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Rule 15C2-12: A Flawed Regulatory Framework Creates Pitfalls For Municipal Issuers

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Twenty-five years ago, the municipal bond[1] market received little attention. At that time, the majority of municipal bonds were general obligation bonds,[2] and the predominant participants in the market were banks, underwriters and bond counsel.[3] Since 1975, there have been substantial changes in this market. Municipal bonds have become increasingly important as sources of funding for industrial development purposes and essential services such as schools, sewers, and roads.[4] By 1995, the municipal bond market consisted of over 1.5 million distinct issues, valued in excess of $1.2 million,[5] and sold by more than 50,000 different state and local government entities. The

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1. The terms "municipal bond" and "municipal security" refer to the debt obligations of states, municipalities, counties and school districts. Ann Judith Gellis, *Municipal Securities Market: Same Problems—No Solutions*, 21 DEL. J. OF CORP. L. 427, 428 n.1 (1996).

2. *See* SEC STAFF REPORT ON THE MUNICIPAL SECURITIES MARKET at 2 (Sept. 1993) [hereinafter 1993 STAFF REPORT].

3. *See id.* at 1.

4. *See* Gellis, *supra* note 1, at 431 n.9 (discussing the shift from general obligation bonds to revenue bonds). *See also* 1993 STAFF REPORT, *supra* note 2, at 1-5. The Report distinguishes between general obligation and revenue bonds as follows:

> The types of securities municipalities generally issue include general obligation bonds, revenue bonds, and conduit bonds. General obligation bonds are secured by the full faith and credit and general taxing power of the issuer. A holder of a general obligation bond may look for repayment to all sources of revenue that the municipality is entitled to receive. Revenue bonds, on the other hand, are typically issued to support a particular project, and are paid for out of revenues from that project. 'Conduit' bonds, such as industrial development bonds, are securities issued to finance a project that is to be used in the trade or business of a private corporation. Typically, investors must look solely to the credit of the private entity for payment of interest and principal.

Id. at 3.

5. *See* Gellis, *supra* note 1, at 431 n.9.

bonds issued are also becoming more complex due to the increased use of derivative features.[6] Moreover, there is a growing secondary market in municipal bonds, which was unheard of in earlier periods.

Despite the increasing growth and complexity of the municipal bond market, it remains subject to minimal regulation. State regulation is non-uniform, and industry customs require only voluntary disclosure. Although municipal issuers are subject to the anti-fraud provisions of the Securities Act of 1933 and the Securities Exchange Act of 1934, they are exempt from the registration and disclosure requirements of the Acts. SEC Rule 15c2-12 and its amendments impose an initial disclosure requirement, periodic disclosure and secondary market reporting. The regulatory framework provided by Rule 15c2-12, however, is insufficient for both issuers and investors.[7]

This article examines the disclosure requirements that issuers face in today's municipal bond market. Previous attention has focused on the failure of Rule 15c2-12 and its amendments to protect investors, due to its inherent inadequacies.[8] This article explores the implications for issuers of the inadequacy of this regulation. The article argues that the existing system of state, federal and voluntary regulation is inadequate and creates numerous pitfalls for issuers—specifically, that the non-specificity weaknesses of Rule 15c2-12 impose burdens that issuers must overcome. First, this article outlines the regulatory environment of the municipal bond market, and highlights gaps in regulation. Second, this article addresses how disclosure is beneficial to issuers. Third, this article addresses how the inadequate disclosure scheme dictated by Rule 15c2-12 affects issuers. Finally, this article recommends that the bifurcated nature of security regulation, with one scheme imposed on issuers of corporate securities and another imposed on municipal issuers, be abandoned.

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6. Examples of derivatives incorporated into municipal bonds include strips, detachable calls, inverse floating rate bonds, and embedded swaps. *See* 1993 STAFF REPORT, *supra* note 2, at 1.

7. The inadequacies of Rule 15c2-12 for investors have been the subject of most prior research in municipal securities regulation. *See generally* Lisa M. Fairchild & Nan S. Ellis, *Municipal Bond Disclosure: Remaining Inadequacies of Mandatory Disclosure Under Rule 15c2-12*, 23 J. CORP. L. 440 (1998); Gellis, *supra* note 1.

8. *See* Fairchild & Ellis, *supra* note 7; Gellis, *supra* note 1.

The conclusion of this article is that the SEC should be given power to regulate municipal securities in a way that mirrors corporate security regulation.

I. THE REGULATORY FRAMEWORK: MUNICIPAL DISCLOSURE PRACTICES

The difficulties imposed on issuers by the patchwork system of regulation that governs municipal bond issues can, perhaps, best be illustrated by examining the regulatory guidelines that a hypothetical issuer faces. Assume that a hypothetical municipality, Springfield, AnyState, wants to raise money to build a hospital. Springfield will look to industry custom and relevant state and federal law to guide its disclosure for the issue.

A. Industry Custom

Municipal market participants have voluntarily adopted disclosure standards.[9] For example, the Government Finance Officers Association[10] (GFOA) publishes guidelines for official statements, which are the primary marketing documents in a municipal offering.[11] These guidelines prescribe both the content and timing of

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9. The fiscal problems of New York City, New York State and other major municipal issuers prompted investor demands for more information about the financial health of issuers. In 1975, in response to investor demand and concern regarding the possible imposition of federal disclosure requirements, municipal market participants developed their own disclosure standards.

10. Initially known as the Municipal Finance Officers Association (MFOA) the organization became the Government Finance Officers Association after development of the disclosure guidelines. William J. Kiernan, Jr., *Disclosure Responsibilities in Municipal Securities Offerings—Some Problems Under SEC Rule 15c2-12*, 20 STETSON L. REV. 704 n.21 (1991).

11. *See* Government Finance Officers Association, DISCLOSURE GUIDELINES FOR OFFERINGS OF SECURITIES BY STATE AND LOCAL GOVERNMENTS (1991) [hereinafter GFOA Guidelines]. All citations are to the 1991 revision. The Municipal Securities Rulemaking board (MSRB) defines the official statement as the "document prepared by the issuer or its representative setting forth, among other matters, information concerning the issuer and the proposed issue of securities." MUNICIPAL SECURITIES RULEMAKING BOARD MANUAL (CCH) ¶ 3656 (1995) [hereinafter MSRB Manual]. The official statement is analogous to the prospectus distributed prior to corporate issuances and contains all information "material" to the bond issue. The document usually includes the following: a description of the issuer, the purpose of the project being financed, a description of the security for the bond, any feasibility

official statements.[12] The suggested content includes financial report information, revenue information, debt information, and demographic, economic and governmental information.

Our hypothetical city of Springfield might voluntarily comply with the GFOA disclosure guidelines in preparing and distributing an official statement. If so, it will prepare an official statement following the content and form prescribed by the GFOA and furnish an official statement to all investors. It should be re-emphasized, however, that such compliance is voluntary. Furthermore, the GFOA disclosure guidelines are considerably less comprehensive than the SEC disclosure requirements for corporate issuers.[13] Compliance only with GFOA guidelines will, therefore, create a disparity between the information available to municipal bond investors and that available to investors in corporate securities.

B. Blue Sky Laws

Springfield will also examine state law to ascertain the applicable disclosure requirements and will discover that municipal disclosure requirements vary substantially under state blue sky laws.[14] At one extreme are the full disclosure states, which require formal registration of all municipal issues, approval by a central repository prior to issuance, and adherence to strict guidelines for the type of information provided in the official statement.[15] In a full disclosure

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studies of the underlying project that are relevant to the issue, any contracts or obligations of the municipality that are either related to the issue or that might affect the issue; and a summary of the principal financing documents.

12. *See* Kiernan, *supra* note 10, at 701, 704.

13. *See* 1993 STAFF REPORT, *supra* note 2, Appendix C, at 1. *See also* Fairchild & Ellis, *supra* note 7 (highlighting differences between GFOA and SEC disclosure requirements).

14. The differences likely exist for several reasons. First, nondisclosure states may have little default experience. Second, state officials in nondisclosure states may assume that rating agencies provide a sufficient type of disclosure. This, of course, does not explain why disclosure is not required for nonrated bonds. Third, nondisclosure states are typically small, rural states with relatively low volume of municipal securities issues. *See* Lisa M. Fairchild & Timothy W. Koch, *The Impact of State Disclosure Requirements on Municipal Yields* 51 NAT. TAX J. 733 (1998).

15. There are 14 full disclosure states which require the filing of official statements and approval by state regulators for all types of tax-exempt debt issued within the state. The full disclosure states are Arizona, Delaware, Florida, Idaho, Illinois, Kansas, Massachusetts, Michigan, Nebraska, North Carolina, Oregon, Rhode Island, Tennessee, and Texas. *See infra*

state, Springfield must file the official statement and obtain approval from state regulators prior to issuance. Information provided in official statements in full disclosure states is relatively homogeneous because these official statements must meet GFOA guidelines.[16] The filing process, however, varies across states.[17]

At the other extreme are nondisclosure states, which exempt all issues from registration and disclosure requirements.[18] Nondisclosure states do not require official statements or state regulatory approval for any type of tax-exempt debt issued within the state, and adherence to industry guidelines is strictly voluntary. Therefore, official statements vary greatly in these states.[19] Thus, if Springfield offers securities for sale in a non-disclosure state, the state imposes no requirements. Springfield could either elect to prepare an official statement meeting GFOA guidelines, use a document of its choosing, or forgo preparation of an official statement.[20]

The remaining states, which fall between the two extremes, subject only a small subset of issues to mandatory disclosure.[21] In

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note 21.

16. *See* Fairchild & Koch, *supra* note 14, at 736, 737.

17. In some states, more than one state regulatory agency scrutinizes the official statement. In Texas, for example, the official statements for all types of debt are filed with and approved by the Comptroller of Public Accounts. Depending on whether the issue is a general obligation or a revenue issue, either the Texas State Treasurer or the State Auditor and Inspector must then approve the official statement. *See* Fairchild & Koch, *supra* note 14, at 737. In other states, such as Tennessee, only the State Controller approves the official statements. *See id.*

18. There are 15 nondisclosure states which have no statutory provisions for the filing of official statements or approval by state authorities. The nondisclosure states are Alabama, Alaska, Colorado, Hawaii, Iowa, Maine, Maryland, Mississippi, Missouri, Nevada, New Mexico, North Dakota, South Dakota, Wisconsin, and Wyoming. Wyoming has statutory disclosure requirements, but does not collect any information from issuers. *See infra* note 21. In these states, although issuers typically provide official statements, the statements are frequently not available until after investors have purchased the bonds.

19. The lack of regulation requiring registration and approval of official statements prior to issuance may impair investors' ability to accurately assess default risk. *See infra* notes 78-85 and accompanying text discussing the implications for issuers of such inability.

20. Rule 15c2-12, discussed *infra* Part II.B, requires that Springfield use an official statement. 17 C.F.R. § 240.15c2-12(b) (1997).

21. According to a 1990 survey conducted by the National Association of State Auditors, Comptrollers, and Treasurers (NASACT), there are 21 partial disclosure states. Detailed survey results are reported in NATIONAL ASSOCIATION OF STATE AUDITORS, COMPTROLLERS, AND TREASURERS, THE MUNICIPAL DISCLOSURE TASK FORCE REPORT (1990). The partial disclosure states are Arkansas, California, Connecticut, Georgia, Indiana, Kentucky, Louisiana,

general, the type of bond (revenue or general obligation) and the type of issuer (local, state, or agency) determine whether regulators demand an official statement. When official statements are required, the contents must be similar to those outlined by the GFOA. For issuers not subject to official statement disclosure requirements, adherence to the GFOA guidelines is voluntary.

Thus, the extent to which blue sky laws dictate Springfield's behavior is determined entirely by the state in which Springfield issues the bonds. Because this patchwork system of state regulation is, by and large, inadequate, the extent to which federal regulation provides uniform disclosure regulations to fill in the gaps in state regulation must be considered.

C. Federal Regulation

1. Federal Statutes

Municipal securities are exempt from the disclosure regulations of both the Securities Act of 1933[22] ("the '33 Act") and the Securities Exchange Act of 1934 ("the '34 Act").[23] Municipal securities, however, are subject to the anti-fraud provisions of the '33 Act.[24] Specifically, Sections 17(a)[25] and 10b[26] of the '33 Act apply to

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Minnesota, Montana, New Hampshire, New Jersey, New York, Ohio, Oklahoma, Pennsylvania, South Carolina, Utah, Vermont, Virginia, Washington, and West Virginia.

22. Securities Act of 1933, 15 U.S.C. §§ 77a-77aa (1994).

23. Securities Act of 1933, 15 U.S.C. §§ 78a-78ll (1994).

24. The 1933 Act includes local governments in its definition of "person." Securities Act of 1933 § 2(2), 15 U.S.C. § 77b(2) (1994).

25. Securities Act of 1933 § 17(a), 15 U.S.C. § 77(q)(a) (1988). Section 17(a) provides:

> It shall be unlawful for any person in the offer or sale of any securities . . . to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading. . . .

In Thiele v. Shields, the court held that § 17(a) is applicable to municipal bonds. *See* 131 F. Supp. 416, 419 (S.D.N.Y. 1955). There is, however, no private cause of action for Section 17(a). *See, e.g.*, In re Washington Public Power Supply System Securities Litigation, 623 F. Supp. 1466, 1476-80 (W.D. Wash. 1985).

26. While courts did not originally apply 10(b) to state and local governments, *see, e.g.*, Woods v. Homes & Structures of Pittsburg, Kansas, Inc., 489 F. Supp. 1270, 1280 (D. Kan. 1980), the Securities Reform Act of 1975 added "government, or political subdivision, agency, or instrumentality of a government" to the definition of "person." 15 U.S.C. § 78c (a)(9) (1994).

fraudulent statements made in connection with the purchase and sale of municipal securities.[27] Under federal securities laws, Springfield will not have to comply with the detailed disclosure requirements applicable to corporate securities,[28] nor face the almost absolute liability imposed for misstatements in corporate security offerings;[29] it must only avoid fraudulent misstatements.[30]

2. MSRB Rules

In addition to the '33 Act and the '34 Act, Springfield must conform to a number of rules promulgated to govern municipal issuer behavior. The Municipal Securities Rulemaking Board (MSRB) has primary rulemaking authority for the municipal bond market.[31] The MSRB has promulgated rules designed to standardize municipal

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Importantly, Rule 10b-5, promulgated pursuant to Section 10b, is applicable to municipal bonds. 17 C.F.R. § 240.10b-5 (1997). *See, e.g.*, In re Washington Public Power Supply System Securities Litigation, 623 F. Supp. 1466, 1479 (W.D. Wash. 1985); Ann Judith Gellis, *Mandatory Disclosure for Municipal Securities: Issues in Implementation*, 13 J. CORP. L. 65, 69-70 (1987); Marc I. Steinberg, *Municipal Issuer Liability Under the Federal Securities Laws*, 6 J. CORP. L. 277, 279-80 (1981). *But see* Margaret V. Sachs, *Are Local Governments Liable Under Rule 10b-5? Textualism and Its Limits*, 70 WASH. U. L.Q. 19, 56 (1992) ("Local governments are immune from liability under section 10(b) and rule 10b-5").

27. The anti-fraud prohibitions have been ineffective in regulating municipal issuer disclosure. In spite of the anti-fraud prohibitions, there was virtually no disclosure prior to Rule 15c2-12. *See, e.g.*, John E. Petersen et al., *Searching for Standards: Disclosure in the Municipal Securities Market*, 1976 DUKE L.J. 1177, 1186-97 (1976). Studies reveal that during this period, investors relied almost exclusively on the rating agencies. Gellis, *supra* note 26, at 71. Investors brought few lawsuits against municipal issuers and/or underwriters alleging violations of either section 17(a) or Rule 10b-5. Robert W. Doty & John E. Petersen, *The Federal Securities Laws and Transactions in Municipal Securities*, 71 NW. U. L. REV. 283, 373-77 (1976). A spokesperson for the MSRB noted in his testimony on proposed regulation 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* Gellis, *supra* note 26, at 72 n.31 (citing *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. 253 (1977)).

28. *See, e.g.*, Securities Act of 1933 § 5, 15 U.S.C. § 77C(a)(2) (1994). *See infra* notes 147-54 and accompanying text (contrasting municipal bond disclosure with that of corporate securities).

29. *See, e.g.*, Securities Act of 1933 § 11(a).

30. 15 U.S.C. § 77K(a) (1994).

31. The MSRB was established by The Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (codified as amended at 15 U.S.C. § 78o-4(b)(1) (1994)).

securities trading practices,[32] including the following: rules applicable to books and records,[33] rules applicable to confirmation, clearance and settlement procedures[34] and rules governing standardized price and commission practices.[35] Some rules of the MSRB specifically pertain to disclosure practices. For example, MSRB rules require dealers to provide their customers with copies of official statements that the issuer has voluntarily supplied,[36] and require underwriters to provide the MSRB with copies of these official statements.[37] Furthermore, under the "suitability rule," dealers must have "reasonable grounds" to believe that the securities they market are suitable for investors.[38]

The applicability of MSRB rules to issuers, however, is problematic. Securities regulations prohibit the MSRB from imposing pre-issuance filing requirements on municipal issuers.[39] In other words, the MSRB cannot require an issuer to register or provide disclosure documents to either the MSRB or to the SEC prior to marketing securities.[40] Moreover, the Tower Amendment to the Securities Acts Amendments of 1975 prohibits the MSRB from requiring that brokers and dealers furnish documents related to an issuer.[41] Thus, regulation by MSRB rule is indirect. Voluntary

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32. *See* Gellis, *supra* note 1, at 434.

33. MSRB Manual, *supra* note 11, at ¶ 3536.

34. *See id.* at ¶ 3571.

35. *See id.* at ¶ 3581.

36. *See id.* at ¶ 3656.

37. *See id.* at ¶ 3676. The goal is for the MSRB to collect the official statements for its primary market repository. *See* PUBLIC SEC. ASS'N, FUNDAMENTALS OF MUNICIPAL BONDS 165-166 (1990).

38. Dealers must found their belief upon a "reasonable investigation." MSRB Manual, *supra* note 11, ¶ 3591.

39. Section 78o-4(d)(1) provides:

> Neither the Commission nor the Board 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 Commission or the Board prior to the sale of such securities by the issuer any application report, or document in connection with the issuance, sale, or distribution of such securities.

15 U.S.C. § 78o-4(d)(1) (1994).

40. *See id.*

41. Section 78o-4(d)(2) provides:

> (2) The Board is not authorized under this chapter to require any issuer of municipal

compliance with these rules, however, has been slowly changing the nature of the municipal securities market.[42]

3. SEC Rule 15c2-12

In addition to the foregoing requirements, Springfield must comply with SEC Rule 15c2-12 and its amendments, which govern municipal bond disclosure.[43] Designed in response to the near-defaults of New York City and Orange County and the Washington Public Power Supply System (WPPSS) scandal,[44] the Rule[45] requires limited dissemination of information by underwriters in municipal securities offerings through the use of Nationally Recognized Municipal Securities Information Repositories (NRMSIRs), rather than SEC filings by issuers.[46] Specifically, Rule 15c2-12 imposes four duties on the Participating Underwriter[47] in a municipal

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> securities, directly or indirectly through a municipal securities broker or municipal securities dealer or otherwise, to furnish to the Board or to a purchaser or a prospective purchaser of such securities any application, report, document, or information with respect to such issuer: *Provided, however,* That the Board may require municipal securities brokers and municipal securities dealers to furnish to the Board 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 Commission under any provision of the chapter.

15 U.S.C. § 78o-4(d)(2) (1994).

42. By 1988, for example, estimates show that official statements were prepared for 84% of municipal bond offerings. *See Municipal* Securities Disclosure, 53 Fed. Reg. 37,778, 37,784 n.45 (Sept. 28, 1988) [hereinafter 1988 Release].

43. 17 C.F.R. § 240.15c2-12 (1997).

44. For a discussion of the WPPSS default, see generally Joel Seligman, *The Washington Public Power Supply System Debacle*, 14 J. CORP. L. 889 (1989) (discussing implications of reform).

45. For a detailed discussion of the rule and its impact, see generally 2 M. DAVID GELFAND, STATE AND LOCAL GOVERNMENT DEBT FINANCING § 8:10 (1995). *See also* Robert A. Fippinger & Edward L. Pittman, *Disclosure Obligations of Underwriters of Municipal Securities*, 47 BUS. LAW. 127 (1991); David S. Goodman, *New SEC Municipal Bond Disclosure Rule*, 10 MUN. FIN. J. 281 (1990); Kiernan, *supra* note 10.

46. 17 C.F.R. § 240.15C2-12(B)(4) (1995). In contrast to the registration requirements for corporate securities, the Rule uses the NRMSIRs to provide investors with information rather than requiring SEC filings. *See* Gellis, *supra* note 1, at 438. A series of Interpretative Releases set forth the essential criteria for constituting a NRMSIR. Municipal Securities Disclosure, 54 Fed. Reg. 28,799, 28,808 n.65 (July 10, 1989) [hereinafter 1989 Release].

47. A participating underwriter is "any broker, dealer, or municipal securities dealer." The

securities offering: 1) to obtain and review a final official statement prior to purchase; 2) to send a preliminary official statement to a potential customer who requests one; 3) to contract with the issuer to obtain a final official statement; and 4) to send a final official statement to any potential customer who requests one.[48] The Rule applies to primary offerings of over $1 million in aggregate[49] and exempts certain limited placements and short term obligations.[50]

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rule specifies the duties of a participating underwriter when the underwriter is participating in "a primary offering of municipal securities with an aggregate principal amount of $1,000,000 or more." 17 C.F.R. § 240.15c2-12(a) (1995). The Rule indirectly imposes the duties on the issuers.

48. The Rule provides:

> (1) Prior to the time the Participating Underwriter bids for, purchases, offers, or sells municipal securities in an Offering, the Participating Underwriter shall obtain and review an official statement that an issuer of such securities deems final as of its date, except for the omission of no more than the following information: The offering price(s), interest rate(s), selling compensation, aggregate principal amount, principal amount per maturity, delivery dates, any other terms or provisions required by an issuer of such securities to be specified in a competitive bid, ratings, or other terms of the securities depending on such matters, and the identity of the underwriter(s).
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> (2) Except in competitively bid offerings, from the time the Participating Underwriter has reached an understanding with an issuer of municipal securities that it will become a Participating Underwriter in an Offering until a final official statement is available, the Participating Underwriter shall send no later than the next business day, by first-class mail or other equally prompt means, to any potential customer, on request, a single copy of the most recent preliminary official statement, if any.
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> (3) The Participating Underwriter shall contract with an issuer of municipal securities or its designated agent to receive, within seven business days after any final agreement to purchase, offer, or sell the municipal securities in an Offering and in sufficient time to accompany any confirmation that requests payment from any customer, copies of a final official statement in sufficient quantity to comply with paragraph (b)(4) of this rule and the rules of the Municipal Securities Rulemaking Board.
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> (4) From the time the final official statement becomes available until the earlier of (i) Ninety days from the end of the underwriting period or (ii) The time when the official statement is available to any person from a nationally recognized municipal securities information repository, but in no case less than twenty-five days following the end of the underwriting period, the Participating Underwriter in an Offering shall send no later than the next business day, by first-class mail or other equally prompt means, to any potential customer, on request, a single copy of the final official statement.

17 C.F.R. § 240.15c2-12(b)(1)- (4) (1995).

49. 17 C.F.R. § 240.15c2-12(a) (1995).

50. Certain transactions are exempt in denominations of $100,000 or more. 17 C.F.R. § 240.15c2-12(d)(1) (1995). Under the limited placement exemption, offerings made to no more than thirty-five sophisticated investors purchasing without a view to distribution are exempt from the Rule. *Id.* Short-term transactions, defined as transactions where the securities have a

Thus, our hypothetical town of Springfield must prepare an official statement describing the offering and make that official statement available to investors through the primary underwriter if its municipal bond offering is over $1 million and no other exemptions apply.[51]

Furthermore, the amendments to Rule 15c2-12 impose obligations on Springfield with respect to the secondary trading of its securities. As with Rule 15c2-12, the regulation is indirect.[52] Dealers may not underwrite municipal bonds unless a municipal issuer agrees to systematically disclose all pertinent factors which might potentially affect the value of the underlying bonds.[53] In other words, this amendment requires Springfield to provide annual financial data and timely updates of material events affecting the issuer and possible repayment prospects of the bond issue.[54] Specifically, the Rule imposes an ongoing disclosure duty and a recommendation duty.[55]

The Ongoing Disclosure Rule requires participating underwriters to reasonably determine that either the issuer or the obligated person,[56] has agreed in writing with the holders of municipal

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maturity date of nine months or less, are also exempt from coverage, as are securities with a put feature under which the holder can demand payment at least as often as every nine months are also exempt. *Id.*

51. See *infra* notes 67-74 and accompanying text for a more detailed discussion of the exemptions available under amended Rule 15c2-12.

52. The Tower Amendment prohibits regulation of issuers of municipal securities. Because the Tower Amendment prohibits direct and indirect regulation, it has been questioned whether Rule 15c2-12, as amended, violates the Amendment. *See, e.g.*, Mark Edward Laughman, *The Leaning Tower: Do the Proposed Amendments to SEC Rule 15c2-12 Violate the Securities Acts Amendments of 1975?*, 69 NOTRE DAME L. REV. 67 (1994).

53. *Id.* at 1187.

54. *Id.* at 1188.

55. *See* Thomas O. McGimpsey, *Secondary Market Disclosure: A Reality for Issuers of Municipal Securities*, 28 URB. LAW. 155 (1996).

56. The term "obligated person" includes:

> any person, including an issuer of municipal securities, who is either generally or through an enterprise, fund, or account of such person committed by contract or other such arrangement to support payment of all, or part of the obligations on the municipal securities to be sold in the Offering (other than providers of municipal bond insurance, letters of credit, or other liquidity facilities.

17 C.F.R. § 240.15c2-12(f)(10) (1995).

Hospital financing provides a useful illustration. Assume that the state health authority issues bonds and lends the proceeds to a non-profit hospital with the hospital having the sole obligation to repay the bonds pursuant to the loan agreement between the hospital and the health authority. In this case, the non-profit corporation is the obligated person and should be

securities to provide specific information on an ongoing basis. In general, the required periodic disclosures mirror the financial information set forth in the final official statement.[57] This Rule requires Springfield, or the obligated person (the state health agency building the hospital in our hypothetical), to provide financial information and operating data on a yearly basis and, if available, audited financial information for each obligated person implicated in the final official statement.[58] Finally, Springfield must agree to provide certain material events disclosures.[59] If Springfield fails to provide the required ongoing disclosure, subsequent official statements must disclose this failure.[60]

As with Rule 15c2-12, Springfield is not required by the amendments to make any SEC filings. Instead, Springfield must disclose to either national (NRMSIR) or state (SIR) information

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the primary source of key information. *See* Robert A. Fippinger, *SEC Mandates Continuing Disclosures for States and Political Subdivisions*, 9 INSIGHTS 17, 18-20 (1995). The contract commits the obligated person to support payment of the debt obligation. *See* Municipal Securities Disclosure, Exchange Act Release No. 34,961, 59 Fed. Reg. 59,590, 59,596 (Nov. 10, 1994) [hereinafter 1994 Release, 2]. In our hypothetical, Springfield is clearly the issuer, but the obligated person might be the state health authority. This affects disclosure and potential liability. *See infra* notes 122-24 and accompanying text.

57. *See* Frederic H. Marienthal et al., *New SEC Amendments Mandate Secondary Market Disclosure for Municipal Issuers*, 24 COLO. LAW. 2359, 2360 (1995).

58. 17 C.F.R. 15c2-12(b)(5)(i)(A)-(B) (1995).

59. 17 C.F.R. § 240.15c2-12(b)(5)(i)(C) lists eleven material events:

(1) Principal and interest payment delinquencies;

(2) Non-payment related defaults;

(3) Unscheduled draws on debt service reserves reflecting financial difficulties;

(4) Unscheduled draws on credit enhancement reflecting financial difficulties;

(5) Substitution of credit or liquidity providers, or their failure to perform;

(6) Adverse tax opinions or events affecting tax-exempt status of the security;

(7) Modifications to rights of security holders;

(8) Bond calls;

(9) Defeasances;

(10) Release, substitution, or sale of property securing repayment of the securities;

(11) Rating changes.

Id.

60. Disclosure of such failure must continue for a five-year period. *See* 17 C.F.R. § 240.15c2-12(f)(3) (1995).

repositories. [61] Material events disclosures and notice of failure to provide required information must also be disclosed to the MSRB.[62]

The Rule, however, fails to specify the scope of the required disclosures for Springfield's bond issue. Because the contract between Springfield and its underwriters, by and large, does define the scope of the disclosure obligation, perhaps the best indicator of what information Springfield must disclose is the contract itself. The participants determine which parties are material to the offering and must provide ongoing disclosures, as well as what information is material and must be disclosed.[63] Rule 15c2-12, then, imposes a duty to annually update the financial information and operating data set forth in the final official statement.

The extent to which Springfield is entitled to remain silent as to other information is also unclear. On the one hand, some commentators argue that the issuer has no obligation to disclose events, even if they are material, if they are not one of the eleven material events listed in Rule 15c2-12.[64] Springfield would have no disclosure obligation even if one of the eleven events occurred, as long as the occurrence was immaterial.[65] On the other hand, while the Rule requires notice only of enumerated events, some believe that occurrence of an *unlisted* material event might also trigger a duty to disclose and create liability for nondisclosure.[66]

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61. *See* 17 C.F.R. § 240.15c2-12(b)(5)(i)(A) (1995).

62. *See* Stanley Keller, *SEC Adopts Rule 15c2-12 Amendments to Improve Municipal Securities Secondary Market Disclosure*, 9 INSIGHTS 35, 36 (1995).

63. *See id*. The SEC explicitly rejected the "line item" disclosures required of corporate securities because of the diverse nature of issuing municipalities. Fippinger, *supra* note 45, at 18-19. Similarly, the SEC decided not to tie the ongoing disclosure directly to the disclosures in the final official statement, fearing that such a requirement would reduce the quality of primary market disclosures. *See* Keller, *supra* note 62, at 36. Nevertheless, the participating underwriter must go beyond the assurances found in the bond purchase agreement and investigate the issuer's actual efforts to comply with the promise to provide ongoing information. *See* 1994 Release 2, *supra* note 56, at 59,592.

64. General principles of law do not require disclosure without a duty to disclose. *See* Backman v. Polaroid Corp., 910 F.2d 10, 12-14 (1st Cir. 1990). *See also* Dennis L. Holsapple & Curtis L. Christensen, *SEC Rule 15c2-12 and Ongoing Disclosure Obligations of Municipal Securities*, 27 URB. LAW. 943, 950-51 (1995).

65. *See* 1994 Release 2, *supra* note 56, at 590,600.

66. Either common law fraud or violations of Rule 10b-5 could serve as the basis for liability. *See supra* note 26 and accompanying text (discussing potential for 10b-5 liability). An issuer cannot incur 10b-5 liability if it remains silent. Issuers do not, however, typically remain

Springfield may not be bound by the disclosure requirements if it qualifies for an exemption. The exemptions mirror the exemptions of the unamended Rule. Private placements, short term municipal bonds,[67] and offerings by certain "small issuers," are exempt.[68] Offerings that have a stated maturity of 18 months or less qualify for a limited exemption.[69] Finally, the SEC may grant a transactional exemption if the exemption is "consistent with the public interest and the protection of investors."[70]

Whether and to what extent Springfield is subject to the ongoing disclosure obligations set forth in Rule 15c2-12 depends, of course, on the nature of the contract, the contents of the official statement, the length of the offering, the investors to whom the securities are offered, and whether Springfield qualifies for the "small issuer" exemption.[71] Given the fact that 71% of the 52,000 municipal issuers in 1994 had less than $10 million in outstanding securities,[72]

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silent. *See infra* note 211 and accompanying text. Public statements, for example, create a duty to release material information. *See* Statement of the commission Regarding Disclosure obligations of Municipal Securities Issuers and Others, Exchange Act Release No. 33-7049, 59 Fed. Reg. 12,748, 12,756 (1994) [hereinafter 1994 Release 1]. *See generally* Holsapple & Christensen, *supra* note 64, at 949-54.

67. The ongoing disclosure rule does not apply to primary offerings in denominations of $100,000 or more if: 1) they are sold to no more than 35 persons, and if the principal underwriter reasonably believes the following: 1) the purchaser is a sophisticated investor purchasing without a view to distribution; 2) the bonds have a maturity of nine months or less; or 3) the securities have a put feature under which the holder can tender the security back to the issuer at least as often as every nine months until maturity, earlier redemption, or purchase by the issuer. 17 C.F.R. § 240.15c2-12(d)(1) (1995). This has been termed the "Big Boy—Short Term—Put Bond Exemption." *See* McGimpsey, *supra* note 55, at 161. Under what has been termed the cross-over exemption, this exemption also exempts the primary underwriter. *See id.* at 162.

68. Under this exemption, the ongoing disclosure rule does not apply if no obligated person will be obligated for more than $10 million at the time of initial delivery of the bonds to the primary underwriter. The $10 million figure refers to the aggregate principal amount of the offering, and includes the obligations exempt under the Big Boy—Short Term—Put Bond Exemption. 17 C.F.R. § 240.15c2-12(d)(2)(i) (1995). Further, to qualify for this exemption, the issuer must agree to provide upon request (at least annually) financial information or operating data to a state repository, and the final official statement must make clear whom to contact to get the required information. *See* 17 C.F.R. § 240.15c2-12(d)(2)(ii) (1995).

69. The requirement to provide annual financial information does not apply to such securities; however, the securities remain, however, subject to the material events disclosure requirements. 17 C.F.R. § 240.15c2-12(d)(3) (1995).

70. 17 C.F.R. § 240.15c2-12(e) (1995).

71. *See supra* notes 67-69.

72. *See* 1994 Release 2, *supra* note 56, at 59,606.

Springfield probably will qualify for this exemption.

Furthermore, the Recommendation Rule of the amendments to Rule 15c2-12 might impact Springfield's disclosure obligations. Under the Recommendation Rule, it is unlawful for any broker or dealer of municipal securities to recommend the purchase or sale of a municipal security (in either the primary or secondary market) unless the broker or dealer has procedures in place to reasonably assure that it will receive prompt notice of 1) material events, and 2) any failure of the issuer (or obligated person) to provide annual financial information as contracted.[73] The Rule does not explicitly require dealers to review the ongoing disclosure[74] because of the belief that the MSRB's "fair dealing" and "suitability"[75] rules implicitly require such review[76] in order for the dealer to have a reasonable basis for its recommendation. The nature of the required procedures is not specified in the Rule.[77] What is clear, however, is that the brokers and dealers who market Springfield's municipal securities will likely demand assurances from Springfield of material event disclosures and financial updates.

Springfield is faced with a complicated system of municipal bond regulation. There is virtually no state regulation[78] and municipal bonds are exempt from the registration requirements of both the 1933 and 1934 Acts. Federal regulations do require, however indirectly, that a final official statement accompany new offerings, and also require dissemination of the official statement to the market either through the MSRB or NRMSIRs.[79] In addition, the issuer[80] is liable for any misstatements that might occur in that document.[81] There is,

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73. 17 C.F.R. § 240.15c2-12(c) (1995).

74. The SEC considered such a requirement in the proposal prior to the adopted amendments. *See* 1994 Release 1, *supra* note 66, at 12,759.

75. *See supra* note 38 and accompanying text.

76. *See* Keller, *supra* note 62, at 36; McGimpsey, *supra* note 56, at 161.

77. 17 C.F.R. 240.15.12.

78. *See* Gellis, *supra* note 1, at 435 n.27. *See also supra* notes 14-22 and accompanying text (discussing diverse state regulations in effect today).

79. *See* 1988 Release, *supra* note 42, at 37787.

80. Underwriters also have a duty to make reasonable investigations prior to an offering and must have a reasonable basis for belief in the claims made in the issuer's official statement. *See* 1988 Release, *supra* note 42, at 37,787.

81. *See infra* notes 147-49 and accompanying text (discussing uncertainty surrounding liability). Specifically, what is the nature of this liability? To whom is this liability owed? What

however, no requirement that investors actually *see* the official statement, unless they request a copy.[82] The content and form of the disclosure documents remains unregulated.[83] A "passive form" of disclosure regulation, therefore, is in place.[84]

In summary, the current framework for regulation of municipal securities consists of limited federal regulation by Rule 15c2-12 and its amendments,[85] quasi-administrative regulation by the MSRB,[86] voluntary industry guidelines set forth by the GFOA[87] and a system of state regulation that is by no means uniform.[88] As a result of this complex regulation framework, the disclosure requirements imposed on the issuers of municipal securities vary dramatically from state to state and from issue to issue.

The question, then, is what disclosures should Springfield make? It must prepare an official statement and, although there are no specific content requirements in federal securities regulations or state blue sky laws, the GFOA offers voluntary guidelines.[89] In addition, Springfield must be prepared to update the material set forth in the official statement, and to provide certain material events disclosures subsequent to the primary offering.[90] Some commentators claim that there are gaps in these disclosure requirements that leave investors inadequately protected.[91] The gaps in these disclosure requirements,

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defenses are available?

82. This is in marked contrast to the registration requirements under the 1933 Act, for example, which require that each investor be given a prospectus prior to an offer to buy or sell. Securities Act of 1988 § 5, 15 U.S.C. § 77e(b)(2) (1988). The underlying assumption in the instance of municipal bonds is not that each investor must be given material information so that he or she can make an informed choice, but instead, "that the market 'should have access to information, so that the market price reflects such information.

83. *See* Gellis, *supra* note 1, at 440; Kiernan, *supra* note 10, at 709-10. Recall, however, that municipal bonds are subject to the anti-fraud provisions of the 1933 and 1934 Acts. Therefore, while there are no explicit content requirements for the official statement, there is still a general prohibition against materially misleading statements.

84. *See* Gellis, *supra* note 26, at 69-71. Professor Gellis calls this a "passive form" of disclosure regulation because the provisions apply only to what the issuer voluntarily chooses to say. There are no affirmative disclosure requirements.

85. *See supra* notes 7, 43-55.

86. *See supra* notes 30-42.

87. *See supra* notes 11-13.

88. *See supra* notes 14-20.

89. *See supra* notes 11-13.

90. *See supra* note 12 and accompanying text.

91. *See* Fairchild & Ellis, *supra* note 7.

however, also negatively impact issuers. To understand how the gaps in coverage impact issuers, it is first important to understand how disclosure affects issuer interests.

II. INCENTIVES FOR MUNICIPAL ISSUERS TO DISCLOSE

There are many incentives for municipal issuers to disclose voluntarily. Disclosure improves the functioning of the market by making it more efficient and by increasing liquidity. Efficient and liquid markets benefit issuers as well as investors. The following sections highlight the benefits to issuers resulting from disclosure.

A. Resolution of Asymmetric Information Problems

Without disclosure, the problem of asymmetric information between the issuer of securities and investors arises. Specifically, asymmetric information occurs when the investor has insufficient knowledge about the issuer.[92] The issuer, of course, knows the truth about the risk of its securities, but without disclosure of this information, the investor is unable to make an accurate assessment of such risk. There are two forms of asymmetric information: 1) adverse selection, and 2) moral hazard.[93] Both forms are relevant to the discussion of how municipal issuers benefit from market disclosure.

1. Adverse Selection

Adverse selection is the presence of asymmetric information *before* the transaction occurs.[94] For example, suppose a person who just lost a job borrows money to buy a house. The borrower knows that he or she does not have steady income with which to repay the loan and does not disclose this information to the lender. Assuming the borrower is not independently wealthy, there is a high likelihood of default. According to adverse selection, it is these borrowers, i.e.

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92. *See* FREDERIC MISHKIN, FINANCIAL MARKETS, INSTITUTIONS AND MONEY 220 (1995).

93. *See id.*

94. *See generally id.*

those most likely to default, who most eagerly seek loans.[95]

Adverse selection is an impediment to well-functioning markets. The disruption of the market resulting from adverse selection resembles the problem created by "lemons" in the used car market and for this reason, it is often referred to as the "lemons problem."[96] To illustrate the effect of the "lemons problem" on market functioning, assume that there are two types of cars sold in the used car market—problematic cars ("lemons") and reliable cars ("peaches"). Further assume that potential buyers of used cars are unable to determine the quality of used cars being sold; that is, potential buyers cannot discern between lemons and peaches because there is a lack of available information.[97] Because potential used car buyers cannot determine vehicle quality, they will only be willing to pay a price for a used car that reflects the *average* quality of the cars being sold.[98] Hence, a buyer's offer price will be somewhere between the low value of a lemon and the high value of a peach.[99]

The seller of a used car knows if his or her car is a lemon or a peach.[100] If the car is a lemon, the seller is more than happy to accept the buyer's offer price.[101] The seller of a lemon knows the offer price is greater than the value of the lemon because it reflects the average value of a lemon and a peach.[102] On the other hand, if the car is a peach the seller will not accept the buyer's offer price because he or she knows the car is undervalued by the buyer.[103] The presence of adverse selection deters the sale of good cars because they are undervalued.[104] Everyone, however, will be very willing to sell lemons and therefore the average quality of cars will fall.[105] Buyers will recognize that there are only lemons on the market and become

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95. *See generally id.* at 229.

96. *See generally* George Akerlof, *The Market for "Lemons": Quality Uncertainty and the Market Mechanism*, 84 Q.J. ECON. 488 (1970).

97. *See generally id.* at 489.

98. *See* MISHKIN, *supra* note 92, at 230.

99. *See id.*

100. *See id.*

101. *See id.*

102. *See id.*

103. *See id.*

104. *See id.*

105. *See id.*

unwilling to buy.[106] The result is that there will be few, if any, cars sold.[107] The market will fail to function.[108]

The "lemons problem" in the securities markets is analogous to that described above for the used car market. In the securities markets, "lemons" are bonds issued by issuers whose securities carry high risk and low expected profit. Peaches are bonds sold by issuers whose securities carry low risk and high expected profit.[109] If investors cannot distinguish between lemons and peaches in the securities market, ultimately the market will not function.[110] Only lemons will be brought to market and investors will not be willing to buy the securities because they recognize that only lemons are being sold.[111]

The lemons problem occurs only when there is information asymmetry among market participants.[112] Disclosure by securities issuers, therefore, helps to resolve the lemons problem. Assuming the information provided in disclosure documents is timely and accurate, investors can adequately distinguish lemons from peaches. As a result, investors will be willing to pay the fair market value for securities. Good issuers, therefore, have an incentive to disclose so as to avoid having their securities undervalued by investors.

Good issuers also have an incentive to disclose to negate the assumption that they are selling lemons. Investors automatically assume that issuers who do not disclose are selling bad securities.[113] Suspicious investors, therefore, would be unwilling to buy securities without disclosure or would purchase these securities only if a substantial risk premium were attached.

Springfield would benefit from disclosure because disclosure allows investors to see Springfield's securities as "peaches" and to

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106. *See id.*
107. *See id.*
108. *See id.*
109. *See generally* MISHKIN, *supra* note 92, at 230.
110. *See generally id.*
111. *See generally id.*
112. *See generally id.* at 231.
113. *See generally* Akerlof, *supra* note 96, at 490.

price the securities accordingly. In addition, disclosure would reduce the risk premium attached to Springfield's bonds.[114]

2. Moral Hazard

A moral hazard is an asymmetric information problem occurring *after* a transaction takes place.[115] Moral hazard exists when a security issuer withholds material information or engages in risky activities that jeopardize the repayment of debt.[116] For example, suppose a borrower tells a lender that he or she wants to borrow money to build a house. After the loan is made, however, the borrower takes the loan proceeds, goes to Las Vegas and gambles away the loan money instead of building a house. The lender is never repaid.

Information provided by mandatory disclosure requirements, especially ongoing disclosure requirements, helps solve the moral hazard problem.[117] Disclosure forces issuers to adhere to standards such as standard accounting principles. For investors, this makes it easier to monitor the issuer and verify profitability.

Moral hazard can be particularly problematic among municipal issuers because the assets funded by bond issues are, in many cases, public assets. Creditors cannot seize public assets in the event of a default or municipal bankruptcy. Because issuers know that the assets cannot be seized, there is little incentive to do a thorough analysis of project viability prior to undertaking the project.

The $2.25 billion WPPSS default in 1983 is a good example of the moral hazard problem within the municipal bond market.[118] The bonds involved in this default funded two nuclear reactor building projects. SEC investigation following the default revealed that WPPSS failed to disclose important financial information to

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114. "Good" issuers benefit from mandatory disclosure also because if the "bad" issuers are forced to disclose, investors can better discriminate between good and bad bonds.

115. *See* MISHKIN, *supra* note 92, at 229.

116. *See id.*

117. There are a number of other ways to resolve the moral hazard problem, for example, protective covenants within the bond indenture and financial intermediaries. For a discussion of these solutions, see MISHKIN, *supra* note 92, at 239-41. Because this paper focuses on disclosure, we limit our discussion to how disclosure solves the moral hazard problem.

118. *See generally id.*

investors.[119] If WPPSS had provided ongoing disclosure, the financial problems would likely have been discovered before they became insurmountable.[120]

Similarly, disclosure by Springfield would reduce the moral hazard problem. Furthermore, Springfield's adherence to standard accounting procedures and ongoing disclosure would reduce investor uncertainty.

B. Market Efficiency

Resolution of asymmetric information problems through disclosure fosters market efficiency (to the extent that capital market efficiency depends upon the free flow of information),[121] because, according to theoretical and empirical studies, increased information flow improves efficiency.[122]

Informational efficiency facilitated by disclosure requirements is beneficial to issuers for several reasons. If markets are informationally efficient, market prices are trustworthy valuations of an investment's worth. When the current market price reflects all available information, the market price equals the intrinsic value of the security.[123] The intrinsic value is the present value of the future cash flows an investor expects to receive from a security.[124]

When markets are informationally efficient, issuers can be confident that they are receiving fair market value when they issue securities. This is important for two reasons. First, when markets are informationally efficient, investor confidence increases, causing capital to flow into the market. Second, investor confidence about the price of a security reduces transaction costs. Otherwise, investors would need to spend a great deal of time and effort to perform their own valuation of the security. Issuer disclosure acts to minimize or

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119. *See* John Petersen, *Information Flows in the Municipal Market*, *in* THE HANDBOOK OF MUNICIPAL BONDS AND PUBLIC FINANCE 687 (Robert Lamb, et al., eds., 1993).

120. *See generally id*. at 687-88.

121. *See* EUGENE F. FAMA, FOUNDATIONS OF FINANCE 133-34 (1976).

122. *See id.* at 133-63.

123. *See* PHILIP COOLEY & PEYTON F. RODEN, BUSINESS FINANCIAL MANAGEMENT 187 (2d ed. 1991).

124. *See id*. at 164.

eliminate the costs involved in such a valuation because the market price accurately reflects the value of the security.

Informationally efficient markets also result in reduced investor uncertainty and decreased volatility regarding returns. With more complete information, investors can determine more precisely the risk of a particular security, and therefore, can more precisely estimate expected returns.[125] The increased quantity and quality of information provided by disclosure reduces investors' uncertainty surrounding expected returns, which translates into lower volatility.[126] As a result, the risk premium[127] on securities subject to disclosure is lower than risk premiums on otherwise comparable securities not subject to disclosure.[128] Issuers benefit because lower risk premiums result in lower costs of borrowing and decreased volatility surrounding the security returns.[129]

The informational efficiency associated with disclosure provides an added benefit unique to municipal issuers. Pricing accuracy can signal potential future shortfalls in tax revenue, allowing for appropriate adjustments to the level of government services provided with the bond revenue.[130] Disclosure, eliminates the potential disparity between municipal expenditures and the ability to finance

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125. *See id.*

126. *See* Jarrell, *infra* note 128. Jarrell assumes that investors possess little information about issuers at the time of issuance and form unbiased expectations of the issuing firm's systematic risk and future payouts from its securities. He then asserts that mandatory disclosure requirements provide more complete information about new issues and enable investors to make more precise predictions about the future prospects of the issuing firm. In this context, disclosure requirements should reduce investors' uncertainty, thereby decreasing the dispersion of the distribution of expected future payoffs from the issuing firm.

127. The risk premium is the differential in yield between the security in question and a default-free one, with all factors other than default risk held constant. *See* JAMES VAN HORNE, FINANCIAL MARKET RATES AND FLOWS 141 (1978).

128. *See, e.g.*, Gregg A. Jarrell, *The Economic Effects of Federal Regulation of the Market for New Security Issues,* 24 J.L. & ECON. 613 (1981); Carol Simon, *The Effect of the 1933 Securities Act on Investor Information and the Performance of New Issues*, 79 AM. ECON. REV. 295 (1989) (discussing how disclosure affects risk premiums).

129. *See, e.g.*, Simon, *supra* note 128, at 304-13 (setting forth specific empirical results). A 1989 study by Carol Simon provides strong evidence that disclosure reduces volatility. Simon examined the effect of the 1933 Act disclosure requirements and found that mandatory disclosure requirements did not affect average risk-adjusted returns for issues with low information costs (e.g., seasoned issues and NYSE-listed firms).

130. *See* Gellis, *supra* note 26, at 69.

those expenditures through the capital markets.[131] In an informed marketplace, this disparity is more likely to be recognized before it reaches a critical point requiring unexpected reductions in the level of services.[132]

C. Improved Liquidity

When investors trust market prices due to informational efficiency, they more actively buy and sell securities in the secondary market. This in turn creates liquidity, which is important for issuers as well as investors.[133] Issuers' knowledge of the market conditions affecting their securities is advantageous[134] because issuer officials can monitor the trading patterns in the secondary market for their bonds, which is especially useful when the issuer anticipates future offerings.[135] For example, the task of pricing a new issue is easier when there an active secondary market for an issuer's existing bonds that gives pricing information that is indicative of what price is suitable for the new issue.[136] Price information also helps issuers estimate investor interest in new issues.[137]

In many cases, issuers want to actively promote new issues coming to market.[138] If an issuer can demonstrate that its existing bonds have consistent trading patterns, investors are more likely to show interest in purchasing future issues.[139] Moreover, investors may be willing to pay a premium for issues with considerable liquidity.[140] Hence, liquidity attracts investors to the market.

Clearly, disclosure benefits Springfield, because it allows the market to price Springfield's bonds accurately, improves liquidity in the market, and reduces both investor uncertainty and volatility. The

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131. *See id.*
132. *See id.*
133. *See* Heather L. Ruth, *Municipal Bond Price Transparency: What It Means for Issuers*, 6 GOV'T FIN. REV. 21, 24 (1995)
134. *See id.*
135. *See id.*
136. *See id.*
137. *See id.*
138. *See id.*
139. *See id.*
140. *See id.*

benefits of disclosure, therefore, outweigh any increased costs[141] of disclosure.[142]

III. POTENTIAL PITFALLS FOR ISSUERS UNDER RULE 15C2-12

Rule 15c2-12 and its amendments indirectly require disclosure by municipal issuers within primary and secondary markets.[143] Unfortunately, the regulatory scheme imposed by the Rule is inadequate. The scheme is inadequate because the Rule 1) fails to detail the disclosure requirements with a sufficient degree of specificity; and 2) fails to specify the liability for noncompliance.[144] It is important for issuers, such as our hypothetical issuer Springfield, to understand to what extent the Rule and its amendments change existing law. Without this understanding, Springfield, and even Springfield executives, may face potential liability, especially to investors. This potential liability stems from gaps in the Rule and its amendments.

Rule 15c2-12 addresses the primary market disclosure process and increases the importance of the official statement. First, the Rule is inadequate because, although it essentially requires issuers to provide official statements, the official statement's content is still nonstandardized. Under Rule 15c2-12, the SEC only makes suggestions regarding the appropriate content of the official statement, which currently coincide with those advocated by the GFOA and the National Federation of Municipal Analysts. The SEC intentionally declined to specify the content of the official statement to provide flexibility and to respond to industry concerns raised during the rulemaking process.[145] However, the resulting uncertainty creates a flawed regulatory scheme. In this context, flexibility creates gaps that may trap unwary issuers.

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141. *See* Gellis, *supra* note 26, at 95-99 (discussing increased issuer costs associated with disclosure).

142. There are documented benefits associated with disclosure. *See* Fairchild & Koch, *supra* note 14. Although benefits are documented, measurement of the costs of disclosure is difficult, if not impossible, because municipal issues and issuers are heterogeneous.

143. *See generally supra* note 20.

144. *See infra* notes 145-54.

145. *See* Fippinger, *supra* note 56, at 18, 19.

Second, the Rule is inadequate because it fails to specify liability for noncompliance. Perhaps the best way to illustrate this inadequacy is to contrast the treatment of municipal bonds with that of corporate securities. Issuers of corporate securities must distribute a prospectus,[146] and they face clear statutory liability for noncompliance.[147] In addition, the statute governing corporate issuers creates a private cause of action for misstatements in the registration statement and prospectus,[148] and provides potential defendants.[149] Rule 15c2-12, on the other hand, fails to establish liability for noncompliance by municipal bond issuers. Because the Rule does not specify penalties for failure to use an official statement, liability for misstatements is unclear.[150] In addition, although statutory obligations for secondary disclosures exist for both corporate and municipal issuers, Rule 15c2-12 again fails to specify liability for noncompliance.[151] Municipal issuers remain uncertain of their potential liability and how to avoid it. In the following sections, we highlight the potential pitfalls faced by issuers in the primary and secondary market caused by the nonspecificity of the Rule and the uncertainty of liability.

A. Potential Pitfalls of the Primary Market Disclosure Process

Because Rule 15c2-12 specifies neither the required contents of the official statement nor the potential liability for noncompliance in the primary offering, issuers face a high degree of uncertainty.[152]

1. Use of Professionals to Prepare the Official Statement

Because the parties control the content of the official statement through the contract terms, disclosure is essentially voluntary.[153] In

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146. Section 5, 15 U.S.C. § 77e(b) (1994).

147. Section 12(1), 15 U.S.C. § 77(l) (1994).

148. Section 11(a), 15 U.S.C. § 77k,l (1994).

149. The list of possible defendants under § 11 includes the issuer, underwriter, broker-dealer, experts, and officers and directors of the issuer. *Id.*

150. *See generally* 17 C.F.R. § 240.15c2-12 (1995).

151. *See id.*

152. *See infra* notes 154-60.

153. *See id.*

general, most issuers rely on financial advisors, underwriters and/or the underwriters' counsel to prepare the official statement and other disclosure documents.[154] Reliance on these professionals can benefit the issuers. These benefits accrue, however, only when the professionals have a sense of responsibility to the issuer and are knowledgeable of securities laws and disclosure responsibilities. Without a sense of responsibility to the issuer, professionals may not act carefully when preparing the disclosure documents because only the issuer is ultimately responsible for the disclosure documents.[155] This creates a potential pitfall for issuers who are not well-versed in securities law, as they may be unaware of their ultimate responsibility.[156] Although the professionals recognize this fact, many are uncomfortable with challenging issuers regarding the accuracy and completeness of the information being provided.[157] Thus, the professional may fail to correct unintentional misstatements for which the issuer may be liable.

Moreover, the Rule provides little incentive for underwriters to thoroughly investigate the official statement because it is unlikely that they will be sued by investors for misstatements in the official statement under the antifraud provisions.[158] Again, this uncertainty for municipal issuers should be contrasted with the clear liability scheme set forth for corporate securities. Under corporate securities regulations, both issuers and underwriters are liable for misstatements in the prospectus, which provides underwriters with an incentive to assure the accuracy of the prospectus.[159] These incentives are lacking for municipal bond offerings.

Hence, issuers should view the use of professionals only as a tool to assist in the preparation of disclosure documents. Because the

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154. *See* Robert W. Doty, *Special Disclosure Considerations for State and Local Government Securities Issuers*, 18 MUN. FIN. J. 43 (1997). *See also* Petersen, *supra* note 119, at 642-44.

155. This is, of course, complicated by the fact that the nature of this liability is unclear. *See supra* notes 147-54 and accompanying text (discussing uncertainties of liability).

156. For more detail, see Doty, *supra* note 154, at 43.

157. *See* 1989 Release, *supra* note 42, at 28,811-28,812 (emphasizing liability of municipal issuers with respect to disclosure).

158. Compared to the corporate securities markets, there have been few incidences of fraud in the municipal market. *See* Gellis, *supra* note 26, at 73-74.

159. *See supra* notes 146-47.

municipal issuer, not the professional preparing the disclosure, is ultimately liable for misleading disclosure or misstatements, municipal issuers should closely scrutinize all information disclosed.[160]

2. Use of Underwriter's Counsel

The problems associated with the use of professionals to prepare the official statement are complicated by the standard use of an underwriter's counsel by municipal issuers.[161] Historically, municipal issuers have relegated preparation of the disclosure documents to the underwriter's counsel. This practice began in the late 1970s when investors began demanding more complete disclosure. Underwriters, as a result, feared increased risk of liability.[162] Issuers, reluctant to pay fees to hire their own counsel, began to rely on underwriter's counsel. Eventually, the underwriters began charging for use of their counsel. Instead of hiring their own counsel, issuers paid the additional fees to the underwriter, and by convention, still allowed the counsel to be employed by the underwriter.[163] This practice is still common. However, it is a risky practice for the issuer because the underwriter's counsel usually does not have a contractual or fiduciary obligation to the issuer[164] and is formally obligated only to the

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160. In Maricopa County, Arizona, however, the SEC acted against both the issuer and its financial advisor. *See, e.g.*, *In re* Peacock, Hislop, Staley, and Given, Inc. (PHS&G), Securities Exchange Act Release No. 34-3777 (October 2, 1996); *In re* Maricopa County, Securities Exchange Act Release No. 34-37779 (October 3, 1996). The SEC based its claim against the county on Section 17(a) and Rule 10b-5. *In re* Peacock, Hislop, Staley and Given, Inc., the SEC brought a public cease and desist proceeding against PHS&G and its president as the financial advisors to Maricopa County in connection with two general obligation bond offerings. The financial statements presented in the official statement were over a year old and failed to reflect material changes in the general financial condition of the county. The SEC reasoned that PHS&G and Given had recklessly aided and abetted the county in violation of Section 17(a) and Rule 10b-5.

161. *See* Petersen, *supra* note 119, at 644.

162. The role of bond counsel entails, but is not limited to, opining on the legality of the issue, tax status, and the form of the bond. In many cases, only one counsel (that of the underwriter) is used. The underwriter's counsel prepares the disclosure documents and issues opinions on the adequacy and accuracy of the disclosure. The issuer's counsel, if also employed in the transaction, has a limited role in the disclosure preparation process, i.e., the underwriter's counsel still prepares the disclosure documents. *See* Petersen, *supra* note 119, at 643-44.

163. *See id.* at 644.

164. *See id.*

underwriter. Because disclosure is ultimately the issuer's responsibility, it is less risky, and certainly makes more sense, for the issuer to hire its own counsel (or other professional).[165] The issuer can then use the employment contract to create a fiduciary duty owed by its own counsel to the issuer.[166]

To some extent the problem of relying on underwriter's counsel is a problem of the issuer's making. The failure of Rule 15c2-12 to specify underwriter liability, however, exacerbates the problem. If the underwriter had clear liability for misstatements in the official statement, as it would for misstatements in a corporate prospectus, the underwriter's counsel would serve the interests of *both* the underwriter and the municipal issuer.[167] The underwriter and the underwriter's counsel would have similar interests in assuring that the official statement accurately reflected the financial and nonfinancial situation of the issuer; they would both have liability if it did not.[168]

3. Timeliness of Audited Financial Statements

Although the SEC does not explicitly specify the content of the official statement,[169] most issuers include audited financial statements.[170] Problems may arise when an issuer uses these statements during the post-audit period.[171] As time elapses after the audit period, material changes will likely occur. For this reason, investors may view the inclusion of outdated audited financial statements in the official statement as materially misleading information.[172] Issuers can avoid this problem by having the auditors

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165. *Id.*
166. *See id.*
167. *See id.* at 645.
168. *See generally id.*
169. *See generally supra* notes 146-47.
170. *See* Doty, *supra* note 154.
171. *See id.* at 54.
172. In cases involving Maricopa County, Arizona, and Orange County, California, the SEC found that these issuers had provided audited financial statements over a year old in the official statement. In both cases, material events had occurred which were not reflected in the financial statements. As a result, the SEC deemed the use of the financial statements to be materially misleading. *See, e.g.*, *In re* Maricopa County, *supra* note 160. *See also* Doty, *supra* note 154, at 54.

conduct an events review prior to including audited financial statements in the official statement. This would enable the auditors to detect the impact on the financial health of the issuer of any material events during the post-audit period.[173]

Rule 15c2-12's nonspecificity with respect to the official statement's contents contributes to this problem.[174] In the corporate securities market, federal regulations require specific prospectus contents and impose detailed periodic disclosure requirements.[175] Moreover, corporate securities regulations explicitly define liability.[176] For these reasons, corporate issuers regularly conduct post-audit reviews.[177] Because Rule 15c2-12 is vague regarding the official statements contents and liability for municipal bond issuers, and because there is no regulatory motivation for municipal issuers to initiate a post-audit review, many municipal issuers do not conduct post-audit reviews.[178]

4. Individual Investor Litigation

Although issuers are ultimately liable for their disclosure documents, the SEC has limited resources available to pursue actions against issuers. Historically, the SEC has pursued only a few selected cases.[179] While issuers may consider the lack of SEC action as good news, the bad news is that issuers still face the threat of litigation from individual investors. The threat of litigation arises not only in the case of default, but also when there is a loss of bond value due to an undisclosed change in financial condition or as a result of secondary market transactions.[180]

The extent to which municipal issuers face liability to investors is,

173. *See* Doty, *supra* note 154, at 54.
174. *See infra* note 178.
175. *See id.*
176. *See id.*
177. *See id.*
178. *See* Doty, *supra* note 154, at 54, 55.
179. *See id.* at 47.
180. Based on a "benefit of the bargain" argument, investors can claim "they have received less than that for which they bargained." *See* Doty, *supra* note 154, at 47. This is similar to the damages available to investors of corporate securities for misstatements in the registration materials.

as discussed above, uncertain. The Rule fails to specify the nature of this liability, possible plaintiffs, possible defendants or possible defenses.[181] This uncertainty is problematic. Although there are no reported cases of investors suing for noncompliance with the disclosure requirements of Rule 15c2-12, the threat is a real one. Moreover, evidence of a Rule 15c2-12 violation could support a 10b-5 claim.[182] The potential for liability is significant, and the Rule's failure to specify a liability scheme is fatal.

5. Personal Liability of Issuer Officials

The potential for liability does not stop with the municipal issuer. In addition to the potential liability faced by issuers, key issuer officials may face personal liability for violations of securities regulations in extreme cases. The precedent for personal liability of key officials is the SEC's investigation of Orange County, California.[183] It came as no surprise that the SEC took action against the county's treasurer and assistant treasurer, because these officials allegedly were responsible for, and lied in, the disclosures. During its investigation, however, the SEC determined also that the Orange County supervisors were personally liable because they allegedly failed to satisfactorily disclose their knowledge of material facts; instead, they delegated their responsibility of disclosure review and recommendations to bond professionals.[184]

The potential for personal liability of key issuer officials is significant because most officials "know" a great deal of information about the issuing entity and this information is potentially "material."[185] In the Orange County investigation, the SEC placed direct responsibility on key officials for reviewing and investigating every disclosure document with respect to completeness and material

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181. Contrast this, for example, with the due diligence defense clearly allowed for corporate securities. Section 11(b), 15 U.S.C. § 77k(b)(3) (1988).

182. *See infra* note 203.

183. *Report of Investigation in the Matter of County of Orange, California as it Related to the Conduct of the Members of the Board of Supervisors*, Securities Exchange Act Release No. 36761 (January 24, 1996).

184. *See id.*

185. *See* Doty, *supra* note 154, at 49.

accuracy.[186] In assigning this responsibility, the SEC assumed that the elected officials had the necessary sophistication to make judgments regarding materiality.[187] Hence, the outcome of the investigation of Orange County sends a strong message to issuers and key officials: knowledge of securities law is essential to avoid the personal liability pitfall.[188]

This raises the additional question of personal liability of issuer officials to private plaintiffs. Again, the Rule's failure to specify a liability scheme is dangerous to issuers and to issuer officials.

6. Definition of an Obligated Person

Rule 15c2-12 and its amendments tie the disclosure required within the primary and secondary market to the issuer or an obligated person.[189] For the majority of issuers, the obligated person can be easily determined. Conduit bonds, however, complicate the definition of an obligated person because the conduit borrower, not the municipal issuer of the conduit bonds is the obligated person. Pursuant to the requirements of Rule 15c2-12 and its amendments, disclosures must provide information with respect to the obligated person, not the municipal issuer of the conduit bond.[190] Similarly, ongoing disclosures must provide information concerning the continued financial health of the obligated person, not the municipal issuer. The municipal issuer is, however, the party responsible for making the principal and interest payments.[191]

Disclosures limited to the obligated person, and ignoring the issuer, fail to adequately protect investors in some situations.[192] In addition, such disclosures expose the issuer to potential liability to

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186. *See id.*

187. *See id.*

188. On November 10, 1995, SEC Chairman Arthur Levitt stated "When someone goes on a board, even if it is the school board, I want them to be as mindful of disclosure and securities laws as directors of a corporate enterprise. I have no patience with municipal officials who say that 'we didn't understand," N.Y. TIMES, Nov. 10, 1995, at C1.

189. *See supra* note 56 and accompanying text (defining obligated person).

190. *See supra* note 42.

191. *See id.*

192. *See* Fairchild & Ellis, *supra* note 7.

private persons.[193] For this reason, issuers should err on the side of providing information about the financial health of the municipal issuer in addition to the obligated person. By providing this information, issuers reduce their liability exposure,[194] reassure investors,[195] and increase the efficient operation of the market.[196]

C. *Potential Pitfalls of the Secondary Market Disclosure Process*

Securities laws impose obligations on both corporate and municipal issuers for secondary disclosures.[197] The disclosure obligations are clearly set forth in the corporate securities arena, and liability for noncompliance is clear.[198] Again, however, the specifics of disclosure and the liability for noncompliance are unclear in the area of municipal bonds.[199]

The amendments to Rule 15c2-12 require issuers to provide ongoing disclosure within the municipal bond market.[200] Specifically, underwriters must obtain an issuer's commitment to provide ongoing disclosure after the initial sale of bonds by filing informatioin with each national repository and a state information repository (if one exists).[201] In general, the potential pitfalls for issuers in the secondary market arise in two areas: 1) disclosure of material events ; and 2) failure to provide ongoing information.

1. Disclosure of Material Events

Under general principles of law, there is no obligation for municipal issuers to disclose information, even material information.[202] Rule 15c2-12 creates a limited duty to disclose by requiring issuers to annually update the financial information and

193. *See id.*
194. *See generally* Doty, *supra* note 154.
195. *See id.*
196. *See id.*
197. *See supra* note 154.
198. *See id.*
199. *See supra* notes 147-54.
200. *See supra* notes 24-27.
201. *See id.*
202. *See infra* note 204.

operating data set forth in the final official statement.[203] As discussed above, the extent to which the issuer must disclose other information is unclear.[204] This uncertainty creates problems for the issuer. On the one hand, some commentators argue that the occurrence of a material event, even one not included on the enumerated list of eleven,[205] triggers a duty to disclose.[206] Rule 15c2-12 fails, however, to specify liability for noncompliance.[207] Issuer noncompliance could subject the issuer to liability under Rule 10b-5.[208] Again, the uncertainty of Rule 15c2-12 liability, coupled with the unclear interactions between Rule 15c2-12 and Rule 10b-5, leaves the issuer unprotected.

On the other hand, it appears that the issuer might have no obligation to disclose events—even material events, if they are not listed as one of the eleven material events[209]—as long as they remain *absolutely* silent.[210] Even under this view, however, the issuer is vulnerable to liability. Municipal issuers can seldom remain absolutely silent.[211] Because municipal issuers are public entities, matters related to bond issues and the financial health of the issuer tend to be discussed openly, whether at a board meeting or council meeting.[212] Hence, material information, even event information not listed as one of the eleven material events, will likely become public because municipal issuers rarely remain absolutely silent.

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203. SEC Rule 10b-5 also applies to disclosures made according to Rule 15c2-12 and its amendments. *See supra* note 28.

204. *See supra* note 66 and accompanying text.

205. *See* Robert A. Fippinger, *SEC Mandates Continuing Disclosure for States and Political Subdivisions*, 9 INSIGHTS 19 (1995); Dennis L. Holsapple & Curtis L. Christensen, *SEC Rule 15c2-12 and Ongoing Disclosure Obligations of Obligors of Municipal Securities*, 17 URB. LAW. 951 (1995).

206. *See id.*

207. *See supra* note 204.

208. *See supra* note 28.

209. *See* Backman, 910 F.2d 10. The material events disclosure requirement "should not be misconstrued . . . as requiring the timely disclosure of all material information." Fippinger, *supra* note 56, at 21.

210. *See* Doty, *supra* note 154, at 42.

211. Typically municipal issuers cannot remain silent. *See* Holsapple & Christensen, *supra* note 64, at 950-51 (discussing the typical release of information by press release and public statements). *See also* Fippinger, *supra* note 56, at 19. Silence is, of course, inconsistent with the issuer incentives toward disclosure. *See supra* notes 96-145 and accompanying text (discussing incentives for disclosure).

212. *See generally id.*

2. Failure to Provide Ongoing Disclosure

Rule 15c2-12 does not require SEC filings. [213] Instead, issuers file the required disclosure documents with national and state repositories and the MSRB.[214] The purpose of the repositories is to make information more accessible to investors. However, in addition to evidence that investors may be no better off within the scheme imposed by Rule 15c2-12,[215] the scheme imposes a potentially time consuming and costly multiple reporting duty upon issuers.

More importantly, Rule 15c2-12's failure to provide an enforcement mechanism and the absence of reported Rule 15c2-12 cases may tempt issuers to ignore the ongoing disclosure requirements. The potential liability, however, remains. The SEC encourages the parties involved to specify remedies for noncompliance in their agreement. [216] The extent to which parties so agree is unknown.

Absent an agreement between the parties, the potential liability for noncompliance is unclear. [217] The questions follow: Who has liability for noncompliance? Is liability imposed for all misstatements, negligent misstatements or only intentional misstatements? To whose benefit does such liability accrue? Is there a private cause of action for violation?

As noted earlier, the SEC does not have the resources to investigate all violations of Rule 15c2-12 and its amendments. Thus, the underwriters and the broker/dealer community must assume the burden of policing the municipal market with respect to initial and ongoing disclosure under Rule 15c2-12 and its amendments. With thousands of municipal issues sold and accompanied by nonstandardized official statements, this is an onerous task for the investment community, especially with respect to the small issuers

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213. *See generally supra* note 42.

214. Rule 15c2-12(b)(5)(i)(A).

215. *See* Fairchild & Ellis, *supra* note 7. The regulatory scheme created by Rule 15c2-12, as opposed to the SEC's role as the central repository for information regarding corporate securities, imposes increased costs on investors because of the time needed to search multiple sources to obtain information.

216. *See* 1994 Release, *supra* note 56, at 59, 601-02.

217. *See generally id.*

with little financial history.

To deal with this task, the investment community can, and does, require issuer officials to sign Rule 10b-5 certificates.[218] By signing these anti-fraud certificates, the issuer affirms that the disclosure documents contain no misstatements or misleading statements. Hence, finance professionals shift the responsibility of verifying the accuracy and completeness of disclosure documents to the issuer and its officials.[219]

Once more, potential liability is unclear. In an attempt to avoid liability, finance professionals require issuers to sign 10b-5 certificates.[220] Presumably, misstatements or misleading disclosures could then subject the issuer to liability from investors who purchased or sold the bonds.[221] The nature of this liability, however, is unclear, as Rule 15c2-12 specifies no liability for noncompliance.[222]

The importance of private cause of action has been previously recognized.[223] In the corporate securities market, a private cause of action for misleading statements arises under section 11,[224] which also provides a laundry list of defendants.[225] Potential plaintiffs include any purchaser or seller of the security.[226] Section 11 provides no scienter requirement, but instead imposes strict liability. Rule 15c2-12 provides no such liability;[227] however, it is possible that a private cause of action exists under Rule 15c2-12 against municipal

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218. *See* Doty, *supra* note 154, at 45.

219. *See id.*

220. *See id.*

221. *See id.*

222. *See id.*

223. *See, e.g.*, Gellis, *supra* note 26, at 83-86 (discussing relative merits of administrative enforcement and a private cause of action in the municipal securities market).

224. *See supra* note 148 and accompanying text.

225. *See supra* note 149 and accompanying text. If liability in the municipal securities market was imposed on the municipal issuer based on the corporate security model, this would ultimately impose liability on the municipal taxpayer. *See* Gellis, *supra* note 26, at 109-112 (discussing the fairness of imposing liability on the "innocent taxpayer" and whether the differences between taxpayers and shareholders justify different treatment). *See also* Doty, *supra* note 154 (discussing enforcement and implication of imposing liability on the issuer, and issuer officials).

226. *See generally supra* note 149.

227. *See* Gellis, *supra* note 26, at 108-18 (proposing enforcement in the municipal market modeled on the corporate securities scheme).

bond issuers.[228] Furthermore, even if a private cause of action exists, it is unclear who the potential defendants are, and whether the liability is subject to limitations.[229] Rule 15c2-12 does not preclude Rule 10b-5, so a private individual can bring a cause of action under 10b-5 for violations in the municipal securities market.[230] The uncertain interaction between 10b-5 liability and the obligations imposed by Rule 15c2-12, however, only complicate the questions posed.

D. Conclusion on the Possible Pitfalls

Rule 15c2-12 increases the liability exposure for municipal issuers and issuer officials. As such, issuers and issuer officials must become more proactive with respect to the preparation of disclosure documents in both the primary and secondary markets. Essentially, issuer officials must have knowledge of securities law and their disclosure responsibilities under those laws, if they want to ensure that they do not become entrapped by the potential pitfalls. In addition, officials should carefully document the investigative process used to verify the accuracy of their disclosure information, including detailed documentation of expert opinions, analyses, and reports. A detailed "paper trail" increases the probability of establishing an issuer's innocence should an accusation arise regarding its disclosure information. Moreover, if misstatements or misleading disclosures result from an analysis or opinion of an expert employed by the issuer, then the issuer may have legal recourse against the expert.[231]

IV. REGULATORY REFORM

Rule 15c2-12 is an indirect attempt by the SEC to regulate the municipal bond market. As noted above, the Rule and its amendments create potential liability pitfalls for issuers and issuer

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228. *See id.*

229. *See* Doty, *supra* note 154, at 47-48. Doty emphasizes the potential for liability for noncompliance with Rule 15c2-12. He discusses primarily Rule 10b-5 and Section 17(a).

230. *See id.*

231. *See* Doty, *supra* note 154, at 46, 49.

officials. These pitfalls stem from the limitations placed on the SEC and the MSRB by the Tower Amendment.[232] This amendment is the primary obstruction to achieving an effective disclosure environment for both issuers and investors in the municipal market.[233]

Although the Tower Amendment is largely responsible for the existing regulatory framework, investors and issuers face a substantially different municipal securities market today than in 1975. Through the rapid growth of the derivatives markets, municipal bonds have evolved into more complex instruments. In many cases, they are identical to corporate bonds, except for the tax-exempt interest income. This complexity is of particular concern to issuers because issuers must have a thorough understanding of the derivatives they embed in their securities.[234]

Two initial steps should be taken to reform the regulatory environment of the municipal bond market.[235] First, Congress should repeal the Tower Amendment. Repealing this amendment will permit the much needed direct regulation of the municipal market at the federal level and benefit both issuers and investors, because the SEC will be able to mandate consistent regulations. Second, Congress should endow one federal entity with both rulemaking and direct enforcement power over *all* participants in the municipal market, including issuers, which will ensure consistent enforcement of the regulations.

The current regulatory framework is fragmented. Rulemaking authority rests with the MSRB while the SEC, NASD, and bank regulators each have enforcement powers.[236] The MSRB's inability to enforce its rules hinders its ability to develop expertise determining compliance with the rules and creates a potential disparate enforcement of MSRB rules, depending upon whether the dealer is a

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232. *See supra* note 52.

233. *See generally id.*

234. Derivatives are also a concern for issuers who invest excess funds in such securities. The Orange County, California bankruptcy highlights the financial perils resulting from investment in derivative securities. *See generally* Doty, *supra* note 154.

235. We are not the first to urge reform of the municipal securities regulatory framework. *See, e.g.*, Gellis, *supra* note 26 (arguing for a system of federally mandated disclosure rules); Fairchild & Ellis, *supra* note 7; Gellis, *supra* note 1.

236. *See infra* note 237.

bank or non-bank entity.[237] Ultimately, this means investors and issuers receive varying degrees of protection and are subject to each particular regulator's interpretation of the rules and enforcement policies.

Our proposed reform recommends eliminating the MSRB and giving the SEC regulatory jurisdiction over the municipal market in a manner identical to its powers over the corporate markets.[238] We believe that the limited differences between municipal bonds and corporate bonds in today's market do not justify the different regulatory treatment that has evolved.

Furthermore, the SEC has a great deal of expertise in the corporate securities market which enable it to best regulate the municipal market. Because the SEC is familiar with the corporate market, it can recognize the limited differences between corporate and municipal securities and, therefore, can tailor the disclosure rules to the municipal securities market.[239] Presumably, the SEC would consider a system to review proposed disclosures prior to issuance,[240] and specify liability for misleading disclosures.[241] Liability must be more precisely defined so that issuers are not subject to risk-shifting

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237. Bank municipal securities dealers are governed by the bank regulators. Non-bank municipal securities dealers and brokers are subject to the enforcement authority of the SEC and NASD. *See* 1993 STAFF REPORT, *supra* note 2, at 41.

238. We considered, but rejected, the alternative of giving the MSRB enforcement powers over all municipal issuers, municipal dealers and brokers. Arguably, the rulemaking ability of the MSRB would be strengthened if it had both rulemaking and enforcement powers. The primary reason the Securities Act of 1933 and the Securities Exchange Act of 1934 effectively made the corporate markets safer was that the SEC has both rulemaking and enforcement powers. 1993 STAFF REPORT, *supra* note 2, app. A at. 4. Currently, the MSRB does not conduct investigations of dealer compliance with its rules. Which would provide useful information regarding the operational aspects of its rules and their efficacy. Consistent enforcement standards would likely result. However, granting the MSRB had enforcement powers would be a duplicate investigations to compliance with the rules, because the SEC has a great deal of expertise in this area and already performs this function in the corporate securities markets. The MSRB's performance of this task in the municipal market would not be an optimal use of resources. More importantly, the composition of the MSRB Board could lead to biased decisions that would limit the liability of underwriters and result in continued inadequate disclosure.

239. For example, the SEC can address the large number of small issues in the municip al market and the segmentation of the market between general obligation and revenue bonds. *See* Gellis, *supra* note 26, at 76 (discussing differences as rationale for retaining § 3(a) exemption).

240. *See id.* at 79-97 (discussing advantages of such a system).

241. *See id.* at 109-18 (discussing benefits of imposing liability in municipal securities market as in corporate market).

by underwriters and other finance professionals.

Although issuers and industry groups oppose increased disclosure requirements,[242] issuers will benefit from our proposed reform. Some benefits are tangible. For example, the additional information provided by disclosure reduces investor uncertainty.[243] The reduced uncertainty translates into a significant reduction in net interest costs for issuers.[244] Other benefits are intangible and stem from issuers potential reductions in exposure to the liability which currently results from the pitfalls created by the existing disclosure requirements.

Although some finance professionals (i.e., underwriters, financial advisors, bond counsel) claim that standardized disclosure requirements would increase disclosure costs for municipal issuers,[245] we argue otherwise. Many of these finance professionals already routinely participate in corporate securities offerings. A similar disclosure process for municipal issues would not require professionals to learn a new set of disclosure requirements. The likely scenario is that finance professionals may have more difficulty in getting issuers to accept total responsibility for the accuracy and completeness of the disclosure documents. Hence, standardized disclosure requirements may mean increased liability exposure for finance professionals, with a concurrent reduction in liability exposure for issuers.

VI. CONCLUSION

Issuers of municipal securities, like our hypothetical town of Springfield, face a highly fragmented regulatory environment. Each state determines whether they must disclose any information to investors prior to the issue, and if so, what type of information is required. At the federal level, municipal issuers need not comply with the SEC registration and reporting requirements imposed on

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242. *See* Vicky Stamas, *Advisory Firms Warn of Higher Fees as Disclosure Rules are Tightened*, BOND BUYER, July 13, 1989, at 1.

243. *See generally*, Lisa M. Fairchild, *Disclosure, Default Rates and Uncertainty in Municipal Bond Markets*, 18 MUN. FIN. J. 77-84 (1997).

244. *See generally*, Fairchild & Koch, *supra* note 14.

245. *See generally* Stamas, *supra* note 242.

corporations. The SEC disclosure rules for municipal securities are "passive" because they require little more than voluntary disclosure. This passive system of disclosure is suboptimal for issuers. Because the current regulatory system is not optimal for issuers or investors, reform is necessary. Our recommendation is replacement of the existing system with a more standardized process similar to that required in the corporate securities market.