

SEC RELEASE No. 34-26100 (September 22, 1988): Proposed Rule 15c2-12

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

Docket No. 34-26100; File No. S7-20-88

Municipal Securities Disclosure

Wednesday, September 28, 1988

AGENCY: Securities and Exchange Commission.

ACTION: Proposed rulemaking.

SUMMARY: The Securities and Exchange Commission is publishing for comment proposed Rule 15c2-12, which would require that municipal securities underwriters review and distribute to investors issuer disclosure documents. The proposed rule would require that underwriters obtain and review a nearly final official statement prior to bidding on or purchasing an offering of municipal securities in excess of ten million dollars. An underwriter participating in an offering of a new issue of municipal securities in excess of ten million dollars also would have to contract with the issuer or its agents to obtain final official statements in sufficient quantities to make them available to purchasers in accordance with rules established by the Municipal Securities Rulemaking Board. In addition, underwriters would have to provide copies of preliminary and final official statements upon request. The Commission also is publishing its interpretation of the legal obligations of municipal underwriters. The interpretation, on which the Commission has invited comments, generally emphasizes that in conjunction with their review of offering documents, municipal securities underwriters must have a reasonable basis for believing in the accuracy of key representations concerning any municipal securities that they underwrite. Finally, the Commission is requesting comment on a recent proposal by the Municipal Securities Rulemaking Board to establish a central repository to collect information concerning municipal securities.

DATE: Comments should be received on or before December 27, 1988.

ADDRESS: Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, NW., Mail Stop 6-9, Washington, DC 20549. Comment letters should refer to File No. S7-20-88. All comment letters received will be made available for public inspection and copying in the Commission's Public Reference Room, 450 Fifth Street, NW., Washington, DC 20549.

FOR FURTHER INFORMATION CONTACT: Catherine McGuire, Esq., Special Assistant to the Director, (202) 272-2790; Robert L.D. Colby, Esq., Chief Counsel, (202) 272-2848; Edward L. Pittman, Esq., Special Counsel, (202) 272-2848; or Beth E. Mastro, Esq., Branch Chief (regarding Part IV), (202)

272-2857; Division of Market Regulation, Mail Stop 5-1, Securities and Exchange Commission, 450 Fifth Street, NW., Washington, DC 20549.

I. Introduction

A. Background

The Securities and Exchange Commission ("Commission") is proposing for comment Rule 15c2-12 under the Securities Exchange Act of 1934 ("Exchange Act"),¹ which is designed to prevent fraud by improving the extent and quality of disclosure in the municipal securities markets. Proposed Rule 15c2-12 would require that underwriters of municipal securities offerings exceeding \$10 million obtain and review a nearly final official statement before bidding on or purchasing the offering. The rule also would require underwriters of municipal offerings exceeding \$10 million to contract with the issuer or its agents to obtain final official statements in sufficient quantities to permit delivery to investors in accordance with any requirements of the Municipal Securities Rulemaking Board ("MSRB") and, depending on the time of the request, to make available a single copy of the preliminary and final official statement to any person on request. In addition, the Commission is publishing an interpretive statement, on which it has invited comments, emphasizing the responsibility of municipal underwriters, after reviewing the issuer's official statement, to have a reasonable basis for belief in the substantial accuracy of key representations contained in the official statement, as well as any other recommendations that they make regarding the offering.

The Commission recognizes that Rule 15c2-12, if adopted as proposed, would impose new requirements on underwriters and also might have an impact on issuers. In particular, although the rule would place the direct burden of obtaining final official statements on the underwriter, an obvious consequence would be that underwriters would require some issuers to make available official statements at a time when, or in quantities in which, they currently might not be produced. The rule is intended to stimulate greater scrutiny by underwriters of the representations made by issuers and the circumstances surrounding the offering. The Commission believes that it is worthwhile to explore the possibility that the imposition of these requirements will result in benefits both to the municipal securities markets as a whole and to individual investors.

The Commission's decision to propose Rule 15c2-12 at this time reflects its concern about the current quality of disclosure in certain municipal offerings. At the time the securities laws first were enacted, the market for most municipal securities largely was confined to limited geographic regions. The localized nature of the market arguably allowed investors to be aware of factors affecting the issuer and its securities.² Moreover, municipal securities

¹ 15 U.S.C. 78a-78jj.

² See Final Report in the Matter of Transactions in the Securities of the City of New York. Submitted to the Senate Committee on Banking, Housing and

investors were primarily institutions, which in other instances have been accorded less structured protection under the federal securities laws. Since 1933, however, the municipal markets have become nationwide in scope and now include a broader range of investors.

Today, state and local government obligations are a major factor in the United States credit markets. Currently, over \$720 billion of municipal debt is held by investors³. Moreover, while new offerings of municipal securities declined in 1987 compared to previous years, they nevertheless accounted

for \$114 billion.⁴ Households now are significant investors in municipal securities. On average, households, including unit investment trusts, have accounted for slightly over one-third of the direct holdings of municipal securities in recent years. Up to an additional 21% of municipal holdings are owned indirectly by households, in the form of mutual fund shares.⁵ At the same time that the investor base for municipal securities has become more diverse, the structure of municipal financings has become increasingly complex. In the era preceding adoption of the Securities Act of 1933 ("Securities Act")⁶ municipal offerings consisted largely of general obligation bonds. Today, however, municipal issues include a greater proportion of revenue bonds that are not backed by the full faith and credit of a governmental entity and which, in many cases, may pose greater credit risks to investors. In addition, more innovative forms of financing have focused increased attention on call provisions and redemption rights in weighing the merits of individual municipal bond investment opportunities. Among other instruments, municipal issuers have utilized tax-exempt commercial paper, tender option bonds, and compound interest bonds in an effort to satisfy the needs of investors and assure efficient funding of municipal projects. Moreover, municipal issuers recently have begun to import financing techniques developed in the corporate debt markets to sell asset-backed securities.⁷

In 1975, Congress, recognizing that changes had occurred in the

Urban Affairs, 96th Cong., 1st Sess. (Comm. Print 1979) reprinted in [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) 81,936 ("New York City Final Report" or "Final Report").

³ Source: Flow of Funds Accounts, First Quarter 1987.

⁴ Source: Bond Buyer Data Base, published in *The Bond Buyer*, July 15, 1988, at 3. In 1986, new issues of municipal securities declined to \$162 billion from the 1985 record high amount of \$223 billion. *Id.* See also, Federal Reserve Bulletin--Domestic Financial Statistics for New Security issues.

⁵ Source: Flow of Funds Accounts, First Quarter 1987; see also Peterson, Retail Buyers Dominate Tax-Exempts, *Credit Week* (June 20, 1988).

⁶ 15 U.S.C. 77a-77aa.

⁷ See generally Amdursky, Creative State and Local Financing Techniques, in *State and Local Government Debt Financing* (Gelfand ed. 1987).

municipal securities markets, enacted a self-regulatory scheme for these markets.⁸[FN8] The Securities Acts Amendments of 1975⁹ created the MSRB and provided a system of regulation for both municipal securities professionals and the municipal securities markets. At the same time, however, a financial crisis experienced by the City of New York revealed serious disclosure problems in offerings of New York City's municipal securities. In 1977, the Commission released a lengthy staff report presenting the results of an investigation of the distribution of debt securities issued by New York City.¹⁰

The New York City Staff Report revealed that from October 1974 through April 1975, a period during which underwriters distributed approximately \$4 billion in short-term debt securities, New York City had serious, undisclosed financial problems. Moreover, a number of proposals concerning the need to modify or increase disclosure about the City's problems were rejected by the underwriters for fear that accurate disclosure would render the securities unmarketable.¹¹[FN11] Even when a decision was made to disclose potential problems in the face of the worsening budget crisis, some underwriters denied that they had any duty to "rummage around" to determine whether, in fact, there would be revenues available to retire a contemplated offering of notes.¹² The underwriters reduced the size of their own positions in the City's debt and ceased purchasing the securities for fiduciary accounts, but they continued to sell them to the public.

The recently released Commission staff report concerning the Washington Public Power Supply System ("Supply System")¹³ provides a second illustration of inadequate disclosure in an extremely large municipal debt offering. As discussed more fully therein, in 1983 the Supply System defaulted on \$2.25 billion in principal¹⁴ on tax-exempt revenue bonds sold to finance the construction of two nuclear power plants. The default on the bonds was the largest payment default in the history of the municipal bond market. The staff's investigation of the default disclosed that the underwriters of the Supply System's offerings did not conduct a close examination of the issuer's disclosure to determine the substantial accuracy of statements made to investors at the time the

⁸ S. Rep. No. 75, 94th Cong., 1st Sess. 3-4 (1975).

⁹ Pub. L. No. 94-29, 89 Stat. 97 (June 4, 1975) ("1975 Amendments").

¹⁰ Securities and Exchange Commission Staff Report on Transactions in Securities of the City of New York, Subcommittee on Economic Stabilization of the House Committee on Banking, Finance and Urban Affairs, 95th Cong., 1st Sess. (Comm. Print. 1977) (Hereinafter, "New York City Staff Report"). See also New York City Final Report.

¹¹ New York City Staff Report at ch. 5, pp. 39-65.

¹² New York City Staff Report at ch. 5, p. 51.

¹³ Securities and Exchange Commission Staff Report on the Investigation in the Matter of Transactions in Washington Public Supply System Securities (1988) (Hereinafter, "Supply System Staff Report").

¹⁴ *Id.* at 1.

bonds were sold.¹⁵

The Supply System's offerings took place over the course of four years, from 1977 to 1981. All but one of the 14 offerings by the Supply System during this period were underwritten on a competitive basis.¹⁶[FN16] Only two selling groups, however, successfully bid on the offerings. Despite the magnitude, frequency, and size of the offerings, and the fact that only one or two syndicates were bidding on the offerings, the underwriters did not require their public finance units to conduct an investigation,¹⁷ or retain underwriters' counsel to conduct an investigation, as they would have done customarily in negotiated sales¹⁸ syndicates to bid on the bonds. The syndicate offering the best bid, usually the lowest interest cost to the issuer, wins the auction and buys the bonds for resale into the market. In a negotiated sale, the issuer selects a lead underwriter, which then usually helps prepare the official statement and investigates the adequacy of disclosure in the official statement. The lead underwriter also advises on timing, price, and structure for the sale of the bonds. When the issuer agrees to the offering terms, the lead underwriter, and the syndicate that it has formed, buy the bonds from the issuer and sell them into the market. See generally Supply System Staff Report at 166-67.

The Commission recognizes that the Washington Supreme Court's decision¹⁹ invalidating contractual agreements between the Supply System and a number of public utilities in the Pacific Northwest was the precipitating factor in the Supply System's default. The most critical nondisclosures relating to matters apart from legal validity occurred after the great majority of the offerings had gone forward. Nevertheless, serious questions exist concerning whether the official statements for the Supply System's bonds adequately disclosed significant facts. Among other things, facts existed that call into question the adequacy of disclosures regarding the estimated cost to complete the Supply System's projects, the ability of the Supply System to meet its growing financing needs, the projected demand for power in the Pacific Northwest, and the extent to which the participating utilities continued to support the Supply System project. The Commission is concerned that the underwriters did not investigate costs and delays in the project in a professional

manner. Had they done so, it is possible that they would have uncovered disclosure deficiencies in the official statements for the later offerings, and could have brought to the attention of the public important information regarding delays in completing the power plants and cost overruns that might have affected individual investment decisions.

B. Need for Improvements

Notwithstanding the problems illustrated by the Supply System's disclosure, the Commission recognizes that significant changes have taken place in the practices associated with the distribution of municipal securities since the events that led to the release of the New York City Staff Report. Municipal issuers have increased substantially the quality of disclosure contained in official statements.²⁰ The voluntary guidelines for disclosure established in 1976 by the Government Finance Officers Association ("GFOA"),²¹ which are followed by many issuers, permit investors to compare securities more readily and greatly assist issuers in addressing their disclosure responsibilities.²²

Moreover, when an issuer voluntarily prepares disclosure documents, the MSRB's rules now require that the documents be distributed to investors.²³ Other means of enhancing the disclosure provided to investors in the initial distribution of municipal securities are also under consideration. Two states, for example, have recently proposed laws requiring that official statements accompany or precede delivery of a confirmation for the sale of certain municipal securities, in the same fashion as corporate securities.²⁴ In addition, two other states recently have excluded from the definition of an exempt security, for state blue sky purposes, the securities of municipal issuers that have been in default.²⁵ Members of the municipal securities industry and the

²⁰ The New York City Staff Report revealed that there was little disclosure in the municipal securities market in 1975 and that investors had to rely primarily on the rating agencies. See New York City Staff Report at ch. 5, p. 5.

²¹ The GFOA was known at the time as the Municipal Finance Officers Association, Inc.

²² The GFOA's guidelines have been revised since 1976. The latest revision was published earlier this year. See Disclosure Guidelines for State and Local Government Securities (January 1988) ("GFOA Guidelines").

²³ See discussion *infra* at notes 51, 52 and accompanying text, regarding MSRB rule G-32.

²⁴ See Minn. Code Agency R. s 2875.2390 and proposed s 2875.0015 (except for general obligation bonds). See also A. 8100/S. 6093, amending N.Y. Gen. Bus. Law s 352 and adding §§ 357-a and 359-ffff (except for general obligation bonds) (still pending in New York State Assembly). Other states already have laws that require such disclosure for certain types of offerings. See, e.g., Ariz. Rev. Stat. Ann. §§ 44-1843.01 and 44-1898 (certain industrial development bonds). The Commission also has learned that draft rules are being circulated by the State of Texas that would require issuers to conform to the GFOA Guidelines.

²⁵ See s 517.051, Florida Securities and Investor Protection Act (unless default disclosed and described in compliance with Fla. Admin. Code, Rule 3E-400.003); New Jersey Uniform Securities Law, s 49.3-50.

¹⁵ *Id.* at 15, 168.

¹⁶ Sales of municipal bonds by issuers to underwriters can be on either a competitively bid or a negotiated basis. In a competitively bid sale, the issuer offers the bonds to underwriters in a sealed-bid auction, usually after circulating a preliminary official statement, and underwriting firms form

¹⁷ Supply System Staff Report at 171.

¹⁸ Supply System Staff Report at 191-192.

¹⁹ *Chemical Bank v. Washington Public Power Supply System*, 99 Wash. 2d 772, 666 P.2d 329 (Wash. 1983), *aff'd*, 102 Wash. 2d 874, 691 P.2d 524 (Wash. 1984), cert. denied sub nom. *Haberman v. Chemical Bank*, 471 U.S. 1065 (1985), and *Chemical Bank v. Public Utility Dist. No. 1*, 471 U.S. 1075 (1985).

MSRB also have recommended the establishment of a central repository for official statements that would provide municipal securities dealers and others with rapid access to information, from a single source, concerning the details of an offering and the terms of any call provisions.²⁶

Despite these developments, a number of commentators have recently expressed concern about a reduction of investor confidence in the municipal securities markets and have urged that mechanisms be established to improve the timeliness, dissemination, and quality of disclosure.²⁷ Although the recent measures by the MSRB, state regulators, and industry groups are significant, the Commission believes that further steps designed to encourage timely dissemination of disclosure to investors in large offerings of municipal securities, and to affirm baseline standards of underwriter review of this disclosure, warrant consideration.

In the absence of specifically mandated disclosure standards to which municipal issuers can adhere,²⁸ the underwriter's review of disclosure concerning the financial and operational condition of the issuer can assume added importance as a means of guarding the integrity of new offerings. The Commission understands that many municipal underwriters currently conduct an investigation of the issuer in negotiated municipal offerings that, in many respects, might be comparable to the investigation conducted by underwriters in corporate offerings. Nevertheless,

²⁶ See discussion *infra* at Part IV.

²⁷ See, e.g., Ciccarone, *Municipal Bondholders Need More Information*, Wall St. J., March 27, 1987, at 22, col. 3; Ciccarone, *We Need Better Muni Disclosure*, 13 *Financial World*, 156 (June 30, 1987); Ferris, *Muni Market Needs Policing and Guidelines for Disclosure*, *The Bond Buyer*, August 31, 1987, at 1; *Disclosure Takes Place Among Top Municipal Market Issues This Year*, *The Bond Buyer*, March 7, 1988, at 1.

²⁸ In the past, the Commission has supported the repeal of the exemption from registration under the Securities Act for industrial development bonds ("IDBs"). See Letter from John S.R. Shad, Chairman, Securities and Exchange Commission, to the Honorable Timothy E. Wirth, Chairman, House Subcommittee on Telecommunications, Consumer Protection, and Finance (March 12, 1988); 1978 Industrial Development Bond Act, S. 3323, 95th Cong., 2d Sess. (1978) (legislative proposal presented to Congress by the Commission). IDB financing was restricted substantially by recent amendments to the federal tax laws, which limit the types of facilities that may be financed, the percentage of proceeds that may be used for private purposes, and the amount of debt service that may be supported by payments from private persons. See Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (Oct. 22, 1986). Under Rule 131 of the Securities Act, 17 CFR 230.131, taxable IDBs also must be registered if they amount to purely conduit financing for corporations. Nevertheless, to the limited extent IDB financing continues, the Commission continues that to support previous recommendations that would require registration of IDBs that are, in fact, corporate obligations. See *Disclosure in Municipal Securities Markets*, Remarks of David S. Ruder, Chairman, Securities and Exchange Commission, Before the Public Securities Association (Oct. 23, 1987) at 17-18.

the practices revealed in the Supply System Staff Report underscore the need to explore the benefits that would result from a specific regulatory requirement that underwriters of municipal securities be uniformly subject to a requirement to obtain and review a nearly final disclosure document and make disclosure documents available to investors in both negotiated and competitive offerings. The Commission understands that no amount of increased review of offering materials by municipal underwriters will prevent municipal defaults totally,²⁹ but the Commission believes that responsible review by underwriters of the information provided by municipal issuers, in both competitive and negotiated offerings, could encourage more accurate disclosure. Investors plainly depend on accurate disclosure in considering whether to buy the offered securities. Moreover, it is a common belief, which the Commission shares, that investors in the municipal markets rely on the reputation of the underwriters participating in an offering in deciding whether to invest.

Issuer defaults pose the most serious economic threat to investors. Nevertheless, investors also may suffer losses as a result of downgrades in ratings. In 1987 alone, one nationally recognized statistical rating organization, Moody's, lowered the ratings of 322 municipal bond issues. See *Municipal Bond Rating Revisions--1987*, Moody's Bond Survey, January 11, 1988, at 1. Moody's report indicated that almost half of the issues downgraded were concentrated in three states closely tied to mineral sectors. During the same period, Standard & Poors reduced ratings of 105 issues, amounting to \$17 billion. *Credit Watch* (Feb. 1, 1988), at 1. Although there is not a great deal of empirical data in this area, downgradings clearly affect the value of bonds. For example, yields to maturity on 30-year AAA general obligation bonds are 7.60% as compared to 8.30% for the same bonds rated Baa. The direct impact of downgrades, however, may depend upon the amount of other information that is available in the markets. See generally, e.g., Ederington, Yawitz & Roberts, *The Information Content of Bond Ratings*, 10 *J. Fin. Res.* 211 (Fall 1987) (discussing the relationship between ratings and yields on industrial bonds).

As noted earlier, the complexity of municipal bonds recently offered to the public increases the value of accurate disclosure of the terms of bond offerings. For example, inadequate disclosure of call provisions has resulted in several recent incidents in which municipal issuers attempted to call bonds that had been traded in the secondary markets as escrowed-to-maturity.³⁰ Because these bonds had been sold to investors in the secondary market on the basis of

²⁹ Of the approximately \$720 billion in municipal debt outstanding, it is estimated that approximately \$5 billion, or roughly 0.7 percent, is currently in default. Source: Bond Investors Association. While the Supply System's \$2.25 billion payment default represents the major portion of this amount, over 300 additional municipal issuers are also currently in default on their obligations. *Id.* In contrast, corporate issues are estimated to have roughly a 1.1% default rate. See Task Force Report, *infra* note 34, at 7.

³⁰ Bonds are considered to be escrowed-to-maturity when the proceeds of a refunding bond offering are placed in an irrevocable escrow account, or trust, in an amount that will generate sufficient income to pay principal and interest on the bonds in accordance with specified payment schedules.

the yields to a fixed maturity, the exercise of early call provisions in the outstanding bonds would have altered significantly the actual yield received by investors.³¹ Apart from concerns about the quality of disclosure, it appears that problems also exist with regard to the timely dissemination of disclosure documents. Currently, many issuers routinely prepare official statements that conform to the GFOA Guidelines for offerings exceeding one million dollars. The preparation and timely dissemination of official statements, in conjunction with a careful review of the issuer's disclosure by the underwriters, are important disciplines that benefit the participants as well as investors. The Commission is aware, however, that in some cases underwriters do not receive sufficient quantities of official statements, or do not receive official statements within time periods that would allow the underwriter to examine the accuracy of the disclosure and to disseminate copies to investors in a timely manner. In rule filings with the Commission, for example, the MSRB has indicated that the completion and delivery of official statements often is given a low priority by underwriters and financial advisors.³² In addition, it appears that many public finance personnel are unfamiliar with the requirements of the MSRB regarding the delivery of official statements.³³ These information dissemination problems are evidenced by a recent report by the Public Securities Association, prepared after an extensive survey of its members, which concluded:

Based on consistent [* * * responses] * * * there appears to be a timing problem when the availability of disclosure documents are [sic] considered. The empirical evidence confirms what has been widely accepted by the marketplace as a problem in disclosure practices in the municipal securities market.³⁴

The markets for municipal securities are vital to the financial management of our nation's state and local governments, and the

³¹ The issuers ultimately abandoned their attempts to call the bonds. The Commission and its staff, along with the MSRB and other self-regulatory and industry organizations, have emphasized the need for clear and conspicuous disclosure of call provisions, particularly in refunding bond issues. See, e.g., letter from Richard G. Ketchum, Director, Division of Market Regulation, Securities and Exchange Commission, to H. Keith Brunnemer, Jr. Chairman MSRB (June 24, 1988); Securities Exchange Act Release No. 23856 (Dec. 3, 1986), 51 FR 44398. Moreover, the Commission understands that similar concerns exist with respect to disclosure of exercise periods for municipal put option bonds.

³² See generally Securities Exchange Act Releases No. 21457 (Nov. 2, 1984), 49 FR 44835; No. 21968 (Apr. 30, 1985), 50 FR 18336; and No. 22374 (Aug. 30, 1985), 50 FR 36505 (concerning amendments to MSRB rules G-9 and G-32).

³³ Id. See also, generally, Picker, *The Disclosure Debate Gets Nasty*, Institutional Investor (April 1988) at 169 (discussing, among other things, problems in disseminating official statements).

³⁴ Public Securities Association Municipal Securities Disclosure Task Force Report: Initial Analysis of Current Disclosure Practices in the Municipal Securities Market (June 1988) ("Task Force Report") at 21.

availability of accurate information concerning municipal offerings is integral to the efficient operation of the municipal securities markets.³⁵ In the Commission's view, a thorough, professional review by underwriters of municipal offering documents could encourage appropriate disclosure of foreseeable risks and accurate descriptions of complex put and call features, as well as novel financing structures now employed in many municipal offerings. In addition, with the increase in novel or complex financings, there may be greater value in having investors receive disclosure documents describing fundamental aspects of their investment. Yet, underwriters are unable to perform this function effectively when offering statements are not provided to them on a timely basis. Moreover, where sufficient quantities of offering statements are not available, underwriters are hindered in meeting present delivery obligations imposed on them by the MSRB's rules.

For these reasons, the Commission has determined to propose a limited rule designed to prevent fraud by enhancing the timely access of underwriters, public investors, and other interested persons to municipal official statements. In the context of the assured access to offering statements provided by the proposed rule, the Commission also is reemphasizing the existence and nature of an underwriter's obligation to have a reasonable basis for its implied recommendation of any municipal securities that it underwrites.

II. Discussion of Proposed Rule 15c2-12

Rule 15c2-12 is designed to prevent fraud by establishing standards for the procurement and dissemination by underwriters of disclosure documents, thus enhancing the accuracy and timeliness of disclosure to investors in large offerings of municipal securities. The rule's standards for obtaining disclosure documents are intended to assist underwriters in satisfying their responsibility to have a reasonable basis for recommending municipal securities that they underwrite. The rule also is designed to provide underwriters greater opportunity to fulfill their reasonable basis obligations by creating an express requirement for review of the mandated nearly final official statement.

The Committee believes that proposed Rule 15c2-12 may promote greater industry professionalism and confidence in the municipal markets. In the past, state and local governments have regarded regulation to enhance the municipal markets as beneficial, so long as there is no adverse impact on their capital-raising function.³⁶ Rule 15c2-12 is designed to strengthen the municipal markets and to benefit all participants, including issuers. The Commission wishes to emphasize, however, that the rule is not intended to inhibit the

³⁵ The current problems with disclosure in municipal securities transactions are illustrated further by statistics on arbitration that are available from the MSRB. In 1987, roughly 84% of all customer complaints, and 49% of inter-dealer complaints, that were arbitrated through the MSRB alleged that inadequate information was provided concerning the securities. MSRB Arbitration Statistics on Allegations of Misdescriptions and Failures to Disclose Information about Municipal Securities: 1985-87 May 18, 1988) (unpublished).

³⁶ See S. Rep. No. 75, 94th Cong., 1st Sess. 44 (1975).

access of issuers to the municipal markets. For this reason, the Commission is particularly interested in receiving the views of municipal issuers on the provisions of proposed Rule 15c2-12.

A. Scope of Rule 15c2-12

As proposed, the provisions of Rule 15c2-12 would apply only to underwriters participating in offerings of municipal securities that exceed \$10 million in face amount.³⁷ Data supplied by the Public Securities Association and the MSRB indicate that in 1987, 1,743 long-term municipal debt offerings, accounting for about 25% of total long-term municipal debt offerings, exceeded \$10 million. These offerings, however, raised over \$89 billion, or approximately 86% of the money borrowed annually by municipal issuers. Thus, the rule would apply only to the largest issues of municipal securities, where there is greatest reason to believe that additional costs the rule might impose by the establishment of specific standards would be justified by the potential protection provided to a large number of investors that otherwise might purchase securities on the basis of inaccurate or incomplete information.³⁸ By conditioning underwriters' participation in large offerings on the preparation and dissemination of official statements, the rule would provide dealers and investors with more timely access to disclosure of basic information about the issuer.³⁹

Purpose	No. iss	\$ amt	\$ average ¹
Elec Util ¹	20	2,412	120.6
Retirement Housing.....	56	725	12.9
Ind. Lease Revenue	60	520	8.6
Nursing Homes	65	411	6.3
Hospitals.....	12	94	7.8
Pollution Control Revenue.....	5	343	68.5
Housing & Apt. Development....	22	209	9.5

³⁷ While the Commission has set an objective threshold for the application of Rule 15c2-12, offerings under that amount would continue to be subject to the general antifraud provisions of the Exchange Act and the Securities Act, e.g., sections 10(b) and 15(c) of the Exchange Act, 15 U.S.C. 78j(b) and 78o(c), and the rules thereunder, and section 17(a) of the Securities Act, 15 U.S.C. 77q(a).

³⁸ Although Rule 15c2-12, as proposed, would apply to offerings exceeding \$10 million, the Commission is aware that many defaults are likely to occur in offerings below the \$10 million threshold. Information supplied by the Bond Investors Association suggests that the average dollar amount of municipal defaults, by purpose, is as set forth below. The Commission requests comment on the distribution of defaults, by purpose, at various thresholds.

³⁹ Of course, dealers still would be required to comply with the provisions of MSRB rule G-15 concerning the disclosure of call and other material provisions in confirmations regardless of offering amount. See also discussion infra at Part IV, requesting comment on a proposal to create a central repository of official statements.

Other Types.....	59	523	9.8
All Types ²	299	5,240	17.5

¹ In million.

²Including the Supply System default.

The Commission requests comment on the proposed \$10 million threshold and whether alternative minimum levels would be more appropriate. Specifically, would some other minimum, such as \$1 million, \$5 million, \$20 million, or \$50 million, be warranted for the rule as a whole or for particular provisions As noted earlier, in 1987, 25% of all new issues of long-term municipal bonds, comprising 38% of all revenue bond issues and 12% of all general obligation bond issues, exceeded the \$10 million threshold. These offerings accounted for 90% and 74% of the dollar amounts issued in revenue and general obligation bound offerings, respectively. The figures for alternative thresholds, as of 1987, were as follows:⁴⁰

⁴⁰ IDD/PSA Municipal Database, including all municipal issues with a final maturity exceeding 13 months.

Offering over	Percent of revenue bond issues	Percent of gen. oblig. bond issues	Percent of total bond issues	Percent of revenue bond dollar amts. issued	Percent of gen. oblig. bond dollar amts. issued	Percent of total bond dollar amts. issue
\$1 million	87	72	79	99	99	99
5 million	56	26	44	96	85	93
10 million	38	12	25	90	74	86
20 million	25	7	16	81	67	77
50 million	10	3	7	60	53	58

The Commission requests comment on the range of costs under the rule for issuers and underwriters in offerings above and below the \$10 million threshold, and the impact that Rule 15c2-12 might have on underwriting spreads in the municipal market. Commentators also are invited to provide their views on the quality and timeliness of disclosure currently provided at various offering amounts.

The Commission recognizes that there may be a range of credit risk and disclosure concerns associated with municipal bonds that vary according to the type of bonds and their maturity. Accordingly, the views of commentators are requested regarding whether distinctions should be made according to the type of bonds, e.g., municipal revenue, general obligation, or private activity bonds,⁴¹ the type of offering (e.g., competitive or Negotiated), or the extent to which innovative financing techniques, or unusual call provisions or redemption rights, are employed in the offering. Similarly, commentators also may address whether distinctions should be made that would exclude issues with shorter maturities.

The primary intent of the rule is to focus on those offerings that involve the general public, and which are likely to be traded in the secondary market. While the Commission recognizes that there may be reason to create an exception from the rule for offerings that are similar to traditional private placements under

⁴¹ As a general matter, there is less evidence of problems of default on general obligation bonds than municipal revenue bonds. Similarly, from 1972 to 1983, there were only 10 reported note defaults, some of which involved obligations owed only to local banks. See generally Advisory Commission on Intergovernmental Relations, *Bankruptcies, Defaults, and Other Local Government Financial Emergencies* (March 1985) at 24-25. Although general obligation bonds as a rule have not presented default concerns, some distinction must be made with regard to the general obligation debt of small, special-purpose districts. From 1972-1984, eleven special purpose districts declared bankruptcy. *Id.* at 9. Some of these districts were the subject of Commission enforcement actions. See *SEC v. Reclamation District No. 2090*, Case No. C-76-1231 (N.D. Cal. Aug. 27, 1978), SEC Litigation Releases No. 7551 (Sept. 8, 1976) and No. 7460 (June 22, 1976); *SEC v. San Antonio Municipal Utility District No. 1*, Civ. Action No. H-77-1868 (S.D. Tex. 1977), SEC Litigation Release No. 8195 (Nov. 18, 1977). In any event, the New York City problems did involve general obligation bonds in very large amounts. See *supra* notes 10 through 12 and accompanying text.

section 4(2) of the Securities Act,⁴² involving a limited number of financial institutions, the proposed rule does not contain such an exception.⁴³ In part, this reflects the Commission's concern that, in the absence of trading restrictions, the bonds could be resold immediately to numerous secondary market purchasers lacking the sophistication of the initial purchasers of the bonds.

In order to consider whether any rule that is adopted should contain some type of "private placement exemption," the Commission requests comment on this aspect of the rule. In particular, the Commission would like specific comments on whether and in what manner the rule's disclosure dissemination provisions should distinguish between offerings made to a limited number of sophisticated investors and those involving broader selling efforts. Comment is requested on whether a specific exemption from the rule should be created for offerings to fewer than 10, 25, 35, or 50 investors and whether an exemption should look to the institutional nature or sophistication of investors. In addition, should the underwriter be required to assure that initial purchasers acquire the bonds with investment intent, rather than to resell the securities into the secondary market, or should other restrictions, such as holding periods or transfer restrictions, be imposed. Finally, the Commission solicits comment on whether exceptions for limited offerings should be applied to all provisions of the rule or only to particular parts of the rule.

B. Receipt and Review of Preliminary Official Statements

Paragraph (b) of the rule would require that prior to bidding on or purchasing a municipal offering in excess of ten million dollars, an underwriter, directly or through agents, obtain and review an official statement that is final, but for the omission of information relating to offering price, interest rate, selling compensation, amount of proceeds, delivery dates, other terms of the securities depending on such factors, and the name of the underwriter.⁴⁴ This provision

⁴² 15 U.S.C. 77d(2).

⁴³ In this regard, proposed Rule 15c2-12 is consistent with the current requirements under MSRB rule G-32. Specifically, the MSRB has taken the position that G-32 applies to both public and private offerings. *Disclosure Requirements for New Issue Securities: Rule G-32*, MSRB Reports, Sept. 1986, at 17.

⁴⁴ Cf. Securities Act Rule 430A, 17 CFR 230.430A (form of prospectus filed as part of registration statement declared effective may omit information with respect to public offering price, underwriting syndicates,

would apply to both competitive and negotiated offerings. It is designed to assure that underwriters receive and avail themselves of the opportunity to review an official statement that contains complete disclosure about the issuer and the basic structure of the financing, before becoming obligated to purchase a large issue of municipal securities for resale to the public.

Many issuers currently are required by state and local law to solicit bids for offerings of municipal debt. Generally, announcements inviting bids are published in newspapers that are widely followed in the industry. In addition, underwriters may be contacted directly by issuers and are invited to submit bids. The actual notice of sale itself often will contain significant information about the issuer and its securities. Moreover, as part of the bidding process, many issuers routinely make available more complete disclosure concerning an offering in the form of a preliminary official statement, which generally includes information concerning the issuer and the offered securities, but omits terms of the offering dependent on the results of the bid. In some cases, the issuer, subsequent to the bidding process, prepares a final official statement containing all the terms of the offering. In other cases, the issuer releases a preliminary official statement prior to the date of sale, which, after pricing, underwriting, and other information is attached, is then regarded as the issuer's final official statement.

The Commission is aware, however, that some issuers do not provide preliminary official statements, so that prospective bidders must rely upon information contained solely in the notice of sale and on their general knowledge of the issuer.⁴⁵ Based upon this limited information, underwriters then solicit binding pre-sale orders or indications of interest from investors, and submit a bid to the issuer. In addition, although negotiated offerings provide the underwriter with greater opportunities to participate in drafting the disclosure documents, in some instances pressure to meet financing needs, or to take advantage of changes in tax laws or favorable interest rate "windows," have caused underwriters to agree to purchase securities in negotiated offerings at a time when disclosure documents were not complete.

Paragraph (b) would prevent the underwriter from submitting a bid in a competitive offering, or from committing to buy securities in a negotiated offering, until it has received and

underwriting discounts or commissions, discounts or commissions to dealers, amount of proceeds, conversion dates, call prices and other items dependent on offering price, delivery dates, and terms of securities dependent on offering price). Although paragraph (b) would require that underwriters receive official statements that are nearly complete prior to bidding for or purchasing an offering, this would not prevent an underwriter from requesting even substantial changes to the document where necessary to assure complete and accurate disclosure.

⁴⁵ A recent survey indicated that official statements were prepared for 84% of municipal bond issues, including both competitive and negotiated offerings. Task Force Report, *supra* note 34, at 14.

reviewed an official statement that is deemed final by the issuer, except for pricing, underwriting, and certain other specified information. This paragraph is designed to prevent fraud by providing the underwriter with information about the issue sufficient to determine, before becoming obligated to purchase the securities, whether changes to the disclosed information are needed and should be obtained before the bid is submitted.⁴⁶

The requirement in paragraph (b) that underwriters obtain a nearly final official statement before bidding on an offering could have the consequence of altering the bidding or offering process employed by some issuers, if the issuer does not currently make available, prior to the bid or sale, a preliminary official statement as complete as required in the proposed rule. Accordingly, the Commission requests comment on the extent to which adequate information currently is available to underwriters during the negotiation or bidding process, and whether possible improvements in the availability of information would outweigh the increased costs that could result from the rule. The Commission also requests comment regarding any timing difficulties and consequent economic burdens that might arise for issuers and underwriters as a result of the requirement that underwriters review the nearly final official statement prior to bidding on or purchasing the municipal securities.

C. Public Dissemination of Preliminary Official Statements upon Request

Proposed paragraph (c) would require that preliminary official statements be sent to any person promptly upon request.⁴⁷ The purpose of paragraph (c) is to provide potential investors⁴⁸ with access to any preliminary official statement prepared by the issuer for dissemination to potential bidders or purchasers at a time when it may be of use to investors in their investment decision. Because preliminary official statements frequently are used as selling documents, large investors often are provided copies when they are solicited to purchase securities in a municipal offering. Indeed, the Commission understands that some institutional investors will not agree to purchase securities in an offering without receiving a preliminary official statement. Even so, there does not appear to be a uniform practice among underwriters of providing preliminary official statements to all potential investors. Because sales efforts may be conducted in competitive offerings prior to the time that an underwriter is awarded a bid, and investors may not have access to a

⁴⁶ See also discussion *infra* in Part III.

⁴⁷ Absent unusual circumstances, this would require that a preliminary official statement be sent by first class mail or other equally prompt means, no later than the close of the next business day following the receipt of the request. Requests could be made orally or in writing.

⁴⁸ Although this requirement is intended primarily to benefit potential investors, the rule requires the preliminary official statement to be given to any person on request to eliminate underwriters' discretion in determining who in fact is a potential investor. Comment is requested on the facility with which analysts and other industry professionals currently can obtain copies of preliminary official statements directly from the issuer; whether the underwriters' obligation to provide these statements should be limited to potential investors; and how potential investors should be defined.

final disclosure document for an extended period of time following their commitment to purchase the securities, the Commission believes that confusion concerning the offering terms and the potential for misleading sales representations would be reduced if investors had the ability to obtain information contained in the preliminary official statement.⁴⁹

Comments are requested regarding the extent to which preliminary official statements are disseminated to investors presently, the likely demand by investors for these preliminary official statements under the proposed rule, and the estimated additional costs to underwriters that compliance with the rule would entail. In addition, the Commission requests comment on whether underwriters that provide preliminary official statements to investors on request should be excused from the requirement that final official statements also be provided to those investors, where the key representations contained in the preliminary official statement continue to be accurate.

D. Distribution of Official Statements

Paragraph (d) of proposed Rule 15c2-12 would require that underwriters contract with the issuer or its agent to obtain copies of final official statements within two business days after a final agreement to purchase the offered securities. That contract must be for sufficient copies to distribute in accordance with paragraph (e) of the proposed rule and any rules adopted by the MSRB. The purpose of paragraph (d) is to facilitate the prompt distribution of disclosure documents so that investors will have a reference document to guard against misrepresentations that may occur in the selling process. In addition, this paragraph would provide investors and dealers in the secondary market with static information concerning the terms of the issued securities.

Rule G-17 of the MSRB's rules requires municipal securities brokers and dealers to deal fairly with customers. The MSRB interprets this rule to require that a dealer disclose, at or prior to a sale, all material facts concerning the transaction, including a complete description of the security.⁵⁰ Moreover, MSRB rule G-32 requires that underwriters deliver to a customer, no later than settlement, a copy of any official statement that is prepared by or on behalf of the issuer. If no official statement is prepared by the issuer, a written notice of that fact must be provided to the customer. The Tower Amendment⁵¹ limits the authority of the MSRB, however, directly or indirectly to require municipal issuers to furnish disclosure documents. Thus, rule G-32 applies only where an official statement is prepared and does not

mandate disclosure of any particular information to the investor in the official statement.

The Commission understands that it is currently the practice for issuers to state, in notices of sale, the number of official statements that will be provided to a successful bidder or that a "reasonable" number of official statements will be provided. If any official statements are prepared by the issuer, the MSRB has taken the position that the underwriter is required to produce sufficient copies to comply with rule G-32.⁵² In most cases, issuers do prepare official statements. Both underwriters and investors have complained, however, that even when official statements are prepared by the issuer, there frequently is not an adequate supply, or sufficient time, to permit distribution to each investor at settlement.

Paragraph (d) of Rule 15c2-12 would require that an underwriter obtain an undertaking from the issuer or its designated agent to provide, within two business days after any final agreement to purchase or sell securities, final official statements in sufficient quantities to enable the underwriter to comply with paragraph (e) of the rule and any MSRB rules regarding the distribution of official statements. Thus, prior to submitting a bid for an offering, or otherwise agreeing to participate in a distribution, an underwriter, or the syndicate of which it is a member, would need to ascertain that it will be able to comply with Rule 15c2-12. If the issuer's notice of sale, bid form, or underwriting agreement does not provide specifically for production of official statements in accordance with Rule 15c2-12, an underwriter would violate the rule if it participates in the offering.⁵³ As a practical matter, therefore, issuers would not be able to go forward with underwritten offerings exceeding the proposed \$10 million threshold, unless arrangements were made to provide official statements.

As discussed below, however, the Commission does not believe that this requirement will affect most issuers.

The proposed rule requires that adequate copies of the official statements would need to be provided within two business days after final agreement is reached. Nevertheless, the issuer's undertaking may call for provision of the official statement to be made by designated agents. Thus, an undertaking would comply with Rule 15c2-12 by indicating that sufficient quantities of official statements will be made available from a printer designated by the issuer, or will be reproduced by the syndicate manager from those official statements that it receives from the issuer. Also, the rule would allow a reasonable fee to be requested by the printer, issuer, or syndicate members or investors.

⁴⁹ Of course, where key representations made in the preliminary official statement are known to the underwriter to be no longer accurate, the underwriter would have to notify investors prior to the time that they make an investment decision and would have to provide copies of the amended final official statement.

⁵⁰ See, e.g., MSRB Manual (CCH) 3581.30.

⁵¹ Exchange Act Section 15B(d), 15 U.S.C. 78o-4(d)(2). See discussion *infra* at text accompanying notes 64 to 69.

⁵² The MSRB has stated that "if an issuer fails to supply a sufficient number of copies of official statements, it is incumbent on a dealer to reproduce the official statement at its own expense. These requirements apply to all municipal securities brokers and dealers who sell new issue securities, not solely to the underwriters of the issue." Rules G-8, G-9, and G-32, MSRB Reports, (Mar. 1984) at 3.

⁵³ Syndicate members also would need to assure themselves that their agreement with syndicate managers will provide for the prompt distribution of official statements.

As emphasized earlier, if the rule is adopted, underwriters would violate the requirements of Rule 15c2-12 if they proceed with an offering in excess of \$10 million without taking steps to assure the availability of official statements. Many issuers already routinely prepare official statements for offerings exceeding one billion dollars.⁵⁴ Thus, while the proposed rule will enhance disclosure to investors, it is not expected that the rule would inhibit the access of any issuers to the municipal markets. The only effect on most municipal issuers offering securities that exceed the proposed minimum thresholds in the rule would be that official statements would be required to be produced in a more expeditious fashion, and perhaps in greater quantities, than currently might be the case.

The Commission preliminarily believes that the costs imposed on issuers that are not now producing official statements for offerings in excess of \$10 million will be offset by the benefits that will inure both to the markets as a whole and to individual investors. The Commission requests comment on any practical problems that might be encountered by underwriters or issuers in attempting to comply with the requirements of the rule. In particular, does the two business day requirement pose a significant burden on issuers or underwriters? Should the delivery period be expanded to three or four business days, or reduced to a single business day, or to the time that final agreement is reached?

The Commission would like to receive comments concerning the net costs that might be incurred by underwriters or issuers in reproducing official statements if Rule 15c2-12 is adopted. In the past, the Commission has received comments on proposed amendments to rule G-32 that estimated the expense of producing an official statement at from three to ten dollars per copy.⁵⁵ The Commission specifically requests comment on current procedures used in estimating the number of official statements to be produced; the estimated marginal costs of producing official statements in order to comply with proposed Rule 15c2-12; and whether, and at what price, those costs may effectively be passed on to recipients of official statements.

The Commission believes that paragraph (d) will allow the MSRB to use its expertise and familiarity with the municipal markets to draft regulations more finely tuned to the needs of the market. The Commission expects that, in the event that Rule 15c2-12 is adopted in its proposed form, the MSRB would amend rule G-32, where appropriate, to modify the standards governing the timeliness of official statement delivery. In this regard, the Commission also requests comment on whether it should regulate directly the timing and manner of disclosure provided to municipal securities investors.

⁵⁴ See, e.g., Forbes & McGrath, *Disclosure Practices in Tax-Exempt General Obligation Bonds: An Update*, 7 *Mun. Fin. J.* 207 (1986).

⁵⁵ See *supra* note 32. Specific comment is requested on the per copy cost of official statements for offerings at the various suggested thresholds for the rule, i.e., \$1 million, \$10 million, \$20 million, and \$50 million. See discussion *supra* at text accompanying note 40.

E. Public Dissemination of Official Statements upon Request

Paragraph (e) of proposed Rule 15c2-12 would require that underwriters provide a copy of the final official statement to any person on request.⁵⁶ The purpose of this provision is to make the underwriter responsible for transmission of information to analysts, rating agencies, industry news services, and individuals who wish to analyze particular municipal securities offerings. In this regard, the Commission believes that increased availability of official statements, to potential investors, analysts, and other persons willing to pay a reasonable fee for access to the information contained in the final official statement, will promote more accurate pricing in the secondary market and may facilitate the discovery of potentially fraudulent practices. Thus, in addition to making final official statements available to actual investors, paragraph (e) would require that other interested parties be provided with copies as well.

No specific time limitation currently is specified in proposed Rule 15c2-12. Comment is solicited on whether and under what circumstances a time period should be established, after which the obligation to provide information would no longer be applicable.⁵⁷ For example, if a central repository is developed, should this obligation expire after the repository receives and is in a position to disseminate the final official statement? The Commission also requests comment on whether a purchaser's ability under paragraph (e) of the rule to obtain an official statement on request for an unlimited time period reduces the need for the requirement imposed on the underwriters by MSRB rule G-32 to supply a final official statement to all purchasers. Finally, the Commission would like to receive comments on the potential costs to underwriters of complying with proposed paragraph (e). Specifically, what costs would be entailed in maintaining and disseminating copies of official statements required to be provided under paragraph (e)? Also, would it be possible, and at what price, for costs to be passed through effectively to recipients of the official statements?

F. Definitions

In addition to containing substantive requirements, proposed Rule 15c2-12 contains two definitions. Subparagraph (f)(1) of Rule 15c2-12 would define the term "final official statement" to mean a document prepared by the issuer or its representatives setting forth,

⁵⁶ The proposed rule requires that the offering statement be provided in a timely manner. For the first month following an offering, absent extraordinary circumstances, this would mean that a copy would be mailed within two business days of the request. Requests could be made orally or in writing. Later, reasonable time would be allowed to locate and duplicate requested documents.

⁵⁷ The Commission recognizes that after a period of time, the disclosures contained in the official statement regarding an issuer no longer may be accurate. Accordingly, where the underwriter receives unsolicited requests for official statements, the Commission would not expect the underwriter to continue to update the disclosure to reflect inaccuracies that have resulted from intervening events. In responding to unsolicited requests, underwriters should indicate that the document contains dated information. The Commission requests comment on this aspect of the rule and any concerns that underwriters may have.

among other matters, information concerning the issuer and the proposed issue of securities that is complete as of the final agreement to purchase or sell municipal securities for or on behalf of an issuer or underwriter. A notice of sale would not be deemed a final official statement for purposes of the rule. The definition contained in subparagraph (f)(1) is based on the definition of official statement in MSRB rule G-32. By using a similar definition, the Commission is seeking to avoid any conflicts that may occur, because paragraph (d) would require that underwriters distribute copies of final official statements in accordance with MSRB regulations. The Commission requests comment on the proposed definition of "final official statement."

The Commission also requests comment on the definition of an "underwriter" used in subparagraph (f)(2) of the proposed rule. As proposed, the definition of an underwriter parallels the definition in section 2(11) of the Securities Act.⁵⁸[FN58] To ensure dissemination of documents by all professional participants in the offering, the definition includes managing underwriters, syndicate members, and selling group members that receive in excess of the usual seller's commission. Comment is requested on the proposed definition of "underwriter" and any foreseeable problems that dealers may encounter in complying with the rule. Comment also is requested concerning whether the definition of underwriter should be limited to the underwriters participating in the syndicate, as in the definition of "principal underwriter" in Rule 405 under the Securities Act.⁵⁹

G. Legislative Background

In contrast to the registration and reporting requirements imposed on non-exempt corporate issuers under the federal securities laws, offerings of municipal securities are not subject to review by the Commission. When Congress adopted the federal securities laws, in addition to being influenced by the local nature of markets, the absence of demonstrated abuses, and the sophistication of investors in municipal securities, it was persuaded that direct regulation of the process by which municipal issuers and municipalities raise funds to finance governmental activities would place the Commission in the position of a gate-keeper to the financial markets, a position inconsistent with intergovernmental comity. Nevertheless, Congress clearly made sales of municipal securities subject to

the antifraud provisions of the federal securities laws.⁶⁰ Accordingly, broker-dealers misstating or omitting to disclose material facts about municipal securities or charging excessive mark-ups have been sanctioned for violating the antifraud provisions of the federal securities laws.⁶¹

The U.S. Supreme Court's interpretation of the scope of the Tenth Amendment has evolved significantly since the federal securities laws were first enacted in the 1930's. Most recently, in *South Carolina v. Baker*,⁶²[FN62] the Court affirmed the principle that the Tenth Amendment's limits on Congressional authority to regulate state activities are structural and not substantive. In doing so, it ruled that a provision of the Internal Revenue Code that required the registration of municipal bonds in order to maintain their tax exempt status was constitutional, since the municipal issuers had redress through the political process. Thus, a federal regulation affecting the manner in which securities are offered, adopted pursuant to Congressionally delegated authority, would not appear to violate the Tenth Amendment.⁶³

In 1975, Congress revisited the application of the general antifraud provisions of the federal securities laws when it established the MSRB and provided for a system of regulation to prevent abuses in municipal securities. In adopting the 1975 Amendments,⁶⁴ Congress struck a balance between the need to protect investors and concerns about intergovernmental comity. This concern was reflected in section 15B(d)(1), which prohibits the Commission and the MSRB from requiring "any issuer of municipal securities, directly or indirectly through a purchaser or prospective purchaser of securities from the issuer, to file with the Commission or the Board prior to the sale of such securities by the issuer any application, report, or document in connection with the issuance, sale, or distribution of such securities."⁶⁵

At the same time, however, Congress more narrowly defined the authority of the MSRB. The so-called "Tower Amendment," which added section 15B(d)(2) to the Exchange Act,⁶⁶ also prohibits the MSRB from requiring municipal issuers, directly or indirectly, through municipal securities broker-dealers or otherwise, to furnish the MSRB or prospective investors with any documents, including

⁵⁸ 15 U.S.C. 77b(11). The definition of underwriter in section 2(11) of the Securities Act has been modified in one respect. Reference to a concession or allowance has been added to the definition to reflect the terms used in the municipal securities industry for a customary distributor's or seller's commission. The terms "concession" and "dealer's allowance," in the context of the sale of a new issue of municipal securities, refer to "the amount of reduction from the public offering price a syndicate grants to a dealer not a member of the syndicate, expressed as a percentage of par value." See Glossary of Municipal Securities Terms (MSRB 1985).

⁵⁹ 17 CFR 230.405

⁶⁰ See, e.g., *In re New York Municipal Securities Litigation*, 507 F. Supp. 169 (S.D.N.Y. 1980); *S.E.C. v. Charles Morris & Associates*, 386 F. Supp. 1327 (S.D. Tenn. 1973); *Thiele v. Shields*, 131 F. Supp. 416 (S.D.N.Y. 1955) (Sections 17(a) of the Securities Act and 10(b) of the Exchange Act apply to sales of municipal securities).

⁶¹ See discussion *infra* at Part III.

⁶² U.S. --, 56 U.S.L.W. 4311 (April 20, 1988).

⁶³ See also *Garcia v. San Antonio Metropolitan Transit Authority*, 469 U.S. 528, 556 (1985) (indicating that the appropriate inquiry in determining the boundaries of state immunity from federal regulation is whether "the internal safeguards of the political process have performed as intended").

⁶⁴ See *supra* note 8.

⁶⁵ 15 U.S.C. 78o-4(d)(1).

⁶⁶ 15 U.S.C. 78o-4(d)(2).

official statements. The MSRB specifically is permitted, however, to require that official statements or other documents that are available from sources other than the issuer, such as the underwriter, be provided to investors.

While Congress limited the power of the MSRB to require that disclosure documents be provided to investors, it was careful to preserve and expand the authority of the Commission under section 15(c)(2) of the Exchange Act.⁶⁷ Section 15B(d)(2) expressly indicates that "[n]othing in this paragraph shall be construed to impair or limit the power of the Commission under any provision of this title."⁶⁸ Thus, although section 15B(d)(1) prevents the Commission from requiring that municipal issuers file reports or documents prior to the issuance of securities in the same fashion as corporate securities, Congress expanded the Commission's authority to adopt rules reasonably designed to prevent fraud, so long as the rules did not require documents to be filed with the Commission.⁶⁹ The Commission believes that Rule 15c2-12 is consistent with its Congressional mandate to adopt rules reasonably designed to prevent fraud in the federal securities markets.⁷⁰

Since Rule 15c2-11, 17 CFR 240.15c2-11, which requires brokers and dealers to obtain certain information about an issuer before initiating quotations, would have applied to municipal securities upon enactment of the 1975 Amendments, Congress indicated that the Commission should specifically exempt municipal securities from Rule 15c2-11 immediately upon their adoption. It was believed that, since Rule 15c2-11 was drafted with corporate securities in mind, municipal securities dealers would not have been able to obtain sufficient information concerning municipal issuers to satisfy the rule's requirements. See S. Rep. No. 75, 94th Cong., 1st Sess. 48 (1975). See also Rule 15c2-11(f)(4), 17 CFR 15c1-11(f)(4) (provisions of rule do not apply to publication of submission of a quotation regarding a municipal security).

III. Municipal Underwriter Responsibilities

In connection with Rule 15c2-12's requirements to obtain and review a near-final official statement, the Commission wishes

to emphasize the obligation of a municipal underwriter to have a reasonable basis for recommending any municipal securities and its responsibility, in fulfilling that obligation, to review in a professional manner the accuracy of the offering statements with which it is associated.

An underwriter, whether of municipal or other securities, occupies a vital position in an offering. The underwriter stands between the issuer and the public purchasers, assisting the issuer in pricing and, at times, in structuring the financing and preparing disclosure documents. Most importantly, its role is to place the offered securities with public investors. By participating in an offering, an underwriter makes an implied recommendation about the securities. Because the underwriter holds itself out as a securities professional, and especially in light of its position vis-a-vis the issuer, this recommendation itself implies that the underwriter has a reasonable basis for belief in the truthfulness and completeness of the key representations made in any disclosure documents used in the offerings.

Under the general antifraud provisions found in section 17(a) of the Securities Act and sections 10(b) and 15(c) (1) and (2) of the Exchange Act,⁷¹ the courts and the Commission long have emphasized that a broker-dealer recommending securities to investors implies by its recommendation that it has an adequate basis for the recommendation.⁷² For example, in *Hanly v. SEC*, affirming the Commission's sanctions against securities salesman who recommended the stock of a financially troubled issuer both by making false and misleading representations and by failing to disclose know or reasonably obtainable adverse information, the court stated:

In summary, the standards by which the actions of each [salesman] must be judged are strict. He cannot recommend a security unless there is an adequate and reasonable basis for such recommendation. He must disclose facts which he knows and those which are reasonably ascertainable. By his recommendation he implies that a reasonable investigation has been made and that his recommendation rests on the conclusions based on such investigation.⁷³

⁶⁷ 15 U.S.C. 78o(c)(2).

⁶⁸ 15 U.S.C. 78o-4(d)(2).

⁶⁹ Section 15(c)(2) of the Exchange Act empowers the Commission with broad authority to adopt rules reasonably designed to prevent fraudulent, deceptive, or manipulative acts or practices. Prior to 1975, the Commission's regulation of municipal securities professionals had been limited largely to post hoc enforcement actions against fraud. The 1975 Amendments expanded the application of section 15(c)(2) to subject municipal securities and municipal securities dealers to the Commission's authority to adopt rules reasonably designed to prevent acts or practices that are fraudulent, deceptive, or manipulative

⁷⁰ Although denominated under section 15 of the Exchange Act, Rule 15c2-12 also is being adopted pursuant to the Commission's authority under sections 2, 3, 10, 15B, 17, and 23 of the Exchange Act, 15 U.S.C. 78b, 78c, 78j, 78o-4, 78j, and 78w.

⁷¹ 15 U.S.C. 77q(a) and 15 U.S.C. 78j(b), 78o(c)(1), and 78o(c)(2), respectively.

⁷² See, e.g., *Feeney v. SEC*, 564 F.2d 260 (8th Cir. 1977); *Nassar & Co.*, Securities Exchange Act Release No. 15347 (Nov. 22, 1978), 16 SEC Docket 222, reprinted in [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) 81,904, aff'd without opinion, 600 F.2d 280 (D.C. Cir. 1979); *Cortlandt Investing Corporation*, 44 S.E.C. 45 (1969); *Crow, Bourman & Chotkin, Inc.*, 42 S.E.C. 938 (1966); *Shearson Hammill & Co.*, 42 S.E.C. 811 (1965); *J.A. Winston & Co., Inc.*, 42 S.E.C. 62 (1964) (concerning transactions by dealers in the secondary market).

⁷³ 415 F.2d 589, 597 (2d Cir. 1969), affirming *Richard J. Buck & Co.*, 43 S.E.C. 998 (1968). See also, e.g., *Merrill Lynch Pierce, Fenner & Smith*, Securities Exchange Act Release No. 14149 (Nov. 9, 1977), 13 SEC Docket 646, 561 ("A recommendation by a broker-dealer is perceived by a customer as (and in fact it should be) the product of an objective analysis [which] can only be achieved when the scope of investigation is extended beyond the

This obligation to have a reasonable basis for belief in the accuracy of statements directly made concerning the offering is underscored when a broker-dealer underwrites securities.⁷⁴ A municipal underwriter's obligation extends to having a reasonable basis for belief in the truth of key representations in an official statement prepared by the issuer. An underwriter's failure to have a reasonable basis for believing key representations in offering documents has resulted in private damage actions under the general antifraud provisions and in enforcement action by the Commission under section 17(a) of the Securities Act. For example, in *Hamilton Grant & Co.*, the Commission found that an underwriter had violated sections 17(a)(2) and (3) of the Securities Act where the underwriter had "failed to make any substantial effort to obtain specific verification of management's key representations" and thus had "no basis for a reasonable belief in the truthfulness of the key representations made in the registration statement and prospectus."⁷⁵

company's management"); *John R. Brick*, Securities Exchange Act Release No. 11763 (Oct. 24, 1975), 8 SEC Docket 240, 242 ("The professional * * * is not an insurer. But he is under a duty to investigate and to see to it that his recommendations have a reasonable basis"); *M.G. Davis & Co.*, 44 S.E.C. 153, 157-58 (1970), *aff'd sub nom. Levine v. SEC*, 436 F.2d 88 (2d Cir. 1971) (broker-dealer registration revoked, because "representations and predictions" made and market letter relied on by registrant "were without reasonable basis," and "registrant could not reasonably accept all of the statements in the [market letter] without further investigation").

⁷⁴ The opportunity for the underwriters to require disclosure from the issuer, as well as the special selling pressures involved in the distribution of securities, generally have given rise to a heightened obligation on the part of underwriters. In *Sanders v. John Nuveen & Co.*, 524 F.2d 1064 (7th Cir. 1075), vacated and remanded on other grounds, 425 U.S. 929 (1976), on remand, 554 F.2d 790 (7th Cir. 1977), rehearing denied, 619 F.2d 1222 (7th Cir. 1980) cert. denied 450 U.S. 1005 (1981), for example, the Seventh Circuit considered a case involving an underwriter of commercial paper. The underwriter did not have a formal underwriting agreement with the issuer and was not subject to liability under section 11 of the Securities Act, 15 U.S.C. 77k. Nevertheless, the court noted that: [a]n underwriters relationship with the issuer gives the underwriter access to facts that are not equally available to members of the public who must rely on published information. And the relationship between the underwriter and its customers implicitly involves a favorable recommendation of the issued security. Because the public relies on the integrity, independence and expertise of the underwriter, the underwriter's participation significantly enhances the marketability of the security. And since the underwriter is unquestionably aware of the nature of the public's reliance on his participation in the sale of the issue, the mere fact that he has underwritten it is an implied representation that he has met the standards of his profession in his investigation of the issuer. 524 F.2d at 1069-70.

⁷⁵ Securities Exchange Act Release No. 24679 (July 7, 1987), 38 SEC Docket 1346, 1353. See also the following decisions concerning corporate underwriters. *Leonard Lazaroff*, 43 S.E.C. 43 (1966) (underwriter did not carry out its "duty to investigate the issuer diligently and ascertain the accuracy of the offering circular"); *Amos Treat & Co.*, 42 S.E.C. 99, 103-4 (1964) (underwriter sanctioned for knowingly using registration statement containing stale financial

statements when recommending securities); *The Richmond Corporation*, 41 S.E.C. 398, 406 (1963) ("It is a well established practice, and a standard of the business, for underwriters to exercise diligence and care in examining into an issuer's business and the accuracy and adequacy of the information contained in the registration statement. By associating himself with a proposed offering, an underwriter impliedly represents that he has made such an investigation in accordance with professional standards" [footnote omitted]); *Brown, Barton & Engel*, 41 S.E.C. 59, 64 (1962) (underwriters "had a responsibility to make a reasonable investigation to assure themselves that there was a basis for the representations they made and that a fair picture including adverse as well as favorable factors, was presented to investors").

Similarly, both the Commission and the courts have indicated that municipal underwriters must exercise reasonable care to evaluate the accuracy of statements in issuer disclosure documents.⁷⁷

statements when recommending securities); *The Richmond Corporation*, 41 S.E.C. 398, 406 (1963) ("It is a well established practice, and a standard of the business, for underwriters to exercise diligence and care in examining into an issuer's business and the accuracy and adequacy of the information contained in the registration statement. By associating himself with a proposed offering, an underwriter impliedly represents that he has made such an investigation in accordance with professional standards" [footnote omitted]); *Brown, Barton & Engel*, 41 S.E.C. 59, 64 (1962) (underwriters "had a responsibility to make a reasonable investigation to assure themselves that there was a basis for the representations they made and that a fair picture including adverse as well as favorable factors, was presented to investors").

⁷⁶ *Walston & Co.*, Securities Exchange Act Release No. 8165 (Sept. 22, 1967), reprinted in [1966-67 Transfer Binder] Fed. Sec. L. Rep. (CCH) 77,474. This case involved a special assessment tax district consisting of one tract of undeveloped land owned by the promoter of the bonds. The manager of the bond department, but not the firm's salesmen, knew that the district consisted of one individual's land, but the firm had not inquired into the financial condition of the owner and developer. In that context, the Commission noted:

It is incumbent on firms participating in an offering and on dealers recommending municipal bonds to their customers as "good municipal bonds" to make diligent inquiry, investigation and disclosure as to material facts relating to the issuer of the securities and bearing upon the ability of the issuer to service such bonds. It is, moreover, essential that dealers offering such bonds to the public make certain that the offering circular and other selling literature are based upon an adequate investigation and that they accurately reflect all material facts which a prudent investor should know in order to evaluate the offering before reaching an investment decision.

⁷⁷ See, e.g., *Walston & Co.*, supra note 76; *Edward J. Blumenfeld*, Securities Exchange Act Release No. 16437 (Dec. 19, 1979), 18 SEC Docket 1379; *Shores v. Sklar*, 647 F.2d 462 (5th Cir. 1981), cert. denied, 455 U.S. 936 (1982) (underwriter of industrial revenue bonds could be liable for recklessness under "fraud on the market" theory under section 10(b) of Exchange Act, 15 U.S.C. 78j(b), where offering circular contained material omissions and underwriter had been aware of misrepresentations and omissions and had failed to look into true value of the issuer's assets); *Shores v. M.E. Ratliff Investment Co.*, No. CA 77-G-0604-5, reprinted in [1981-82 Transfer Binder] Fed. Sec. L. Rep. (CCH) 98,425 (N.D. Ala. 1982) (underwriter of industrial development bonds liable under Rule 10b-5, 17 CFR 240.10b-5, for using offering circulars not disclosing material facts and for failing to conduct reasonable inquiry); but see, *Ross v. Bank South, N.A.*, 837 F.2d 980 (11th Cir. 1988), vacated and reh'g en banc granted sub nom. *ross v. Rice*, 848 F.2d 1132 (June 10, 1988) (granting rehearing to consider a case involving, among other things, application of the fraud on the market theory to sales of bonds in an undeveloped market).

In recognition of their responsibilities under the general antifraud provisions of the federal securities laws and the MSRB's general fair dealing rules,⁷⁸ for some time underwriters generally have undertaken an investigation of the issuer's disclosure in negotiated offerings of municipal securities.⁷⁹ Among other things, depending upon the nature of the issuer, this has included meetings with municipal officials, visits to physical facilities, and an examination of the issuer's records and current economic trends and forecasts that bear upon the ability of the issuer to repay its debt. In addition, underwriters usually require so-called "Rule 10b-5" letters from their counsel with respect to municipal offerings.⁸⁰

Although general practice among municipal underwriters appears to recognize a responsibility to assess the accuracy of disclosure documents used in negotiated offerings, the Commission is not convinced that this practice is recognized universally or followed in all negotiated municipal offerings. Moreover, with respect to competitively bid municipal underwritings, some underwriters mistakenly consider themselves to have virtually no responsibility regarding the accuracy of the offering disclosure document. As the Commission noted in the New York City Final Report, there appears to be no clear understanding of an underwriter's

⁷⁸ Apart from the general antifraud provisions of the federal securities laws, municipal securities brokers and dealers also must comply with the MSRB's rules. Rule G-17 of the MSRB's rules requires municipal securities brokers and dealers to deal fairly with investors and prohibits them from engaging in any deceptive, dishonest, or unfair practice. The MSRB has interpreted this rule to require that a dealer disclose all material facts known by the dealer to a customer at the time of the transaction. See *supra* note 50. In addition, rule G-19 requires that a municipal securities broker or dealer not recommend a transaction to a customer unless it has reasonable grounds, based upon its knowledge of the security, for believing that the transaction is suitable for that particular customer.

⁷⁹ The recent report by the American Bar Association and National Association of Bond Lawyers on the disclosure roles of counsel in municipal offerings acknowledged that:

While issuer officials and underwriters are * * * exempt from civil liabilities under section 11 of the 1933 Act, both the SEC and private litigants have taken the position that a duty exists under the antifraud provisions similar to, although perhaps not so severe as, the investigating activities which form the American Bar Association, Section of Urban, State and Local Government Law, and National Association of Bond Lawyers, *Disclosure Roles of Counsel in State and Local Government Securities Offerings* (1987), at 37 ("ABA-NABL Report").

⁸⁰ Rule 10b-5 letters are obtained by underwriters from their counsel to provide negative assurance concerning the disclosure document (e.g., "nothing has come to our attention that would indicate that the disclosure document contains any untrue statement of a material fact or omits to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading"). See 17 CFR 240.10b-5(b). Such letters generally provide a description of the investigation undertaken by the counsel on behalf of the underwriter which serves as a basis for those assurances.

responsibility to assure the accuracy of the information disclosed.⁸¹ The Supply System Staff Report also suggests that underwriters, even in nominally competitive bid offerings, view their responsibilities regarding the accuracy of the official statement as extremely limited.⁸² The underwriters of the Supply System's bonds acknowledged no legal responsibility to read the official statements with a view to gauging their accuracy, much less to conduct a review to establish a basis for a reasonable belief in the accuracy of the key representations made in the offering statement.⁸³

In light of the above, the Commission believes that further articulation of a municipal underwriter's obligations to the investing public in both negotiated and competitively bid offerings is appropriate at this time to encourage meaningful review of issue disclosure.⁸⁴ In the Commission's view, the reasonableness of a belief in the accuracy and completeness of the key representations in the final official statement, and the extent of a review of the issuer's situation necessary to arrive at this belief, will depend upon all the circumstances. In both negotiated and competitively bid municipal offerings, the Commission expects, at a minimum, that underwriters will review the issuer's disclosure documents in a professional manner for possible inaccuracies and omissions.⁸⁵ Beyond this

⁸¹ New York City Final Report, *supra* note 2. The Supplemental Staff Report, which was an appendix to the New York City Final Report, stated that:

The underwriters, those discussed in the Staff Report as well as several other national and local underwriting firms interviewed by the staff, can and do perform independent credit analyses of municipalities whose securities offerings they underwrite. The underwriters have generally stated, however, that circumstances severely restrict their ability to conduct any "due diligence" inquiry in any competitive bid offering and that, in these circumstances, the inquiry may consist of nothing more than a perusal of the official statement or other information provided in connection with the offering or contained in their files. In contrast, the underwriters generally state that in any negotiated offering they do perform a "due diligence" inquiry in some ways similar to that conducted in underwriting corporate issues.

⁸² Supply System Staff Report at 168-169. See also discussion *supra* at text accompanying notes 13 to 19.

⁸³ Unlike many competitively bid offerings, only two syndicates successfully bid on the Supply System's 14 offerings. Moreover, there appeared to be little uncertainty about which syndicate would be awarded a particular offering.

⁸⁴ As discussed above, these obligations arise out of the general antifraud provisions of the federal securities laws, particularly section 17 of the Securities Act and sections 10(b) and 15(c)(1) and (2) of the Exchange Act, and the rules thereunder. The factors set forth below do not change the applicable legal standards, e.g., scienter or negligence, and conduct in a specific case must be measured against these standards. Nor do they attempt to establish objective standards of recklessness for purposes of any scienter requirement.

⁸⁵ Proposed Rule 15c2-12 expressly would require that municipal underwriters review preliminary official statements in offerings of over \$10 million.

baseline review, the Commission believes that a number of factors generally will be relevant in determining the reasonableness of a municipal underwriter's basis for assessing the truthfulness of the key representations in final official statements. These factors would include: The extent to which the underwriter relied upon municipal officials, employees, experts, and other persons whose duties have given them knowledge of particular facts;⁸⁶ the type of underwriting arrangement (e.g., firm commitment or best efforts); the role of the underwriter (manager, syndicate member, or selected dealer)⁸⁷; the type of bonds being offered (general obligation, revenue, or private activity); the past familiarity of the underwriter with the issuer; the length of time to maturity of the bonds; the presence or absence of credit enhancements; and whether the bonds are competitively bid or are distributed in a negotiated offering.

In negotiated municipal offerings, where the underwriter is involved in the preparation of the official statement, the Commission believes that development of a reasonable basis for belief in the accuracy and completeness of the statements therein should involve an inquiry into the key representations in the official statement that is conducted in a professional manner, drawing on the underwriter's experience with the particular issuer, and other issuers, as well as its knowledge of the municipal markets. Sole reliance on the representations of the issuer would not suffice.⁸⁸ The role of the underwriter in assessing the accuracy of the issuer's key disclosures is of particular importance where the underwriting involves an unreasoned issuer.⁸⁹ Because of the varying types of municipal

⁸⁶ The Commission wishes to caution underwriters that this factor does not imply that an underwriter may merely rely upon formal representations by the issuer, its officials, or employees regarding the general accuracy of disclosure contained in the official statement. The underwriter must review the information submitted to it with a view to resolving inaccuracies and inconsistencies. Reliance on portions of a statement prepared and certified or authorized by an expert to be included in the document generally would be reasonable absent actual knowledge, or a reason to know, of the inaccuracy of those statements.

⁸⁷ In other contexts, the Commission and the courts have distinguished between the obligations of managing underwriters and syndicate members. See generally Securities Exchange Act Release No. 9671 (July 26, 1972) (discussing the responsibility of underwriters, brokers, and dealers trading in securities, particularly of high risk ventures). Generally, a participating underwriter in an offering of municipal securities need not duplicate the efforts of the managing underwriter, but must satisfy itself that the managing underwriter reviewed the accuracy of the information in the official statement in a professional manner and therefore had a reasonable basis for its recommendation. Nevertheless, in both competitive and negotiated offerings, the syndicate members, as part of forming their own recommendations to investors, must at least familiarize themselves with the information in the official statement and should notify the managing underwriters of any factors that suggest inaccuracies in disclosure or signal the need for additional investigation.

⁸⁸ See, e.g., *Hamilton Grant & Co.*, supra note 75.

⁸⁹ *Charles E. Bailey & Co.*, 35 S.E.C. 33, 42 (1953) ("where, as here, an issuer seeks funds from the public to finance a new and speculative

debt and extent of disclosure practices, the Commission is not attempting to delineate specific investigative requirements in this release. However, the Commission notes that commentators already have suggested a variety of investigative procedures to be followed by underwriters in connection with negotiated municipal securities offerings.⁹⁰

With respect to competitively bid offerings of municipal securities, members of the municipal securities industry have argued that the uncertainty of the bidding process and time pressures associated with these offerings make it difficult for underwriters to conduct an investigation of the issuer or its statements.⁹¹ The fact that an offering is underwritten on a competitive basis does not negate the responsibility that the underwriter perform a reasonable review. Nevertheless, the Commission recognizes that municipal underwriters may have little initial access to background information concerning securities that have been bid on a competitive basis. Therefore, the fact that offerings are competitively bid, rather than sold through a negotiated offering, is an element to be considered in determining the reasonableness of the underwriters' basis for assessing the truthfulness of key representations in final official statements. In this regard, the fact that an underwriting is nominally classified as competitive will not be relevant to the scope of an underwriter's review where there is little uncertainty about the choice of underwriters or where other factors are present that would command a closer examination.

The Commission believes that in a normal competitive bid offering, involving an established municipal issuer, a municipal underwriter generally would meet its obligation to have a reasonable basis for belief in the accuracy of the key representations in the official statement where it reviewed the official statement in a professional manner, and received from the issuer a detailed and credible explanation concerning any aspect of the official statement that appeared on its face, or on the basis of information available to the underwriter, to be inadequate. In reviewing the issuer's disclosure documents, therefore, underwriters bidding on competitive offerings should stay attuned to factors that suggest inaccuracies in the disclosure or signal that additional investigation is necessary.⁹² If

venture, the underwriter must be particularly careful in verifying the issuer's obviously self-serving statements as to its operations and prospects").

⁹⁰ See ABA-NABL Report, supra note 79, at 74-98; Doty, *The Disclosure Process and Securities Laws, State and Local Government Debt Financing* (D. Gelfand ed, 1986) ("Doty") at ss 8-69, 8-71.

⁹¹ See, e.g., *Municipal Securities Full Disclosure Act of 1976*, Hearing on S. 2969 and 2574 before the Subcommittee on Securities, Senate Committee on Banking, Housing and Urban Affairs, 94th Cong., 2d Sess. 126, 127 (1976) (statement of Richard Kezer, President of the Dealer Bank Association).

⁹² In a competitively bid offering, the task of assuring the accuracy and completeness of disclosure is in the hands of the issuer, who usually will employ a financial adviser, which frequently is a broker-dealer. Ordinarily, financial advisers in competitively bid offerings publicly associate themselves with the offering, and perform many of the functions normally undertaken by the underwriters in corporate offerings and in municipal offerings sold on a negotiated basis. Thus, where such financial advisers

these factors appear, the underwriter should investigate the questionable disclosure and, if a problem is uncovered, pursue the inquiry until satisfied that correct disclosure has been made.⁹³

While a municipal underwriter in a competitive bid offering may approach its reasonable basis obligation first through a professional review of the offering documents, it may not, of course, ignore other information regarding the issuer that it has available. Generally, underwriters receive notices of competitively bid offerings one week prior to the date bids must be submitted. During this period, they have the opportunity to review the issuer's preliminary official statement⁹⁴ and bring to bear any additional information they have about the issuer.

With respect to both negotiated and competitively bid offerings, apart from the information contained in the issuer's disclosure documents, an underwriter may have had opportunities to develop an independent reservoir of knowledge about an issuer. As noted above and in the Supply System Staff Report,⁹⁵ [FN95] even in competitively bid offerings, underwriters may have access to information about the issuer that would allow them to reach some conclusion about the worth of its bonds and the validity of representations in the preliminary or final official statement. In addition, underwriters often engage in trading of other bonds of the issuer in the secondary market and acquire

have access to issuer data and participate in drafting the disclosure documents, they will have a comparable obligation under the antifraud provisions to inquire into the completeness and accuracy of disclosure presented during the bidding process. See generally Doty, *supra* note 90, at s 8-78. Although the underwriter may choose to rely upon the fact that a broker-dealer acting as a financial adviser is assisting the issuer, such reliance does not relieve the underwriter of its duty to investigate questionable disclosure.

⁹³ The Commission requests comment on the nature and extent of any problems experienced by underwriters and issuers involving underwriting agreements that do not contemplate a reasonable investigation by the underwriters. One commentator has suggested that issuers may attempt to retain good faith deposits if underwriters refuse to go forward with an offering where sufficient disclosure is not provided. See Doty, *Municipal Securities Disclosure*, 13 Rev. of Sec. Reg. No. 1 (January 16, 1980). The Commission believes that any problems previously experienced in this area may be avoided by proper drafting of purchase contracts or underwriting agreements. Moreover, issuers and underwriters should consider whether agreements that do not allow for a reasonable investigation would be voidable under Section 29(b) of the Exchange Act, 15 U.S.C. 78cc(b). Compare *Kaiser-Frazer Corp. v. Otis & Co.*, 195 F.2d 838 (2nd Cir. 1952), cert. denied, 344 U.S. 856 (1952) (invalidating an underwriting agreement under Section 14 of the Securities Act, 15 U.S.C. 77n, where inadequate disclosure was provided by the issuer); see also, generally, *Gruenbaum & Steinberg*, Section 29(b) of the Securities Exchange Act of 1934: A Viable Remedy Awakened, 48 Geo. Wash. L. Rev. 1 (1979).

⁹⁴ The Commission expects that the responsibilities of municipal underwriters described above would require them, in most cases, to receive a preliminary offering statement in this time frame.

⁹⁵ Supply System Staff Report at 170-72.

information on a continuing basis in their role as dealers of the bonds, regardless of whether they underwrite a particular offering. Moreover, many municipal issuers return to the market frequently to meet their financing needs. Underwriters that participate in multiple offerings for an issuer have a continuing opportunity to become familiar with the issuer's financial and operational condition. From each of these sources, an underwriter may develop a reservoir of knowledge about the issuer and its securities that should be used to assess the adequacy of disclosure.

An additional source of information is the underwriter's research department. The research units of municipal underwriters produce research on bonds sold by both competitively bid and negotiated offerings, and may assist in the sales activities of the underwriter. The research units also draft reports that are sent to potential customers, including institutional investors, and sometimes write more abbreviated information circulars for the direct use of the firm's salespersons in promoting the bonds. When an underwriter participates in an offering, the research unit may have substantive knowledge about the issuer and should be consulted by the underwriter in performing its investigation.⁹⁶

The Commission believes that the provisions in Rule 15c2-12 also contribute to a municipal underwriter's ability to meet its "reasonable basis" obligation. In particular, paragraph (b) of Rule 15c2-12 would assist underwriters in complying with their reasonable basis obligation by providing that an underwriter receive a nearly final official statement prior to bidding for or purchasing an offering, which it then must review. In order to allow the underwriter to meet this obligation, issuers will have to begin drafting disclosure documents earlier and perhaps with greater care than in the past. Furthermore, this requirement should enable underwriters to receive, and if necessary influence the content of, the final official statement before committing themselves to an offering.

The Commission believes that the conduct of the underwriters in the Supply System offerings, and the position advanced by some members of the industry, with respect to their responsibilities in competitively bid offerings, raise serious concerns that warrant additional review. Although the legal standards stated above reflect the current Commission views based upon judicial decisions and previous administrative actions, the Commission is concerned that the standards applicable to municipal underwriters be articulated correctly. Accordingly, the Commission would like to receive views on the interpretation expressed above. In addition, the Commission would like to receive comment from underwriters and other members of the industry regarding current practices in both negotiated and competitively bid underwritings, and the extent to which they meet the standards articulated in this release. In this regard, the Commission requests comment on any problems experienced by underwriters in fulfilling their responsibilities that could be resolved through further Commission or MSRB rulemaking. Commentators also are invited to address whether a clearer articulation of an underwriter's responsibilities is desirable,

⁹⁶ The Commission notes, however, that care should be taken to avoid the misuse of any material, non-public information by the firm or its clients.

either through additional Commission interpretation or rulemaking, or through amendment to the statutory provisions of the federal securities laws. Alternatively, should the MSRB adopt general guidelines or interpretations to assist underwriters in determining the scope of their responsibilities

IV. Creation of a Central Repository

In addition to soliciting views on proposed Rule 15c2-12, and the methods used to satisfy an underwriter's responsibility to have a reasonable basis for recommending the securities it underwrites, the Commission requests comment on a proposal advanced by the MSRB and members of the industry to create a repository of municipal securities disclosure documents. This proposal is intended to improve the flow of information to the municipal marketplace. Information concerning corporate offerings is available to the public at a single location, because most corporate issuers file registration statements with the Commission.⁹⁷ In addition, many corporate issuers are subject to the annual and periodic reporting requirements of the Exchange Act,⁹⁸ which provide a continual source of disclosure about the issuer to the secondary markets. No similar registration or reporting requirements exist for municipal issuers, however.

Although some repositories do collect information concerning municipal offerings,⁹⁹ there is no central and complete source of documentary information. Moreover, even when official statements are prepared, dealers may not retain copies following the distribution. Consequently, they may not have adequate access to complete descriptive information about an issuer's securities when trading in the secondary market. As noted earlier, lack of disclosure about important features of an issuer's securities has been a frequent complaint in MSRB arbitration proceedings and has resulted in pricing and trading

⁹⁷ Unless an exemption is available, Section 5 of the Securities Act, 15 U.S.C. 77e, requires a registration statement to be on file with the Commission prior to any offers of corporate securities, and that a registration statement have been declared effective prior to any sales. A statutory prospectus must accompany or precede the sale or delivery of a security. Registration statements are public at the time of filing with the Commission. 15 U.S.C. 77f(d). In contrast, municipal securities, which are exempt from section 5, may be offered and sold without filing with the Commission. Compare MSRB rule G-34 (requiring certain information concerning a new issue to be provided to the MSRB or its designee in order to obtain a CUSIP number).

⁹⁸ E.g., Sections 12 and 15(d), 15 U.S.C. 78l and 78o(d).

⁹⁹ Repositories for municipal securities information are maintained by the Bond Buyer in New York, under the name "Munifiche," and by Securities Data Company, Inc. While submission of documentary data to these repositories is voluntary, it has been strongly urged by the GFOA. See Procedural Statement No. 8, Dissemination of Information and Providing Statements, Reports, and Releases to a Central Repository, GFOA Guidelines at 91.

inefficiencies.¹⁰⁰

In an effort to improve the quality of disclosure available to both the primary and secondary market, the MSRB recently has proposed the creation of a central repository of official statements and certain refunding documents.¹⁰¹ [FN101] As envisioned by the MSRB, participation in the repository by municipal issuers would be mandatory, and information concerning new issues would be made available to interested persons, for a fee, shortly after filing with the repository by the issuer. Among other things, the MSRB expects that the repository would alleviate current informational problems in the offering of municipal securities by allowing dealers executing transactions in new issues of securities to gain access to information contained in official statements through in-house computer screens. It is also expected that benefits would accrue to the secondary market. Rapid access to descriptive information concerning all issues would facilitate compliance with the MSRB's rules and would provide a more complete and reliable source of information than is available at this time.

While the concept of a central repository has been endorsed by elements of the municipal securities industry, the proposal has generated a number of issues that deserve careful study.¹⁰² The issues range from technical and operational concerns to more fundamental policy considerations regarding the nature of information to be provided to the repository, and the role of the Commission, if any, in assisting in the creation of the repository.

The Commission requests comments concerning the creation of a central repository. In addition to general comments concerning the need for a repository, commentators should address the following issues: Should the repository be created by the industry or mandated by the Commission; should participation in a repository be voluntary or assisted by rulemaking efforts by the MSRB or the Commission; should the deposit requirement be placed on issuers, underwriters, or dealers; what kind of information should be submitted to the repository (e.g., official statements, escrow agreements, annual financial reports); when should the information be submitted; should there be periodic reporting requirements to keep the information current; should data be submitted in summary or complete form, in hard copy (without restrictions as to the type font or format, or with restrictions designed to facilitate use of optical character recognition technology) or electronically; and, how should the repository be funded?

¹⁰⁰ See *supra* note 35.

¹⁰¹ Letter from James B.G. Hearty, Chairman, MSRB, to David S. Ruder, Chairman, Securities and Exchange Commission (December 17, 1987).

¹⁰² See Letter from Jeffrey L. Esser, Executive Director, GFOA, to David S. Ruder, Chairman, Securities and Exchange Commission (December 18, 1987); letter from James H. Cheek, III, Chairman, Committee on Federal Regulation of Securities, and Robert S. Amdursky, Chairman, Subcommittee on Municipal and Governmental Obligations, American Bar Association, to David S. Ruder, Chairman, Securities and Exchange Commission (March 30, 1988) (suggesting that a careful study be made of the issues raised by a central repository before any formal actions are taken).

V. Effects on Competition and Regulatory Flexibility Act Considerations

Section 23(a)(2) of the Exchange Act¹⁰³ [FN103] requires that the Commission, in adopting rules under the Act, consider the anticompetitive effects of such rules, if any, and balance any anticompetitive impact against the regulatory benefits gained in terms of furthering the purposes of the Exchange Act. The Commission is preliminarily of the view that proposed Rule 15c2-12 will not result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act. The Commission requests comment, however, on any competitive burdens that might result from adoption of the rule. Although the rule applies equally to all underwriters of municipal securities, the Commission in particular is interested in receiving comments on the extent to which any of the proposed dollar thresholds would burden one segment of the industry more than another.

In addition, the Commission has prepared an Initial Regulatory Flexibility Analysis ("IRFA"), pursuant to the requirements of the Regulatory Flexibility Act,¹⁰⁴ [FN104] regarding the proposed rules. The IRFA indicates that Rule 15c2-12 could impose some additional costs on small broker-dealers and municipal issuers, particularly if a lower dollar threshold is adopted. Nevertheless, the Commission believes that many of the substantive requirements of the rule already are observed by underwriters and issuers as a matter of business practice, or to fulfill their existing obligations under the general antifraud provisions of the federal securities laws. The Commission requests comment on the extent to which current practice deviates from the requirements of the proposed rule, and the extent to which additional costs may be imposed on small municipal issuers and broker-dealers if the rule is adopted as proposed.

A copy of the IRFA may be obtained from Henry E. Flowers, Attorney, Office of Legal Policy, Division of Market Regulation, Securities and Exchange Commission, 450 Fifth Street NW., Mail Stop 5-1, Washington, DC 20549, (202) 272-2848.

VI. Statutory Basis and Text of Amendments

The Commission proposes to adopt s 240.15c2-12 in Chapter II of Title 17 of the Code of Federal Regulations as follows:

List of Subjects in 17 CFR Part 240

Securities.

PART 240--GENERAL RULES AND REGULATIONS, SECURITIES EXCHANGE ACT OF 1934

1. The authority citation for Part 240 is revised by adding the following citation:

Authority: Sec. 23, 48 Stat. 901, as amended; 15 U.S.C. 78w. * * * s 240.15c2-12 also issued under 15 U.S.C. 78b, 78c, 78j, 78o, 78o-4 and 78q.

2. By adding s 240.15c2-12 as follows:

240.15c2-12 Municipal securities disclosure.

(a) As a means reasonably designed to prevent fraudulent, deceptive, or manipulative acts or practices, it shall be unlawful for any broker, dealer, or municipal securities dealer to act as underwriter in an offering of municipal securities with an aggregate offering price in excess of \$10,000,000 unless it complies with the requirements of paragraphs (b) through (e) of this section.

(b) The broker, dealer, or municipal securities dealer shall, prior to the time it bids for or purchases securities of the issuer, directly or through its designated agents, obtain and review an official statement that is complete, except for the omission of the following information: The offering price, interest rate, selling compensation, amount of proceeds, delivery dates, other terms of securities depending on such factors, and the identity of the underwriter.

(c) The broker, dealer, or municipal securities dealer shall send promptly by first class mail or other equally prompt means to any person, on request, a single copy of any preliminary official statement prepared by the issuer for dissemination to potential bidders or purchasers.

The broker, dealer, or municipal securities dealer shall contract with the issuer or its designated agents to obtain, within two business days after any final agreement to purchase or sell the securities, copies of a final official statement in sufficient quantities to comply with paragraph (e) of this section and the rules of the Municipal Securities Rulemaking Board.

(e) The broker, dealer, or municipal securities dealer, in a timely manner, shall send to any person, on request, a single copy of the final official statement.

(f) For the purposes of this section--

(1) The term "final official statement" means a document prepared by the issuer or its representatives setting forth, among other matters, information concerning the issuer and the proposed issue of securities that is final as of the date of the final agreement to purchase or sell municipal securities for, or on behalf of, an issuer or underwriter.

(2) The term "underwriter" means any person who has purchased from an issuer with a view to, or offers or sells for an issuer in connection with the distribution of, any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not

¹⁰³ 15 U.S.C. 78w(a)(2).

¹⁰⁴ 5 U.S.C. 603.

include a person whose interest is limited to a commission, concession or allowance from an underwriter, broker, dealer, or municipal securities dealer not in excess of the usual and customary distributors' or sellers' commission, concession or allowance.

By the Commission.

September 22, 1988.

Shirley E. Hollis,

Assistant Secretary.

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