

**Interpretive Release Relating to
Disclosure Obligations of
Issuers and Others**

SECURITIES ACT OF 1933

**Release No. 33-7049; 34-33741; FR-42/March
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File No. S7-4-94

17 CFR Parts 211, 231 and 241

**STATEMENT OF THE COMMISSION
REGARDING DISCLOSURE
OBLIGATIONS OF MUNICIPAL
SECURITIES ISSUERS AND OTHERS**

AGENCY: Securities and Exchange Commission.

ACTION: Interpretation: Solicitation of comments regarding possible future agency action.

SUMMARY: The Securities and Exchange Commission ("Commission") is publishing its views with respect to the disclosure obligations of participants in the municipal securities mar-

kets under the antifraud provisions of the federal securities laws, both in connection with primary offerings and on a continuing basis with respect to the secondary market. This interpretive guidance is intended to assist municipal securities issuers, brokers, dealers and municipal securities dealers in meeting their obligations under the antifraud provisions. The Commission is seeking comment on issues discussed in this release and possible future agency action.

DATES: Comments should be received on or before [120 days after Federal Register Publication date].

ADDRESSES: Comments should be submitted in triplicate to Jonathan G. Katz, Secretary, Securities and Exchange Commission, 450 Fifth Street, N.W., Stop 6-9, Washington, D.C. 20549. Comment letters should refer to File No. S7-4-94. All comments received will be available for public inspection and copying at the Commission's Public Reference Room, 450 Fifth Street, N.W., Washington, D.C. 20549.

SUPPLEMENTARY INFORMATION: In a companion release, the Commission is proposing rule amendments that prohibit a broker, dealer or municipal securities dealer from underwriting a municipal issue unless the issuer agrees to disseminate information to the secondary market and from recommending the purchase of a municipal security without reviewing such information.

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I. EXECUTIVE SUMMARY

The recent high volume of municipal securities offerings, as well as the growing ownership of municipal securities by individual investors, has highlighted the need for improved disclosure practices in the municipal securities market, particularly in the secondary market. To encourage and expedite the ongoing efforts by market participants to improve disclosure practices, and to assist market participants in meeting their obligations under the antifraud provisions, the Commission is publishing its views with respect

ord financing was heavily influenced by re-fundings. Nevertheless, the level of long term new money financings, representing 49% of financings for the year, reflected continued growth. In 1993, there were \$142 billion of new money long term financings, compared to \$81 billion in 1988, a 75% increase.³

In recent years, the forms of securities used to meet the financing needs of these issuers have become increasingly diverse and complex. For example, conduit bonds, certificates of participation, and a variety of derivative products have joined traditional general obligation and revenue bonds as prevalent forms of municipal financing.⁴

In addition, there has been a change in the investor profile in the municipal securities market. By 1992, individual investors, including those holding through mutual funds, held 75% of the municipal debt outstanding, compared to 44% in 1983.⁵

Along with the changing investor profile, there has been a change in investor strategy. Traditionally, municipal bondholders have been buy and hold investors; however, this strategy has changed significantly with the growth and development of municipal bond funds. Many of these funds actively trade their portfolio securities to take advantage of market conditions or to meet redemption needs.

B. SEC Oversight of the Municipal Securities Market

As the agency charged with administering the federal securities laws and overseeing this nation's securities markets, the Commission has an obligation to protect investors in the municipal markets from fraud, including misleading disclosures. As the New York City report stated nearly two decades ago:

By virtue of the large dollar volume of municipal securities issued and outstanding each year, such securities are a major factor in the Nation's economy and the national securities markets. In light of the national scope of the municipal

securities markets, there is an overriding federal interest in assuring that there is adequate disclosure of all material information by issuers of municipal securities.

Although municipalities have certain unique attributes by virtue of their political nature, insofar as they are issuers of securities, they are subject to the proscription against false and misleading disclosures.⁶

The burgeoning volume and complexity of municipal securities offerings, as well as the retail nature of the market, heighten the need for market participants to seek to prevent fraud through the timely provision of material information concerning municipal issuers and securities.

While Congress exempted offerings of municipal securities from the registration requirements and civil liability provisions of the Securities Act of 1933,⁷ and a mandated system of periodic reporting under the Securities Exchange Act of 1934,⁸ it did not exempt transactions in municipal securities from the coverage of the antifraud provisions of Section 17(a) of the Securities Act,⁹ Section 10(b) of the Exchange Act, and Rule 10b-5 promulgated thereunder.¹⁰ These antifraud provisions prohibit any person, including municipal issuers and brokers, dealers and municipal securities dealers, from making a false or misleading statement of material fact, or omitting any material facts necessary to make statements made by that person not misleading, in connection with the offer, purchase or sale of any security. In addition, brokers, dealers and municipal securities dealers are subject to regulations adopted by the Commission, including those regulations adopted to define and prevent fraud.¹¹ Municipal securities dealers are also subject to rules promulgated by the Municipal Securities Rulemaking Board ("MSRB").¹²

C. Disclosure Practices and Calls for Enhanced Disclosure

In the absence of a statutory scheme for municipal securities registration and reporting, disclosure by municipal issuers has been governed by

³"A Decade of Municipal Finance." *The Bond Buyer* (Jan. 6, 1994) at 24.

⁴Staff Report at 1-2.

⁵*The Bond Buyer 1993 Yearbook* ("Bond Buyer 1993 Yearbook") at 61-63.

⁶Staff Report on Transactions in Securities of the City of New York ("NY City Report") (Aug. 1977) Chapter III, at 1-2.

⁷See Section 3(a)(2) of the Securities Act (15 U.S.C.

77c(a)(2)).

⁸See Section 3(a)(29) of the Exchange Act (15 U.S.C. 78c(a)(29)).

⁹15 U.S.C. 77q(a).

¹⁰15 U.S.C. 78j(b); 17 CFR 240.10b-5.

¹¹Sections 15(c)(1) and (2) of the Exchange Act (15 U.S.C. 78c(c)(1) and (2)).

¹²See *MSRB Manual* (CCH).

fied that today "secondary market information is difficult to come by even for professional municipal credit analysts, to say nothing of retail investors."²² Substantial issuer information, in the form of official statements, state-required reports, and other public documents, is available from the approximately 20% of municipal issuers that come to market frequently, accounting for 80% of the dollar volume of municipal securities issued.²³ However, the remaining issuers, representing 20% in dollar volume but 80% in number, which come to the market much less frequently, provide substantially less continuing information. Many of these issues are health care issues, housing issues, industrial development bonds, and other conduit financings,²⁴ financing sectors which have had the greatest incidence of defaults, both monetary and technical.²⁵ In addition, information often is unavailable for smaller issues of securities of general purpose units of government and the securities of special purpose districts and authorities.²⁶

In response to a request by Commission Chairman Arthur Levitt for a recommended "market-participant sponsored solution" to the disclosure issues in the municipal securities market, on December 20, 1993, 12 groups and associations representing a broad range of market participants submitted to the Commission a Joint Statement on Improvements in Municipal Securities Market Disclosure (the "Joint Statement").²⁷ The Joint Statement sets forth "a framework for improving the availability of infor-

mation in the marketplace" that calls for both continued market initiatives to improve issuer disclosure and "support from the SEC and the Municipal Securities Rulemaking Board (MSRB)."²⁸ Among other things, its participants recommend the adoption of a rule or interpretive guidance restricting underwriting of municipal issues unless continuing information covenants are provided by the issuer.

III. PRIMARY OFFERING DISCLOSURE

A. Application of the Antifraud Provisions

The antifraud provisions of the federal securities laws prohibit fraudulent or deceptive practices in the offer and sale of municipal securities.²⁹ Disclosure documents used by municipal issuers, such as official statements, are subject to the prohibition against false or misleading statements of material facts, including the omission of material facts necessary to make the statements made, in light of the circumstances in which they are made, not misleading. The adequacy of the disclosure provided in municipal security offering materials is tested against an objective standard: an omitted fact is material if there is a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable [investor]. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having sig-

merce, Telecommunications and Finance Subcommittee, Oct. 7, 1993 ("PSA Testimony") at 5-7; NASACT, *State and Local Government Securities Markets and Secondary Market Disclosure* (Oct. 1993) at 5; Stamas, "Issuers' Intentions on Secondary Market Disclosure are Starting to Appear in Official Statements," *The Bond Buyer* (Dec. 14, 1992) at 1; Standard & Poor's, "In Support of Secondary Market Disclosure," *CreditWeek Municipal* (Mar. 16, 1992).

²² PSA Testimony at 5. See also Lehmann Testimony at 4; NASACT Testimony at 3; Nemes, "Investors' Service Steps in to Fill Void in Hospital Data Disclosure," *Modern Healthcare* (Feb. 3, 1992) at 46; Quint, "Credit Markets; Aiming for More Data About Municipal Bonds," *The New York Times* (June 28, 1993) at D5; Schifrin, "Hello, Sucker," *Forbes* (Feb. 1, 1993) at 40.

²³ NASACT, *Report of the Blue Ribbon Committee on Secondary Market Disclosure—Improving Secondary Market Disclosure* (Aug. 1993) ("NASACT Blue Ribbon Committee Report") at 1-2.

²⁴ See *id.* at 1. See also Allstate Letter.

²⁵ See *Bond Buyer 1993 Yearbook* at 3-5; *Municipal Bond Defaults—The 1980's: a Decade in Review* (J.J.

Kenny Co., Inc. 1993) ("Kenny Default Report"); Public Securities Association, *An Examination of Non-Rated Municipal Defaults 1986-1991* (Jan. 8, 1993) ("PSA Default Report"); Staff Report, Appendix B.

²⁶ See NASACT Blue Ribbon Committee Report at 1-2.

²⁷ *Joint Statement on Improvements in Municipal Securities Market Disclosure* ("Joint Statement") (Dec. 20, 1993) at 1. The Joint Statement was submitted by the American Bankers Association's Corporate Trust Committee, American Public Power Association, Association of Local Housing Finance Agencies, Council of Infrastructure Financing Authorities, Government Finance Officers Association, National Association of Bond Lawyers, National Association of Counties, National Association of State Auditors, Comptrollers and Treasurers, National Association of State Treasurers, National Council of State Housing Agencies, National Federation of Municipal Analysts, and Public Securities Association.

²⁸ *Id.*

²⁹ See *In re Washington Public Power Supply System Securities Litigation*, 623 F. Supp. 1466, 1478 (W.D. Wash. 1985). See also *Brown v. City of Covington*, 805 F.2d 1266, 1270 (6th Cir. 1986).

C. Areas Where Improvement is Needed

1. Conflicts of Interest and Other Relationships or Practices

Information concerning financial and business relationships and arrangements among the parties involved in the issuance of municipal securities may be critical to an evaluation of an offering.³⁵ Recent revelations about practices used in the municipal securities offering process have highlighted the potential materiality of information concerning financial and business relationships, arrangements or practices, including political contributions, that could influence municipal securities offerings. For example, such information could indicate the existence of actual or potential conflicts of interest, breaches of duty, or less than arms' length transactions. Similarly, these matters may reflect upon the qualifications, level of diligence, and disinterestedness of financial advisers, underwriters, experts and other participants in an offering. Failure to disclose material information concerning such relationships, arrangements or practices may render misleading statements made in connection with the process, including statements in the official statement about the use of proceeds, underwriters' compensation and other expenses of the offering. In addition, investors reasonably expect participants in municipal securities offerings to follow standards and procedures established by such participants, or other governing authorities, to safeguard the integrity of the offering process; accordingly, material deviations from those procedures warrant disclosure.

Existing rules and voluntary guidelines call for certain specific disclosures by offering participants. GFOA guidelines call for offering statement disclosure to investors of contingency fees

to named experts, including counsel, and any other interest or connection those parties have with other transaction participants.³⁶ MSRB rules call for dealer disclosure to issuers and investors of any financial advisory relationship between an issuer and a broker, dealer, or municipal securities dealer, under certain circumstances.³⁷ MSRB rules also call for dealer disclosure to investors of, among other things, certain fees and expenses in negotiated transactions.³⁸

Beyond existing specific disclosure requirements and guidelines, the range of financial and business relationships, arrangements and practices that need to be disclosed depends on the particular facts and circumstances of each case. If, for example, the issuer (or any person acting on its behalf) selects an underwriter, syndicate or selling group member, expert, counsel or other party who has a direct or indirect (for example, through a consultant) financial or business relationship or arrangement with persons connected with the offering process, that relationship or arrangement may be material.³⁹ Areas of particular concern are undisclosed payments to obtain underwriting assignments and undisclosed agreements or arrangements, including fee splitting, between financial advisers and underwriters.⁴⁰ If the adviser is hired to assist the issuer, such relationships, financial or otherwise, may divide loyalties. Similarly, affiliations between sellers of property to be used in a financed project and conduit borrowers raise questions regarding, among other things, the determination of fair market value of the property and self-dealing.

2. Terms and Risks of Securities

Evolution in the financial markets has led to increasingly complex and sophisticated derivative and other municipal products. While these new

special district and industrial development revenue bonds.

³⁵See *SEC v. Washington County Utility District*, 676 F.2d 218, 222 (6th Cir. 1982) ("Flagrant violations" of anti-fraud provisions arising from failure to disclose use of proceeds to purchase options on property held by issuer's manager and financial arrangements between the manager and the underwriter).

³⁶Section XII.D. of the GFOA Guidelines.

³⁷MSRB rule G-23.

³⁸MSRB rule G-32. See Section 15B(c)(1) of the Exchange Act (15 U.S.C. 78o-4(c)(1) (requiring compliance with MSRB rules); MSRB rule G-17.

³⁹Gasparino, "The Trouble with Consultants", *The Bond Buyer* (Nov. 16, 1993) at 1. In his testimony before the Subcommittee on Telecommunications and Finance, An

drew Kintzinger, on behalf of the National Association of Bond Lawyers ("NABL"), stated:

[M]embers of the municipal finance bar should work with issuers to develop procurement procedures for state and local governments to ensure that all material financial arrangements between underwriters within the syndicate and between underwriters and financial advisors and possible conflicts of interest between issuers and members of the underwriting syndicate or other participants be accurately documented and disclosed or, if appropriate, prohibited.

NABL Testimony at 28. See Joint Statement at 2.

⁴⁰Gasparino, "Several Issuers Start to Scrutinize Ties Between Advisers, Bankers," *The Bond Buyer* (Dec. 27, 1993) at 1. See Section XII.C. of the GFOA Guidelines; Rule G-23 of the MSRB.

of cities, 78.3% of counties and 69% of school districts responding to a research survey.⁴⁹ Forty-six states currently require, or are in the process of establishing a requirement, that state government financial statements be presented in accordance with GAAP.⁵⁰ In addition, local as well as state governments that receive significant amounts of federal aid must prepare financial statements in accordance with GAAP or provide information concerning variance from GAAP.⁵¹

The GFOA Guidelines call for financial statements that are either prepared in accordance with GAAP or accompanied by a quantified (if practicable) explanation of the differences.⁵² To avoid misunderstanding, investors need to be informed of the basis for financial statement presentation. Accordingly, when a municipal issuer neither uses GAAP nor provides a quantified explanation of material deviations from GAAP, investors need a full explanation of the accounting principles followed.

b. Audits

Investors in the public securities markets have a reasonable expectation that annual financial statements contained in offering documents or periodic reports are subject to audit.⁵³ In the case of municipal issuers, these financial statement audits are typically conducted by either an independent certified public accountant or a state auditor. Although the frequency and timeliness of audits vary, every state requires some periodic audit verification of government financial statements.⁵⁴ A prudent investor needs to be able to evaluate the extent to which he or she can rely on the second look an auditor provides. Accordingly, the offering statement should state whether the financial statements it contains were audited in accordance with generally accepted auditing standards ("GAAS"), as estab-

lished by the American Institute of Certified Public Accountants.

c. Other Financial and Operating Information

Financial information beyond that contained in the financial statements—provided in tabular and narrative format, footnotes, supplemental tables, schedules and discussions of operations and financial position—is essential to the fair presentation of an issuer's financial performance and position. As reflected in industry guidelines,⁵⁵ the type of information needed (e.g., tax revenue base, budget, demographics, project revenues and operations) varies depending on the type of issuer, the type of security sold, and the sources for repayment of the bond obligations.

There are a number of areas in which greater care needs to be taken to provide investors with adequate information. In a pooled financing structure, such as that used by bond banks, in addition to providing financial information concerning the issuing authority or program in the aggregate, it may be necessary to provide information on participating obligors. This will depend on diversification and risk concentration factors, such as the significance of any single obligor to the overall financing.

Conduit bond issuers need to provide operational information concerning the activities of the private enterprise that will provide the cash flows to service the debt—for example, financial reporting, legal proceedings, changes in indebtedness, defaults and other significant developments relating to the underlying corporate obligor. Where the issuing authority in a conduit financing has no remaining obligation for the repayment of the indebtedness, in providing financial information about the issuing entity (as compared to the obligor on the bonds), care

⁴⁹Ingram & Robbins, *Financial Reporting Practices of Local Governments*, Government Accounting Standards Board (1987) at 12 (The survey results were based on information received from 567 respondents to a survey questionnaire mailed to 1161 government units).

⁵⁰*State Comptrollers: Technical Activities and Functions* (1992 Edition).

⁵¹Where state and local governments programs that are subject to the federal "Single Audit Act of 1984," P.L. 98-502 *et seq.* prepare financial statements on a basis other than GAAP, "the audit report should state the nature of the variances therefrom and follow professional guidance for reporting on financial statements which have not been

prepared in accordance with GAAP." Office of Management and Budget, "Questions and Answers on the Single Audit Process of OMB Circular A-128, 'Single Audits of State and Local Governments,'" 52 FR at 43716 (Nov. 13, 1987), question 35.

⁵²GFOA Guidelines at 45.

⁵³See Gauthier, *An Elected Official's Guide to Auditing* (1992) at vii and xi.

⁵⁴State Comptrollers: Technical Activities and Functions: NASACT, *Municipal Task Force Report* (1990) ("NASACT 1990 Task Force Report") at 12.

⁵⁵See generally, GFOA Guidelines; NFMA Handbook. See also *infra* n. 84.

writing securities absent a commitment to provide ongoing information. In the Companion Release, the Commission is proposing such a rule for comment. In order to fully inform investors, an issuer needs to include in the official statement a description of the scope of its continuing disclosure commitment, the type of information that would be provided, the repositories to which the information would be sent, when annual and other periodic information would be available, and the consequences of the issuer's failure to abide by the requirements of the covenant.

5. Clarity and Conciseness

Like other disclosure documents, official statements need to be clear and concise to avoid misleading investors through confusion and obfuscation. The expanded level of disclosure in official statements and increased sophistication of municipal securities instruments have, in many cases, resulted in longer and more complex disclosure documents, with the corresponding danger of overly detailed, legalistic, and possibly obtuse disclosure.⁶³

The location, emphasis, and context of the disclosure can affect the ability of a reasonable investor to understand the relationship between, and cumulative effect of, the disclosure.⁶⁴ As the U.S. Court of Appeals for the Second Circuit has stated:

[D]isclosures in a prospectus must steer a middle course, neither submerging a material fact in a flood of collateral data, nor slighting its importance through seemingly cavalier treatment. The import of the information conveyed must be neither oversubtle nor overplayed, its meaning accurate, yet accessible.⁶⁵

Appropriate disclosure "is measured not by literal truth, but by the ability of the material to accurately inform rather than mislead" inves-

tors.⁶⁶ As the Commission has indicated in other contexts, legalistic, overly complex presentations and inattention to understandability can render the disclosure incomprehensible and consequently misleading.⁶⁷

6. Delivery of Official Statements

One of the concerns leading to the adoption of Rule 15c2-12 was that underwriters were not receiving official statements within time periods that would allow them to examine the accuracy of the disclosure.⁶⁸ The Commission noted in proposing the rule that

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.⁶⁹

To address this concern, the rule requires any underwriter, including lead underwriters, syndicate members, and selling group members that receive in excess of the usual seller's commission, to obtain and review an official statement that is deemed final as of its date by the issuer, except for the omission of certain information, before bidding for, purchasing, offering, or selling municipal securities in a primary offering.

Since the adoption of Rule 15c2-12, however, there have been continued problems with the timeliness of receipt by underwriters of the "near final" official statement required by the Rule.⁷⁰ In addition to compromising the ability

⁶³ See GFOA Testimony at 6. See also Allstate Letter.

⁶⁴ *Isquith v. Middle South Utilities*, 847 F.2d 186, 201 (5th Cir.), cert. denied, 488 U.S. 926 (1988); *Kas v. Financial General Bankshares, Inc., et al.*, 796 F.2d 508, 516 (D.C. Cir. 1986); *Kennedy v. Tallant*, 710 F.2d 711, 720 (11th Cir. 1983).

⁶⁵ *Isquith*, 847 F.2d at 202.

⁶⁶ *McMahan & Company, et al. v. Warehouse Entertainment, Inc.*, 900 F.2d 576, 579 (2d Cir. 1990).

⁶⁷ See, e.g., Limited Partnership Reorganizations and Public Offerings of Limited Partnership Interests, Securities Act Release No. 6900 (June 25, 1991) 56 FR 28979, 28980 ("Limited Partnership Release").

⁶⁸ Proposing Release, 53 FR at 37781.

⁶⁹ Proposing Release, 53 FR at 37782.

⁷⁰ As a practical matter, near final official statements distributed to underwriters to satisfy Rule 15c2-12(b)(1) are often the same document as the preliminary official statement distributed to potential customers pursuant to Rule 15c2-12(b)(2). See Mudge Rose Guthrie Alexander & Fendon (April 4, 1990) ("Mudge Rose") (rejecting the argument that in a negotiated offering, the identification of a credit enhancer and related information about the credit enhancer may be omitted on the assumption that the information depends on pricing). See also Fippinger & Pittman, *Disclosure Obligations of Underwriters of Municipal Securities*, 47 Business Lawyer 127, 140 (Nov. 1991). In addition, underwriters are required to deliver to potential cus-

note, from a private enterprise, rather than from the general credit and taxing power of the governmental issuer. The tax-exempt status of interest payments does not alter the fundamental analysis that these are private obligations, in which the investor looks, and can look, only to a private entity for repayment.

The private nature of many conduit enterprises distinguishes them from traditional municipal financings. The incidence of bond default appears to be inversely related to the degree a financed project represents an essential public service.⁷⁹ A study conducted by the PSA on non-rated issues that defaulted found that 75% were issued by local authorities in the areas of health care and industrial related sectors such as energy, chemical, pollution control and industrial development.⁸⁰

Given the essentially private nature of non-governmental industrial development financings, investors need the same disclosure regarding the underlying non-municipal corporate obligor as they would receive regarding any corporate obligor, and the same regulatory and liability scheme should apply. Accordingly, the Commission has consistently supported legislative proposals to amend Section 3(a)(2) of the Securities Act⁸¹ and Section 3(a)(29)⁸² of the Exchange Act to remove the registration exemption for the corporate credit underlying municipal conduit securities involving non-governmental industrial development (private activity) financing.⁸³ The Commission today renews that legislative recommendation.

Pending amendment to the securities laws to eliminate the registration exemption, the disclosure provided by such non-governmental conduit borrowers should be substantially the same as if such conduit borrower were subject to the information requirements of the federal securities laws applicable to the particular conduit borrower. For example, financial statements prepared in accordance with generally accepted accounting principles prescribed by the Financial Accounting Standards Board should be provided.

IV. DISCLOSURE IN THE SECONDARY MARKET FOR MUNICIPAL SECURITIES

While significant progress has been made in primary market disclosure practices in recent years, the same development has not taken place with respect to secondary market disclosure. The GFOA issued separate secondary market disclosure guidelines in 1979, but they have not yet achieved the broad acceptance accorded its primary offering guidance. In the last five years, the NFMA, the National Council of State Housing Agencies, and the Association of Local Housing Authorities have published sector specific guidelines for secondary market disclosure; the National Advisory Council of the National Association of State Auditors, Comptrollers and Treasurers ("NASACT") is in the process of preparing such guidelines for adoption by the states.⁸⁴ The GFOA's longstanding Certificate of Achievement program recognizes issuers that have prepared comprehensive annual financial reports meeting its guidelines. The

⁷⁹Kenny Default Report at 2.

⁸⁰PSA Default Report at 12.

⁸¹15 U.S.C. 77c(a)(2).

⁸²15 U.S.C. 78c(a)(29).

⁸³See Remarks of David S. Ruder, Chairman, SEC, "Disclosure in the Municipal Securities Markets." Before the Public Securities Association (Oct. 23, 1987) at 17-18; Letter from John S.R. Shad, Chairman, SEC to Representative Timothy E. Wirth, Chairman, House Subcommittee on Telecommunications, Consumer Protection, and Finance (March 12, 1985); 124 Cong. Rec. 21, 639 (1978) (letter from SEC Chairman Harold M. Williams to Senator Harrison A. Williams). There were two bills introduced, one in 1975 and one in 1978, that would have repealed the exemption from the registration requirements of the Securities Act of 1933, the filing and qualification provisions of the Trust Indenture Act and the periodic reporting requirements of the Securities Exchange Act of 1934. Neither bill was enacted. See also "Municipal Securities Full Disclosure Act of 1976," S. 2969, 94th Cong., 2d Sess. (Feb. 17, 1976).

Governmental industrial development financings, which would have retained their exempt status under prior proposals, include those financings in which the bonds are repaid from the general revenues of the governmental unit or the project or facility is a public facility (or part of a public facility) and owned and operated by or on behalf of the governmental unit. The prior proposals to register conduit financings would not have affected the separate exemption for securities issued by non-profit charitable organizations in Section 3(a)(4) of the Securities Act (15 U.S.C. 77c(a)(4)).

⁸⁴See Association of Local Housing Finance Agencies, *Guidelines for Information Disclosure to the Secondary Market* (1992) ("Local Housing Guidelines"); National Council of State Housing Agencies, *Quarterly Reporting Format for State Housing Finance Agency Single Family Housing Bonds* (1989) and *Multi-family Disclosure Format* (1991) collectively ("State Housing Guidelines"); NFMA Handbook. See also Healthcare Financial Management Association, *Statement of Principles of Public Disclosure of Financial and Operating Information by Healthcare Providers* (Exposure Draft dated Aug. 1, 1993) ("Healthcare Disclosure Principles").

current information from indenture trustees are often turned away on the grounds that they are not current holders of the securities.⁹¹ As a result, investors purchasing municipal securities in the secondary market risk doing so on the basis of incomplete and outdated information.

Since access by market participants to current and reliable information is uneven and inefficient, municipal issuers presently face a risk of misleading investors through public statements that may not be intended to be the basis of investment decisions, but nevertheless may reasonably be expected to reach the securities markets. As market participants have urged,⁹² in order to minimize the risk of misleading investors, municipal issuers should establish practices and procedures to identify and timely disclose, in a manner designed to inform the trading market, material information reflecting on the creditworthiness of the issuer and obligor and the terms of the security.⁹³

B. *Secondary Market Disclosure*

There is general recognition of the need for disseminating comprehensive information on an annual basis and, on a more timely basis, information about material events that reflect on the credit quality of the security.⁹⁴

1. *Annual Information*

Investors need updated comprehensive information sufficient to enable them to evaluate the financial condition, results of operations and cash flows of the issuer or underlying borrower. Although the issuance of comprehensive annual information has not yet become prevailing practice, it is recommended by industry disclosure

guidelines, including those published by the GFOA in connection with its Comprehensive Annual Financial Reports ("CAFRs") award program, NFMA, and the other industry specific guidelines,⁹⁵ and is an effective means of providing the market updated information about the issuer and the issue. The GFOA Guidelines for Continuing Disclosure call for, either in an official statement or comprehensive annual report, a description of:

- the issuer and its structure, management, assets and operations;
- the issuer's debt structure (including changes in indebtedness);
- the issuer's finances (including financial condition and results of operations and financial practices of the issuer of the enterprise);
- legal matters affecting the issuer, including litigation and legislation.
- ratings, and
- interests of certain persons.

The GFOA Guidelines also specify additional information to be provided by conduit borrowers. The eligibility criteria for a Certificate of Achievement from GFOA include audited financial statements prepared in accordance with GAAP, reported upon by an independent public auditor. The guidelines for CAFRs include both a financial section and a statistical section.⁹⁶

For frequent issuers, current information can be disseminated in official statements for new offerings, and thus is readily available without the preparation of a separate annual financial report. Regardless of the form of document relied

⁹¹ Under notice provisions of indentures, the issuer and trustee generally are required to provide notice to existing bondholders of events of default and other significant matters, such as draw on reserves, a failure to renew a letter of credit, or a substitution of collateral. ABA 1991 Guidelines at 10. Indeed, trustees often deny requests by market participants for information out of concern for liability arising from exceeding the authority set forth in the indenture. Fippinger at 325. This situation led the American Bankers Association Corporate Trust Committee, in cooperation with the National Association of Bond Lawyers, to develop agreed upon guidelines for indenture provisions permitting the trustee to provide public notice of specified events. See ABA 1991 Guidelines.

⁹² See GFOA Guidelines at 91-97; Joint Statement.

⁹³ National Association of Bond Lawyers and Section of Urban, State and Local Government Law, American Bar Association, *Disclosure Roles of Counsel in State and Local Government Securities Offerings* at 135 (forthcoming 1994) (Pre-publication Draft) ("ABA Disclosure Roles")

(noting that many municipal issuers have concluded that post-issuance disclosure in accordance with GFOA guidelines can be more efficient and expose them to less potential liability than ad hoc disclosures).

⁹⁴ See GFOA Testimony; Mires, "An Investor's Framework for Examining Disclosure Issues and Possible Solutions," *The Bond Buyer* (Feb. 7, 1994) at 24; NASACT Blue Ribbon Committee Report at 7. See also PSA Testimony at 6, supporting annual financial statement filing requirements and submission of information regarding any material fact for issuers who borrow \$1 million or more annually.

⁹⁵ See ABA Disclosure Roles at 134-136; ABA 1991 Guidelines; Association of Local Housing Guidelines; Healthcare Disclosure Principles. The Disclosure Task Force of the National Council of State Housing Agencies is developing standards for the issuance of audited financial and annual reports.

⁹⁶ See GFOA Certificate of Achievement for Excellence in Financial Reporting Program: GFOA Guidelines at 64.

tors of information to the market due to the capacity and duties of trustees under the terms of the indentures, which positions them to have knowledge of the events requiring disclosure, and the ability and authority to communicate with bond-holders.¹⁰⁰ The Commission encourages the inclusion of provisions in trust indentures that authorize trustees to transmit information to the market, particularly in structured financings where the issuer's obligations generally are delegated to various participants. Trustees also may provide a service to other small issuers, by enabling them to notify the market in a timely manner and at a lower cost.

The common denominator for current proposals to improve secondary market disclosure for municipal securities is the establishment and designation of one or more information repositories to serve as a collection and access point for annual and current information.¹⁰¹ Such repositories would serve as predetermined sources for information concerning a particular issuer, allowing participants to verify that they have the latest available information concerning the issuer before recommending, purchasing, or bidding for a security. The repositories would supplement, not substitute for, the existing access bond holders may have to issuers to obtain current information.¹⁰²

In the accompanying release, the Commission is proposing an amendment to Rule 15c2-12 to prohibit, as suggested by the Joint Statement, underwriting of a municipal securities issue unless the issuer of the municipal security has

covenanted to provide annual and ongoing disclosure to a repository.

V. INTERPRETIVE GUIDANCE WITH RESPECT TO OBLIGATIONS OF MUNICIPAL SECURITIES DEALERS

In the Proposing and Adopting Releases for Rule 15c2-12, the Commission set forth its interpretation of the obligation of municipal underwriters under the antifraud provisions of the federal securities laws. The interpretation discussed the duty of underwriters to the investing public to have a reasonable basis for recommending any municipal securities, and their responsibility, in fulfilling that obligation, to review in a professional manner the accuracy of statements made in connection with the offering. The interpretation was set out in the Proposing Release, and modified slightly in the Adopting Release. The Commission reaffirms its Interpretation with respect to underwriters' responsibilities under the antifraud provisions of the federal securities laws.¹⁰³

Furthermore, the Commission believes that it is also appropriate to emphasize the responsibilities of brokers and dealers in trading municipal securities in the secondary market. The Commission historically has taken the position that a broker-dealer recommending securities to investors implies by its recommendation that it has an adequate basis for the recommendation.¹⁰⁴ A dealer, unlike an underwriter, ordinarily is not obligated to contact the issuer to verify information. A dealer must, however, have a reasonable basis for its recommendation.¹⁰⁵ If, based on publicly available informa-

¹⁰⁰ See ABA 1991 Guidelines at 3.

¹⁰¹ Consistent with the recent recommendation of the Joint Statement, the GFOA Guidelines call for lodging secondary market disclosure with a repository, as did the ABA guidelines published in 1991. GFOA Guidelines, Procedural Statement No. 8; ABA 1991 Guidelines at 3.

¹⁰² The American Bankers Association Corporate Trust Committee and the National Association of Bond Lawyers, as well as the Joint Statement, have expressed concern that securities depositories and their participants do not retransmit notices they receive from trustees and issuers to the beneficial owners of the issuer's securities. The ABA Corporate Trust Committee sought to address the problem by calling for simultaneous dissemination of the information to the marketplace through an information repository. The National Association of Bond Lawyers has suggested that the Commission promulgate a rule mandating that all depositories and their direct and indirect participants promptly retransmit notices received from the issuer or indenture trustee. While the establishment of information repositories may address the problem to some extent, the Commission staff intends to work with the relevant organizations to assure that steps are taken to provide for consistent retransmission of the information.

¹⁰³ In light of the underwriter's obligation, as discussed in the prior releases, to review the official statement and to have a reasonable basis for its belief in the accuracy and completeness of the official statement's key representations, disclaimers by underwriters of responsibility for the information provided by the issuer or other parties, without further clarification regarding the underwriter's belief as to accuracy, and the basis therefor, are misleading and should not be included in official statements.

¹⁰⁴ See *Donald T. Sheldon*, Securities Exchange Act Release No. 31475 (Nov. 18, 1992); *Elizabeth Bamberg*, Securities Exchange Act Release No. 27672 (Feb. 5, 1990); *Feeney v. SEC*, 564 F.2d 260 (8th Cir. 1977); *Nassar & Co.*, Securities Exchange Act Release No. 15347 (Nov. 22, 1978). See also Proposing Release, 53 FR at 37787, n. 72-73.

¹⁰⁵ *Richard J. Buck & Co.*, 43 SEC 998 (1968), *aff'd sub nom. Hanley v. SEC*, 416 F.2d 589 (2d Cir. 1969). See also *The Obligations of Underwriters, Brokers and Dealers in Distributing and Trading Securities, Particularly of New High Risk Ventures*, Securities Act Release No. 5275 (Aug. 9, 1972) 37 FR 16011, 16012-13; *In Re Blumenfeld*,