities fraud based on improper valuations, conflicts of interest, and unauthorized fees.[162] The SEC found that the city had inflated its valuations on a municipal bond offering in April 2008. The SEC charged the bond underwriter with misappropriating more than $2.7 million in bond proceeds that were used to "keep [the underwriter] afloat."[163] The SEC also found that $450,000 of the underwriter's fees were not justified.[164]

C. Different Investor

Although retail investors hold seventy-five percent of municipal securities, these are not the same investors that hold corporate securities. A predominant portion of retail investors in the municipal marketplace "buy and hold" the securities until maturity.[165] "About 99% of outstanding municipal securities do not trade on any

156. *Id.*
157. *Id.*
158. *Id.*
159. *Id.*
160. *Id.*
161. *Id.*
162. Press Release, *SEC Charges City of Victorville, Underwriter, and Others with Defrauding Municipal Bond Investors*, U.S. SEC. & EXCH. COMM'N (Apr. 29, 2013), *available at* https://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171514980#.U2RQI61dUs8.
163. *Id.*
164. *Id.*
165. MUNICIPAL REPORT, *supra* note 7, at 12.

given day."[166] "While trading is most active in newly issued bonds, it declines significantly as time passes. For example, only 15% of municipal securities trade in the second month after issuance."[167] In other words, municipal market investors are not concerned with real-time information, or essentially any ongoing reports, because they are not actively trading the securities. "Further . . . 25% of the outstanding principal amount is held on behalf of individual investors by mutual, money market, closed-end, and exchange-traded funds."[168] This signifies that while retail investors fund the investments, they do not manage the investments themselves, but rely on the sophistication of investment managers.

D. Federalism

Issues of intergovernmental comity and financial federalism have hovered over the federal regulation of state and local authorities since the inception of the Securities Act.[169] The explanation for this is "recognition of the fact that municipal issuers are themselves U.S. sovereigns."[170] While this is true, the Constitution's Commerce Clause permits the federal government to regulate interstate commerce.[171] The Commerce Clause has received great deference from the U.S. Supreme Court, and already encompasses the selling of corporate securities that pass through state lines.[172] Still, it is not clear if courts would uphold an act of Congress that creates a federal regulation imposing direct disclosure obligations on municipal issuers.

States themselves may challenge the validity of these federal regulations. For example, Texas recently passed a law enabling the state to avoid following the rules of the Governmental Accounting Standards Board ("GASB"), a federally backed source of accounting principles used by United States municipalities.[173] Connecticut has also considered taking the same action.[174] This shows that states may defy federal standards on the basis of sovereignty.

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166. Elisse B. Walter, *Speech by SEC Commissioner: Brining Municipal Bond Trading into the Light*, U.S. SEC. & EXCH. COMM'N (Oct. 1, 2012), *available at* https://www.sec.gov/News/Speech/Detail/Speech/1365171491308#.U2KL_61dUs8.

167. *Id.*

168. *Id.*

169. *See* Theresa A. Gabaldon, *Financial Federalism and the Short, Happy Life of Municipal Securities Regulation*, 34 J. CORP. L. 739, 753–55 (2009) (discussing the federalism issues with federal regulation of municipal securities issuers).

170. Cox, *supra* note 5.

171. *See* U.S. CONST., art. I, § 8, cl. 3.

172. *See* Securities Act of 1933, § 5(1), 48 Stat. 74, 87 (1933) (codified as amended at 15 U.S.C. § 77x (2006)).

173. *Mission, Vision, and Core Values*, GOVERNMENTAL ACCT. STANDARDS BD., http://www.gasb.org/jsp/GASB/Page/GASBSectionPage&cid=1175804850352 (last visited Apr. 1, 2015); *see also* Daniel M. Gallagher, Comm'r, *Remarks at Municipal Securities Rulemaking Board's 1st Annual Municipal Securities Regulator Summit*, U.S. SEC & EXCH. COMM. (May 29, 2014), *available at* http://www.sec.gov/News/Speech/Detail/Speech/1370541936387#.VMGAey7F-E4.

174. *See* Marie Leone, *Will Connecticut Swallow GAAP Whole?*, CFO.COM (June 19, 2007), http://ww2.cfo.com/accounting-tax/2007/06/will-connecticut-swallow-gaap-whole/.

E. Who Pays

Perhaps the most important issue in regulating the municipal securities market with disclosure rules—one that has received little attention by scholars and regulators alike—involves who the additional disclosure costs fall on. In the corporate realm, increased disclosure costs ultimately fall on the corporation's shareholders.[175] In contrast, increased compliance costs with municipal securities bleed to taxpayers. While the taxpayers may have an interest in the public project, this is not a sufficient rationale for why they should bear the costs. SEC Chairman Christopher Cox justified placing increased disclosure costs on taxpayers with this statement, "I suppose you could make the argument that municipal issuers are merely saving taxpayer dollars by not having to pay the auditor for additional procedures. You could also save a bundle on pre-surgery medical evaluation by relying on last year's MRI. Personally, I'd like to know the recent findings, and whether something has changed."[176] However, his statement only demonstrates the reality that investors may want increased disclosure, but taxpayers are the ones fitting the bill for these disclosures. This factor unveils a crucial discord between the municipal securities and corporate securities markets.

Summarily, the foregoing differences between the municipal and corporate marketplaces demonstrate the incompatibility of a standardized, disclosure-based method of regulating municipal securities. Congress got it right in 1933, and again in 1975—municipal securities issuers *should* only be regulated by anti-fraud actions.

VI. Conclusion

This Article has examined the fundamental discord between regulating the municipal securities market with the same structure and intensity as the corporate securities market. This Article has proposed limiting the reach of federal regulatory bodies on the municipal securities market because of the harmful impacts had by overreaching regulation. To address these harms, this Article has ultimately suggested that registration and disclosure requirements place undue burdens on municipal entities and their counterparts, and that regulatory bodies should only focus their control on municipal securities through enforcement actions.

There are several ways to achieve this result of deregulation. Any litigant could raise an action against the SEC under the Administration Procedure Act for overstepping its authority with the creation of Rule 15c2-12, Congress could get involved and reinforce the Tower Amendment, courts could invalidate SEC failure to disclose actions, or states could take the Texas approach and create contradicting state laws. However it is done, it is time to set municipal securities issuers free from disclosure bondage.

175. *See* Merritt B. Fox, *Why Civil Liability For Disclosure Violations When Issuers Do Not Trade?*, 2009 WIS. L. REV. 297, 317–18 (2009).

176. Cox, *supra* note 5.