STAFF REPORT ON THE MUNICIPAL SECURITIES MARKET

The Division of Market Regulation
U.S. Securities and Exchange Commission*

September 1993

*Although the Commission has authorized publication of this report, it has expressed no view regarding the analysis, findings, or conclusions herein.

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I. The Municipal Securities Market Today

The municipal securities market comprises approximately 50,000[1] state and local issuers[2] with an outstanding principal amount of securities in excess of $1.2 trillion.[3] In 1992, 12,709 new issuances of municipal securities took place, with a value of $235 billion.[4] (See Charts A & B). Approximately 2,600 municipal securities dealers, banks, and brokers actively trade in municipal securities.[5]

The types of securities municipalities generally issue include general obligation bonds, revenue bonds, and conduit bonds. General obligation bonds are secured by the full faith and credit and general taxing power of the issuer.[6] A holder of a general obligation bond may look for repayment to all sources of revenue that the municipality is entitled to receive.[7] Revenue bonds, on the other hand, are typically issued to support a particular project, and are paid for out of revenues from that project.[8] "Conduit" bonds, such as industrial development bonds, are securities issued to finance a project that is to be used in the trade or business of a private corporation.[9] Typically, investors must look solely to the credit of the private entity for payment of interest and principal.[10]

During the past few years, the municipal bond market has experienced a proliferation of complex derivative products. Among these are principal and interest strips,[11] pooled municipal investment vehicles, detachable call options,[12] and new variable rate securities.[13] These new forms of municipal securities are designed to reduce issuers' costs while creating securities that meet perceived investment needs of particular types of municipal investors. The complexity of new products appears to be limited only by the ingenuity of investment bankers and inherent limitations on issuers as a result of state and federal laws, including federal tax laws.

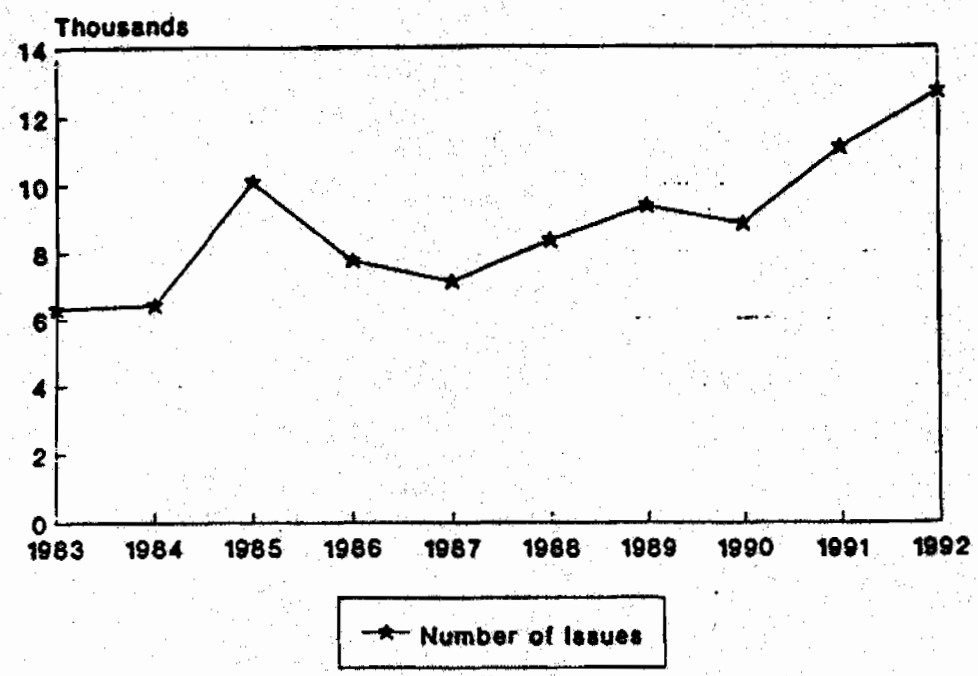
The profile of the typical investor in municipal securities also has changed dramatically over this century. Historically,[14] investors in municipal bonds were institutions and wealthy individuals wishing to take advantage of the tax-exempt status of fairly low-

risk[15] municipal securities.[16] The interest received by holders of most municipal securities was exempt from federal income taxation, and in some cases, from state and local income taxation, and thus was very attractive to taxpayers in higher tax brackets. With the changing income tax rates, persons of more moderate means increasingly have invested in municipal securities.[17] Today, households are the largest holders of municipal debt, followed by municipal bond mutual funds, property and casualty insurers, commercial banks, and money market funds.[18] (See Chart C).

At the same time that the investors in municipal securities have become more diverse, municipal financings have become increasingly complex. At one time, general obligation bonds were most prevalent. Today, however, most offerings consist of revenue bonds, which are not backed by the full faith and credit of the issuer, and may have the potential for greater investment risk. (See Chart D). In addition to the trend away from the general obligation bond, there has been an increase in issuances by statutory authorities or special purpose public corporations. Partly as a result of the increasing complexity of underwritings, negotiated underwritings, rather than competitively bid underwritings, are now much more prevalent than in the past.[19] (See Chart E).

Both the changes in investors and in offerings have caused shifts in the manner in which municipal securities are marketed. More diverse investors have different objectives that must be satisfied, and the greater number of smaller transactions has increased the costs of issuing municipal securities.[20] Furthermore, the introduction of complex derivative instruments has increased the difficulty of both investors and salespeople in understanding these products. The relative lack of sophistication of individuals purchasing municipal securities places a greater responsibility on salespeople to determine that investments are suitable for particular individuals and increases reliance on disclosure documents. Municipal securities regulation must be reviewed in light of these diverse and dynamic developments.

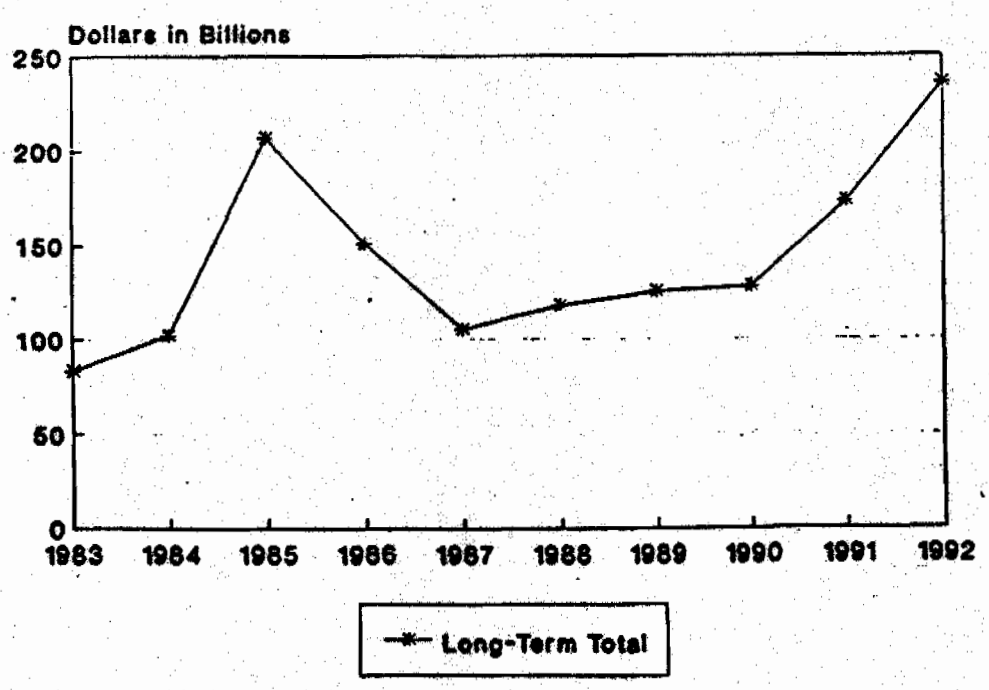
Municipal Bond Issues 1983-1992



Source: Bond Buyer 1993 Yearbook

Chart A

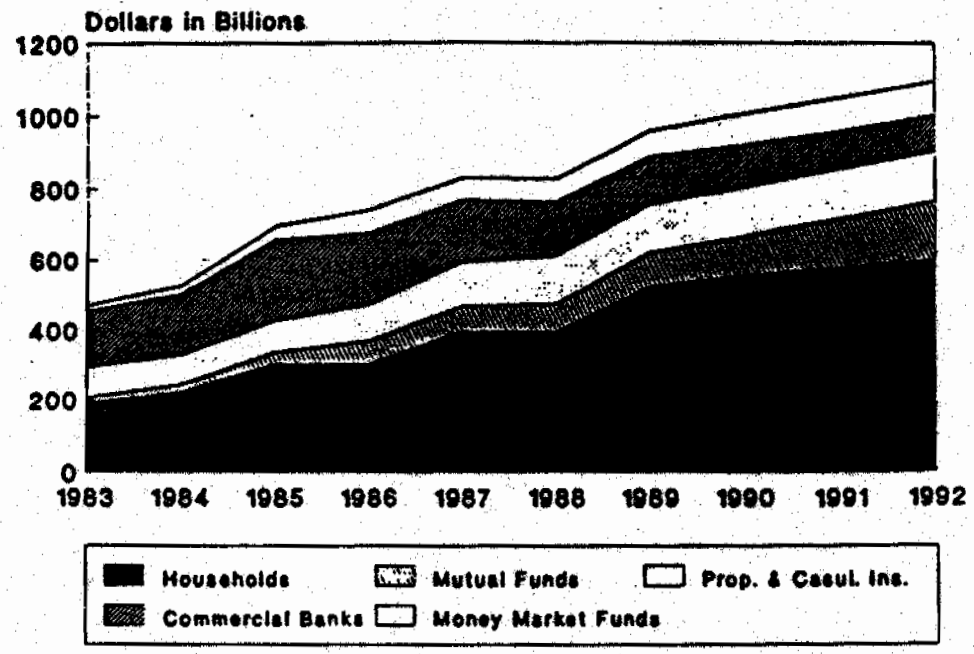
Long-Term Total $ Volume 1983-1992



Source: Bond Buyer 1993 Yearbook

Chart B

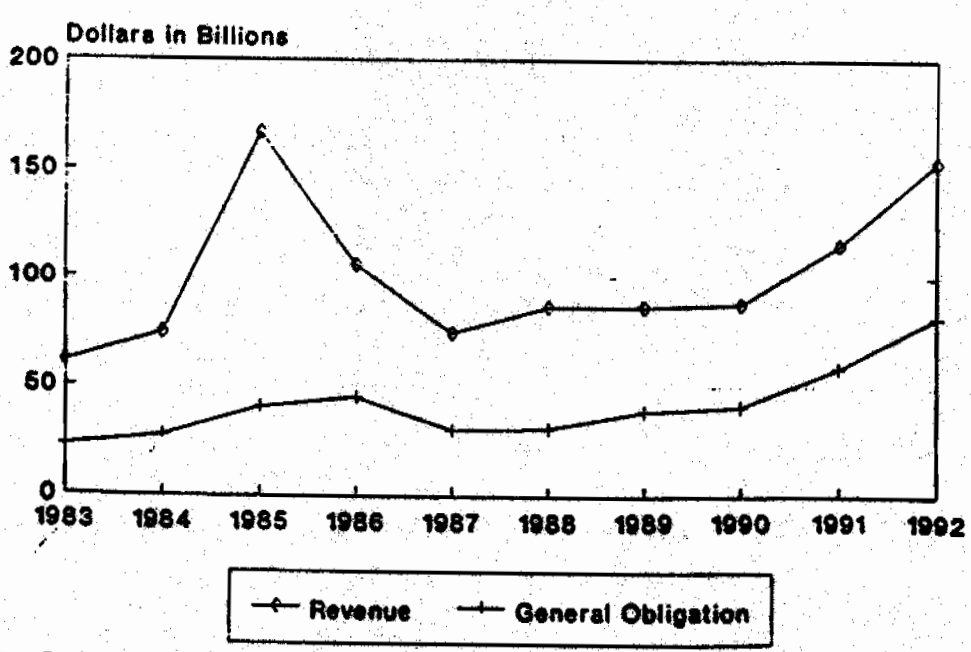
Holders of Municipal Debt 1983-1992



Source: Bond Buyer 1993 Yearbook

Chart C

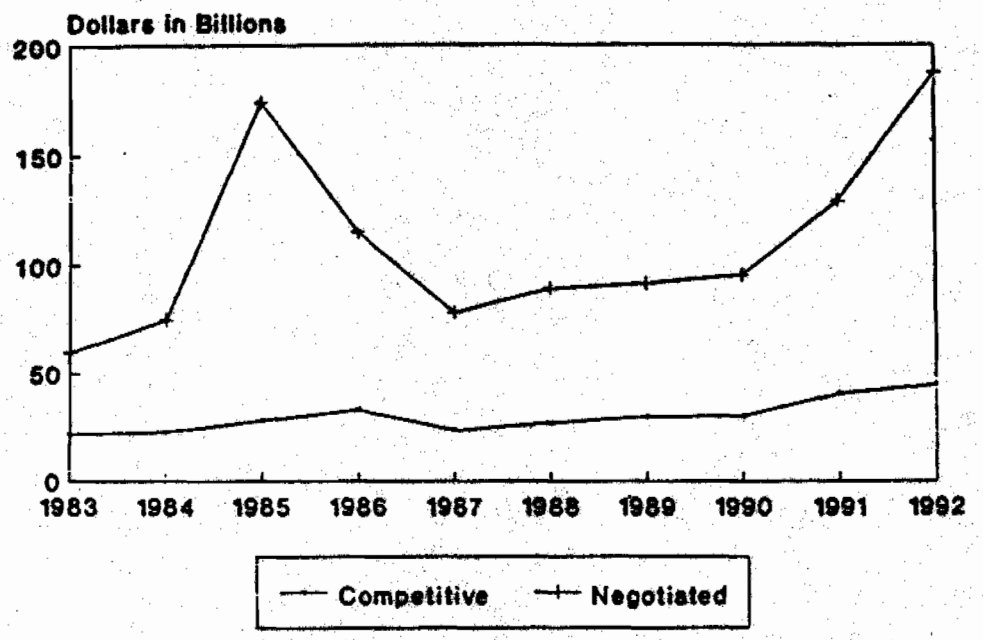
Municipal Debt 1983-1992
Revenue vs General Obligation Bonds



Source: Bond Buyer 1993 Yearbook

Chart D

Municipal Bonds 1983-1992
Competitive vs Negotiated Bonds



Source: Bond Buyer 1993 Yearbook

Chart E

II. The Regulatory Structure

The market for municipal securities was largely unregulated at the federal level for much of this century. Both the Securities Act of 1933 ("Securities Act")[21] and the Exchange Act of 1934 ("Exchange Act")[22] were enacted with provisions containing broad exemptions for municipal securities from all of their provisions except for the antifraud provisions of Securities Act Section 17(a) and Exchange Act Section 10(b).

During the early 1970s, the Commission brought seven injunctive actions against 72 municipal securities professionals for a variety of abusive practices, including excessive mark-ups, churning of customers' accounts, misrepresentations concerning the nature and value of municipal securities, disregard of suitability standards, and high pressure sales techniques.[23] In light of these types of problems in the market, as well as the changing profile of the typical investor, the growth in the size of the market, and the variety of types of debt issued, Congress, as part of the Securities Acts Amendments of 1975 ("1975 Amendments"),[24] created a limited regulatory scheme at the federal level.[25] That scheme included mandatory registration of municipal securities brokers and dealers, and creation of the Municipal Securities Rulemaking Board ("MSRB") with authority to promulgate rules governing the sale of municipal securities. In addition, Congress gave the Commission broad rulemaking and enforcement authority over all municipal securities brokers and dealers.[26]

The 1975 Amendments required firms that dealt only in municipal securities, and that operated on an interstate basis, to register with the Commission as broker-dealers. Although banks continued to be excluded from the general broker-dealer definitions,[27] municipal securities dealers were defined to include any person engaged in the buying or selling of municipal securities for its own account, including a separately identifiable department or division of a bank,[28] and were required to register with the Commission. In addition to banks, firms dealing in municipal securities on an intrastate basis, which were not previously

subject to Exchange Act registration requirements, were required to register as municipal securities dealers.

The 1975 Amendments also established the MSRB as a self-regulatory organization ("SRO") for brokers and dealers in municipal securities. The MSRB has a 15 member board that represents non-bank broker-dealers, bank dealers, and members of the public (including an issuer representative).[29] The MSRB, unlike other SROs, was not given inspection or enforcement powers, nor was it created as a membership organization.

In establishing the MSRB, Congress created a single rulemaking body whose rules applied equally to banks and non-banks. The MSRB, under the Commission's supervision, was given rulemaking authority over municipal securities brokers and dealers in the areas, among others, of professional qualifications, recordkeeping, quotations, and advertising.[30]

Congress divided responsibility for enforcement of MSRB rules. Bank regulatory agencies were granted enforcement authority regarding these rules over bank municipal securities dealers.[31] The National Association of Securities Dealers, Inc. ("NASD") was granted enforcement authority over non-bank firms registered with the Commission.[32] The Commission has broad disciplinary authority over all municipal securities brokers, dealers, and their associated persons.[33] Enforcement activities regarding municipal securities dealers must be coordinated by the Commission, the NASD, and the appropriate regulatory agency.[34] The 1975 Amendments also extended the Commission's specialized broker-dealer antifraud, recordkeeping, and reporting rulemaking authority to municipal securities dealers.[35]

The 1975 Amendments did not create a regulatory regime for municipal issuers or impose any new requirements on these municipal issuers. Indeed, the 1975 Amendments expressly limited the Commission's and the MSRB's ability to establish municipal issuer disclosure requirements. The Commission and the MSRB are prohibited from requiring municipal securities issuers, either directly or indirectly, to file any application, report, or

document with the Commission or the MSRB prior to any sale by the issuer. The 1975 Amendments do not, by their terms, preclude the Commission from promulgating disclosure standards in municipal offerings, although there is no express statutory authority contained in the Exchange Act over disclosure by municipal issuers. The MSRB also is prohibited, either directly or indirectly, from requiring issuers to furnish investors or the MSRB with any "report, document, or information" not generally available from a source other than the issuer. This section was intended to make clear that the legislation was not designed to subject states, cities, counties, or any other municipal authorities, to any disclosure requirements that might be devised by the MSRB.[36] These sections collectively are known as the "Tower Amendment."[37]

Since the 1975 Amendments, the Commission has recommended legislative changes and, in particular, questioned the wisdom of the limitations imposed.[38] In 1985, the Commission advocated the repeal of the limitations imposed on the MSRB's authority in the aftermath of the default on bonds issued by the Washington Public Power Supply System ("WPPSS").[39] The 1983 default on $2.25 billion of WPPSS bonds issued between 1977 and 1981 was the largest non-payment default in municipal bond history. A Commission investigation into the circumstances of the default highlighted the deficient disclosure made to investors in WPPSS securities.[40] The Commission suggested that broadening of the MSRB's authority was a way to strengthen municipal securities disclosure, and was the "least intrusive" means of improving the flow of information to investors.[41] In 1987, Chairman David Ruder again called for repeal of Exchange Act Section 15B(d)(2), prompted by a concern that issuers were not making copies of disclosure statements available to underwriting syndicates.[42] The Commission subsequently acted directly to address the issues highlighted by Chairman Shad and Chairman Ruder in its adoption of Exchange Act Rule 15c2-12 and accompanying interpretation concerning the due diligence obligation of municipal securities underwriters.[43]

III. Market Practices

A. Political Contributions

Recently, concern has arisen regarding press reports of allegations that certain registered municipal securities dealers, their employees, and related parties, have made payments, political contributions, or entered into business ventures with political figures to obtain the underwriting business of municipal securities issuers. These reports call into question the integrity of the municipal securities market and the business practices municipal underwriters use to obtain underwriting contracts. Without guidelines regarding political contributions and influence seeking practices, and because of great competitive pressures to obtain business, municipal securities firms and the offering process may become compromised.

The use of political contributions and influence buying to obtain municipal underwriting business raises a number of concerns for the municipal securities markets. If political influence is the determinative factor in the choice of municipal dealers as underwriters in an offering, the ability and willingness of the underwriter to conduct a thorough due diligence inquiry is likely to be compromised. If underwriter selection is swayed by political contributions or influence, then underwriters may be chosen based on their history of contributions or political contacts, rather than their expertise or competence in a particular type of municipal issuance.[44] Underwriters working on a particular issuance may be assigned similar roles, and take on equivalent risks, but be given different allocations of bonds to sell -- leading to differing profits -- based on their political contributions or contacts. Political contributions also may add an element of expense to the cost of underwriting a municipal issuance that is eventually passed on to taxpayers in higher issuance costs. Underwriters may demand higher spreads to account for such expenses. The greatest cost to undisclosed contributions or improper payments, however, may relate to the loss of investor confidence in the integrity of the market.

The Staff is currently reviewing the practices of a number of brokers and dealers with respect to the use of political contributions and other forms of political influence, including possible improper payments to financial advisers and other third parties for purposes of influencing issuers' selection of underwriters. On June 4, 1993, the Staff of the Commission's Division of Enforcement requested that a number of municipal securities broker-dealers who engage in significant municipal securities underwriting activities voluntarily provide information on their political contributions or special arrangements.[45] The Staff sought information from firms regarding all municipal securities offerings for which they acted as lead or co-lead underwriter or financial adviser. The Staff also has requested information about each firm's procedures, if any, that address firm or underwriting department political contributions, as well as information about contributions made by each firm and its officials to elected officials or employees of government agencies connected to municipal financings being handled by each firm. The Staff is presently reviewing the information received in response to the inquiry. The Staff is unable at this time to draw conclusions regarding the extent of political contributions by underwriters and other influence seeking activities, or the federal securities provisions that may be implicated by such activities, though it expects to be able to make a further report after fully analyzing all of the information it will eventually receive.

The Staff also has made a preliminary review of both the authority of the Commission and of the MSRB to regulate municipal underwriters' gifts and political contributions to employees of municipal issuers.[46] The Staff believes that the Commission has sufficient authority under Sections 15(c)(2) and 17(a)(1) of the Exchange Act to require disclosure of political contributions and other payments to obtain political influence by municipal underwriters. Exchange Act Rule 15c2-12 currently imposes disclosure dissemination requirements on municipal underwriters.[47] As discussed below, however, the rule does not currently contain specific disclosure requirements with respect to the issuer or

the underwriter. Instead, underwriter disclosure provisions traditionally have been imposed by the MSRB.

The Staff also believes that the MSRB has the authority to regulate underwriters' gifts and political contributions under the 1975 Amendments and specifically, Section 15B of the Exchange Act. In enacting Section 15B of the Exchange Act, Congress provided the MSRB with broad rulemaking authority over municipal securities brokers and dealers limited to Section 15B's enumerated purposes and standards. Two principal purposes of Section 15B include the prevention of fraudulent and manipulative acts and practices and the promotion of just and equitable principles of trade.[48] The legislative history to the 1975 Amendments adopting Section 15B stated that Congress did not believe it would be desirable to restrict the MSRB's authority by a specific enumeration of subject matters. "The ingenuity of the financial community and the impossibility of anticipating all future circumstances are obvious reasons for allowing the [MSRB] a measure of flexibility in laying down the rules of the municipal securities industry."[49]

B. Sales Practices

Traditionally, municipal securities were considered a safe, but conservative investment. Municipal issuers commonly were governmental units that sold conventional general obligation debt instruments. Because for many years interest rates were stable, purchasers who chose to sell municipal bonds before redemption faced little risk of loss of principal. The buyers of municipal securities were predominantly institutional investors such as banks and insurance companies. Those individuals who purchased municipal securities often put their funds in the securities of local issuers whose credit was known and respected.

As conditions changed over the years, the protection of investors in the municipal markets became a greater concern. A wide variety of municipal instrumentalities have entered the municipal securities market; new forms of municipal bonds have been developed; interest rates have grown more volatile; and individual investors have become greater

participants in these markets. These factors have created new risks for investors in the municipal markets, and have made the individual investor more reliant on the advice of the salesperson at a municipal securities broker-dealer. As a result, the regulation and oversight of the sales practices of municipal securities broker-dealers has grown in importance.

In response to these developments, Congress in 1975 granted the MSRB the authority and responsibility to develop standards governing the sales activities of brokers and dealers in municipal securities. At the same time, Congress gave the Commission authority to regulate directly the municipal securities activities of brokers, dealers, and municipal securities dealers.

As noted above, prior to the enactment of the 1975 Amendments, the activities of bank dealers and securities firms as municipal market professionals were governed solely by the antifraud provisions of the federal securities laws.[50] A primary purpose of Section 15B of the Exchange Act, added by the 1975 Amendments, is to establish rules governing the conduct of municipal securities brokers and dealers to prevent fraudulent and manipulative acts and practices and promote just and equitable principles of trade.[51]

1. MSRB Fair Practice Rules

The MSRB has promulgated rules of fair practice to regulate the conduct of municipal securities brokers and dealers. In particular, these rules, which are designed to assure that brokers and dealers observe high professional standards in their conduct toward customers, address fair dealing, suitability, and fair pricing.

MSRB rule G-17, the MSRB's general fair dealing rule, requires each municipal securities broker and dealer, in the conduct of its business, to deal fairly with all persons and prohibits any deceptive, dishonest, or unfair practice. The MSRB has interpreted this requirement to mean, among other things, that a dealer must disclose to a customer, at or before the time of sale, all material facts concerning the transaction, including a complete description of the security, and must not omit any material fact that would render any other

statement misleading.[52] The rule requires municipal securities brokers and dealers to provide customers with sufficient information to ensure that the customer can make a reasoned and informed investment decision.

Under the MSRB's rules, the test for disclosure is whether the information would be relevant to a reasonable investor seeking to make an informed investment decision.[53] For example, the credit quality and the existence of early redemption provisions would be relevant to all investors and thus, brokers and dealers must disclose this information to investors. If the credit quality of an issue is questionable, or if an early redemption would affect substantially the customer's yield, the importance of these disclosures increases, as does the specificity of the disclosure required.[54]

The MSRB's suitability rule, MSRB rule G-19, requires brokers and dealers to know their customers and any security recommended to customers, and to ensure that securities recommended are suitable for the customer. MSRB rule G-19 requires that brokers and dealers either have prior knowledge of or inquire about "the customer's financial background, tax status, and investment objectives and any other similar information."[55] MSRB rule G-19 further provides two requirements that are applicable to each recommendation made to the customer -- (i) to know the security,[56] and (ii) to recommend only those securities that are suitable for the particular customer.

Following reports of investor losses in speculative municipal securities, such as Colorado special assessment districts,[57] in May, 1992 the Staff of the Commission's Division of Market Regulation ("Division") asked the MSRB to review its suitability rule. In particular, the Division was concerned about the sale to retail investors of non-rated bonds and the potential for reliance by dealers on what appeared to be a loophole in the MSRB's suitability rule.[58]

To satisfy the MSRB's current suitability requirement, the broker or dealer either must have reasonable grounds to believe that the recommendation is suitable in light of the

information that it knows, or have no reasonable grounds to believe that the recommendation is unsuitable for the customer if all of such information is not furnished or known. The Division urged the MSRB to consider whether brokers and dealers should in each case be required to obtain specified information bearing on suitability prior to the recommendation or the transaction. In particular, the Division asked the MSRB to review the effect of the provision of MSRB rule G-19 that permits the transaction to occur if the broker or dealer lacks relevant information but has "no reasonable grounds to believe the recommendation is unsuitable."

In response, the MSRB began a complete review of its customer protection rules, which is still underway. As part of its review, the MSRB requested comment generally on how customer protection could be improved,[59] and specifically on amendments to MSRB rule G-19, to strengthen municipal brokers' and dealers' suitability obligations. In June, 1993, the MSRB published for comment amendments to MSRB rule G-19 to strengthen the suitability requirements.[60] Among other things, the amendments to MSRB rule G-19 would require municipal brokers and dealers that recommend any municipal securities transaction to have reasonable grounds for believing the recommendation is suitable. The amendments also would require municipal securities brokers and dealers to make reasonable efforts to obtain information from non-institutional customers concerning: (1) the customer's financial status, (2) the customer's tax status, (3) the customer's investment objectives, and (4) other information considered reasonable and necessary in making recommendations to customers.

MSRB rule G-30 requires dealers to effect transactions with customers at fair and reasonable prices. Under this rule, the fairness and reasonableness of the price of a transaction is determined in light of all relevant factors, including: (1) the best judgment of the dealer as to the fair market value of the securities at the time of the transaction and of any securities exchanged or traded in connection with the transaction, (2) the expense

involved in effecting the transaction, (3) the fact that the dealer is entitled to a profit, and (4) the total dollar amount of the transaction.[61]

Municipal securities brokers and dealers have an obligation to deal fairly with public customers.[62] This duty of fair dealing entails an implied representation that the price a municipal securities broker or dealer charges bears a reasonable relationship to the prevailing market price.[63] If a broker or dealer's price to a customer includes an excessive mark-up over the prevailing market price, then, absent proper disclosure, the dealer has violated the antifraud provisions.[64]

To determine the mark-up charged to the customer, the dealer must determine the "prevailing market price."[65] The dealer mark-up equals the price charged to the customer less the prevailing market price. The Commission has held that mark-ups on debt securities, including municipal securities, are expected to be lower than mark-ups on equity securities.[66] Recently, the Commission upheld an NASD decision finding mark-ups as low as 4% to violate the rules of the MSRB.[67]

2. Disclosure of Mark-ups

In the equity markets, excessive mark-ups are addressed both by direct enforcement of the antifraud provisions and the NASD's mark-up policy,[68] and by disclosure to customers of transaction charges imposed by dealers in principal trades. This disclosure, provided on customer confirmations, includes mark-ups charged in riskless principal trades in equity securities,[69] as well as the difference between the reported trade price and the price to the customer in principal trades in all exchange-listed and NASDAQ equity securities.[70] In contrast, in the municipal market (and other debt markets), dealer transaction charges are not disclosed in any form.

Customer confirmation disclosure for municipal securities transactions is governed by MSRB rule G-15. This rule requires disclosure to customers of the amount of commission or other remuneration received if the municipal broker-dealer is acting as agent, but the rule

does not require mark-up disclosure for principal transactions, including riskless principal transactions.[71]

In the past, the Commission has published proposals to require confirmation disclosure of mark-ups in riskless principal transactions in municipal and other debt securities.[72] Although these proposals were never adopted, the Staff continues to believe that investors would benefit from information on mark-ups in riskless principal transactions, and where practicable, other principal transactions in debt securities. Although yield may be of primary importance to investors, this information would allow investors to understand the costs that affect the yield. It would allow investors to observe the transaction charges imposed by a broker-dealer and compare these charges to other broker-dealers selling the same securities. It also would allow investors to compare transaction charges in different markets.

Moreover, mark-up disclosure in riskless principal trades appears to be more feasible than it was a decade ago. Advances in order processing and trading technology have substantially reduced the costs of tracking and confirming mark-ups in riskless principal trades. In addition, since the earlier proposals, the Commission has had substantial experience with disclosure of mark-ups in riskless principal transactions in equities, and has not observed any harmful effects on the equity markets. For these reasons, the Staff is prepared to recommend for Commission consideration a proposal to require disclosure of mark-ups in riskless principal trades in debt securities.

3. Continuing Education/Qualifications Testing

In order to ensure that securities industry professionals are knowledgeable about the financial products they sell and to assist in the protection of investors, the SROs require that persons applying for positions as registered representatives of member firms pass an examination testing their knowledge of securities products and practices.[73] For example, a registered representative must pass the Series 7 examination (General Securities

Representative) in order to sell a wide range of securities products. Securities industry principals must pass the Series 24 exam (General Securities Principal), and financial and operations principals must pass the Series 27 exam.

Registered representatives that have passed the Series 7 exam are authorized to sell municipal securities. Of the 250 questions on the Series 7 exam, 60 questions deal with municipal securities. Registered representatives also may take a Series 52 exam to become a municipal securities representative and Series 53 is available to become a municipal securities principal; the exams contain 100 questions each and are solely on municipal securities.

The staff is concerned that, with the proliferation of derivative products based on municipal securities, sales personnel may not have the expertise to be able to adequately evaluate each new product. Committees formed by the SROs review and rewrite the exam questions on a periodic basis to reflect changes in products and practices. In light of the relative lack of continuing disclosure information, however, securities industry personnel may not be able to properly determine a new product's suitability for an individual customer.

There is the possibility that this situation may be remedied soon. The NASD and five other SROs have agreed to develop a single continuing education program for all securities industry registered representatives and principals.[74] An eleven member industry task force will report back to the six SROs by September 1993 with recommendations for implementing the program.

C. Transparency

Transparency is defined as the degree to which real-time trade and quotation information and other market-related information, such as information about the depth of the market, is available to all market participants. In a completely transparent market, all market participants have equal and immediate access to all quotations, including the size of

the quotations, and to reports of prices and volumes on all trades effected in the market. Although efforts to improve transparency in the market for municipal securities have been made, as discussed below, the Staff believes that the current level of transparency in the municipal securities market is inadequate.

There are significant structural differences between the secondary market for municipal debt when compared to the secondary market for other debt issues, such as corporate or United States Treasury debt obligations. There also are differences between the characteristics of municipal and equity securities. For example, although there exist over one million different municipal securities issues, only an average of 180 issues actively trade in the secondary market at any given time.[75] Further, most trading activity in a municipal securities issue occurs shortly after issuance. Municipal securities also are priced very differently from equity securities, in part because of their nature, and in part because of the way they trade. Nevertheless, those differences should not necessarily preclude last sale, volume and real-time quote dissemination to public investors and market participants for a segment of actively traded municipal securities.[76]

MSRB rule G-14 allows for voluntary dissemination of transaction information and establishes requirements for transaction reports voluntarily disseminated. MSRB rule G-13 prohibits the dissemination of a quotation relating to municipal securities unless the quotation represents a bona fide bid for, or offer of, municipal securities, and the quotation is based on the dealer's best judgment of the fair market value of the securities. The MSRB's rules do not require municipal securities brokers or dealers to disseminate firm quotations or last sale reports. Consequently, important market data, including last sale reports and firm quotations, is unavailable in the municipal securities market. Private initiatives are useful steps but, at the present time, do not provide a complete picture of broker and dealer trading.

Currently, several services disseminate limited municipal securities quotation information. For example, Standard & Poor's provides a computerized subscription service to dealers, through Telerate, known as the "Blue List Bond Ticker." The Blue List Bond Ticker disseminates municipal market information, including the price at which a dealer may be willing to sell a particular security.[77] Standard & Poor's provides approximately 8,900 listings per day through the Blue List Bond Ticker, with an 18% turnover for new listings and deletions. Other securities information vendors, such as Bloomberg, Quotron, and Bridge Data,[78] provide services primarily designed to list securities for which bids are being sought by dealers.[79] This enables brokers and dealers to disseminate information on municipal securities they are seeking to buy or sell, but does not include firm prices or sizes and does not include reports of executed trades.

An important source of data is the broker's broker. Broker's brokers act as agents and provide several services for municipal securities dealers. When dealers cannot obtain bids for securities in their inventory or if dealers want to maintain anonymity, they may request a broker's broker to find buyers in the market by obtaining bids from other dealers. Broker's brokers also may locate in the market certain securities or types of securities a dealer is willing to buy. Because of the anonymity provided by broker's brokers, they generally have access to more market information than dealers.

One such broker's broker is J.J. Kenny Co., Inc., ("Kenny") which has developed an automated communication system through which it disseminates quotations in certain municipal securities. For approximately 40 actively traded securities, Kenny publishes two-sided dealer quotations voluntarily provided. Kenny requires dealers to be firm for 250 bonds at their published bids and offers. For inactively traded securities, dealers willing to sell securities may request Kenny to list the security or may request Kenny to locate a purchaser without listing the security. Direct access to Kenny data is limited to broker-dealers. Institutions may subscribe to the Kenny screen, but may not enter quotations.[80]

Typically, dealers active in the municipal securities market rely on a variety of sources for receiving and disseminating information. They may subscribe to one vendor, such as Kenny, to receive quotation information, and another, such as Bloomberg or Bridge Data, to publish interest in a particular security. No participant is clearly dominant in this field.

Given the limited availability of this data, availability of market information for the municipal securities market can be improved. Most significantly, last sale reports for municipal securities transactions are not disseminated. Release of market information would enhance the ability of brokers, dealers, and investors to judge actual or potential transaction prices in the market. This information would be particularly useful in this market as the pricing of many issues currently depends on the pricing of similar issues trading in the secondary market.[81]

In June 1993, the MSRB proposed a pilot program to collect and publish on a delayed basis information on transactions occurring in the inter-dealer market for municipal securities.[82] The proposal would make public on a daily basis certain aggregate information on National Securities Clearing Corporation ("NSCC") compared inter-dealer transactions for approximately 180 frequently traded issues. The information would include: (1) the CUSIP number and description; (2) the total number of transactions in the security; (3) the highest and lowest prices of transactions in the security; and (4) the number of transactions in the security involving par values between $100,000 and $1,000,000, inclusive, and the average price of those transactions. This information would be made available two days after the trade occurred.

The Staff has a longstanding interest in improving the transparency of the municipal securities market, so that investors can obtain the quotations and trading prices of actively traded municipal issues. Transparency is critical to efficient pricing mechanisms and investor protection.[83] As a preliminary matter, the Staff believes that the MSRB's proposal

represents a positive first step toward the development of a more transparent market. The Staff is concerned, however, that the proposal does not provide for dissemination of quotation or transaction information on a real-time basis.[84]

The Staff believes that the MSRB has the authority to require dissemination of quotation and last sale information by municipal securities brokers and dealers. Such a rule would be within the broad authority and purposes enumerated in Section 15B, and specifically Sections 15B(b)(2)(F), which provides the MSRB the authority to govern the form and content of quotations disseminated by municipal securities dealers,[85] and 15B(b)(2)(C), which requires the MSRB to adopt rules designed to prevent fraudulent and manipulative acts and practices.[86]

The Commission has extensive experience in implementing facilities to improve transparency in various markets. For example, in the equity securities market, the Commission has overseen the implementation of facilities designed to fulfill the Congressional objectives of Section 11A of the Exchange Act, similar to those enumerated in Section 15B. Section 11A of the Exchange Act directs the Commission to oversee the development of a National Market System ("NMS"), to facilitate, among other things, improved investor confidence and efficiency.[87] Pursuant to this directive, the Commission has adopted rules governing NMS plans,[88] and has overseen the development of several important NMS facilities.[89] These facilities have helped market participants to maximize the efficiency of the market and to implement the Congressional goals enumerated in Section 11A.

Most recently, the Commission has overseen the extension of transparency to the market for high yield debt securities. In September 1991, the Commission released to Congress a report by the Staff that recommended a quote and/or trade reporting system for at least the 40 to 50 most actively traded high yield debt securities.[90] Thereafter, the Commission encouraged the high yield debt community to design a proposal to increase

transparency and to provide for surveillance reporting in the market. In March 1993, the Commission approved an NASD proposal to establish and to operate an electronic facility, FIPS, to collect, process, and disseminate, real-time, firm quotations for 30 to 50 of the most liquid high yield bonds and to require transaction reporting in all high yield bonds traded in the over-the-counter market.[91] That proposal will become effective in the Fall of 1993.

D. Municipal Securities Transfer Agents

The mechanics for registering the transfer of ownership of municipal securities are similar to that for equity securities and corporate debt. A transfer agent, which can be the indenture trustee, the issuer, or an independent agent, is responsible for cancelling certificates in the name of the seller and issuing new certificates in the name of the new owner. The transfer agent also must record the change of ownership in its records.

Section 17A(c)(1) of the Exchange Act requires that a transfer agent be registered with the Commission if it performs the function of a transfer agent with respect to any security registered under Section 12 of the Exchange Act. Due to the exemption from registration for municipal securities, a transfer agent that acts solely as a transfer agent for municipal securities is required neither to register with the Commission nor to comply with the rules and regulations of the Exchange Act pertaining to transfer agents. Thus, transfer agents acting exclusively for municipal securities issues are not subject to Commission rules requiring specific turnaround times for transfers or rules regarding reporting, recordkeeping and retention, and signature guarantees.[92]

Under Section 3(a)(12)(B)(ii) of the Exchange Act, however, municipal securities are not considered exempted securities for purposes of Section 17A. In Section 17A, Congress set out its findings regarding the clearance and settlement of securities transactions and ordered the Commission to facilitate the establishment of a national system for the clearance and settlement of securities. The anomaly created by Exchange Act Sections 3, 12, and 17A

is that municipal securities are not exempted securities for certain subsections of Exchange Act Section 17A, but are considered exempted securities in determining whether a transfer agent must register with the Commission. This creates a situation whereby a transfer agent that deals exclusively in municipal securities is not required to register with the Commission and can operate outside of Exchange Act Section 17A, while a clearing corporation that clears municipal securities transactions must register with the Commission and abide by Section 17A. Because the Commission does not have jurisdiction over all the entities involved in the process of clearing and settling municipal securities transactions, the establishment of a national system with uniform standards and procedures for the prompt and accurate clearance and settlement of municipal securities transactions has been impeded.

IV. Disclosure

A. Initial Disclosure

As noted above, the Commission has long been concerned with the adequacy of disclosure in the municipal securities markets.[93] As a result of the exemption afforded municipal securities from the registration and reporting provisions of the federal securities laws, disclosure by municipal issuers has been governed only by federal antifraud provisions and by state law. As already described, the federal securities laws limit the authority of the Commission to regulate issuer disclosure by exempting municipal securities from the disclosure requirements of the Securities Act and the Exchange Act,[94] and exempting municipal issuer disclosure from the rulemaking authority of the MSRB.[95] As a consequence of these regulatory exemptions, the extent of municipal issuer disclosure has been governed by the perceived level of demand for information from the buyers of municipal securities, and by requirements under the antifraud provisions.[96]

The Government Finance Officers Association ("GFOA") has taken the lead in improving municipal issuer market disclosure by publishing the Disclosure Guidelines for State and Local Government Securities ("GFOA Guidelines").[97] Originally published in

1976 by the then-named Municipal Finance Officers Association, the GFOA Guidelines comprise three parts: guidelines with respect to the original offering of securities, continuing disclosure, and procedures for disseminating information to investors.[98]

The drafters of the GFOA Guidelines emphasize their voluntary nature, and conclude that the ultimate test of effective disclosure should be the effective communication of the requisite information relevant to an informed decision.[99] While the GFOA Guidelines are not intended to establish standards for legal sufficiency of information, they identify information that over the years has been important for disclosure in most instances, taking into account the need for flexibility in light of changing market conditions and innovative instruments.[100] The GFOA Guidelines were revised in 1988 and 1991. The GFOA Guidelines, which presently serve as an industry standard for disclosure, require less disclosure in a number of respects than the Commission's disclosure requirements for registered offerings.

Although the MSRB is prohibited from setting disclosure requirements for municipal issuers, it has taken steps to require the delivery to investors of the official statements and other disclosures voluntarily prepared by issuers. In 1978, the MSRB adopted MSRB rule G-32, which requires municipal securities brokers and dealers selling new issues of municipal securities to deliver to the customer a copy of the final official statement (or, if no final official statement is being prepared, a written notice to that effect) and, in addition, with respect to negotiated sales of new securities, information concerning the underwriting spread, the amount of fees paid to the dealer, and the initial offering price for each maturity offered by the underwriters.[101] In spite of the requirements of the rule, underwriters and issuers have both complained that, frequently, there was not an adequate supply, or sufficient time, to permit distribution to each investor at settlement.[102]

In the aftermath of the default on bonds issued by the WPPSS, and in view of concerns that sufficient numbers of offering statements were not being made available to

customers purchasing new issues, the Commission, in 1989, adopted Rule 15c2-12.[103] That rule requires that municipal underwriters (both bank and non-bank) of primary offerings of municipal securities with an aggregate principal amount of $1,000,000 or more obtain and distribute to their customers official statements from municipal issuers. The rule was designed to achieve broader dissemination of disclosure documents, and to "assist underwriters in meeting their responsibilities under the general antifraud provisions of the federal securities laws."[104] Specifically, the rule requires an underwriter: (1) to obtain and review an issuer's official statement that, except for certain information, is "deemed final" by an issuer prior to making a purchase, offer, or sale of municipal securities; (2) in negotiated sales, to provide the issuer's most recent preliminary official statement (if one exists); (3) to deliver to customers, upon request, copies of the final official statement for a specified time period;[105] and (4) to contract to receive within a specified time, sufficient copies of the issuer's final official statement to comply with this delivery requirement, the MSRB requirement under rule G-32, and other rules. The rule contains specific exemptions for three types of municipal securities offerings.[106]

Rule 15c2-12 requires underwriters to insist that municipal issuers make available official statements at a time when, and in quantities which, they might not otherwise be produced.[107] The rule is purely procedural; it does not impose any requirements regarding the content of official statements. The content of these statements continues to be governed by the antifraud provisions. Nonetheless, the proposing and adopting releases for Exchange Act Rule 15c2-12 contained an interpretation regarding the due diligence responsibilities of underwriters under the federal securities laws that emphasized the importance of complete disclosure in the issuer's offering documents, and the underwriter's duty to review these documents for omissions or misstatements.[108]

Exchange Act Rule 15c2-12 created an incentive to provide copies of official statements to nationally recognized municipal securities information repositories

("NRMSIRs"). This has proven to be quite effective in assuring public availability of official statements, though NRMSIRs do not assure the accuracy or completeness of information that is furnished to them. Three municipal securities vendors have obtained no-action relief from the Commission to act as NRMSIRs.[109] These three vendors provide individual copies of official statements for a fee.

In addition to other efforts by the Commission and the MSRB to promote disclosure, the MSRB recently developed the Municipal Securities Information Library ("MSIL") system to aid in the collection and dissemination of issuer information. MSIL is a facility through which information collected pursuant to MSRB rule G-36[110] is made available electronically to market participants and information vendors.[111]

The Staff is of the view that disclosure in offerings by municipal issuers has been steadily improving over the years. This has come about as a result of the voluntary efforts of groups such as the GFOA and the National Federation of Municipal Analysts ("NFMA"), a growing awareness of the implications of the federal antifraud provisions for issuer offering statements, and the requirements imposed on underwriters in Exchange Act Rule 15c2-12 and MSRB rule G-32.

As a result, the official statements for large municipal issuers frequently are extensive documents that meet or exceed the GFOA Guidelines. These comprehensive official statements include extensive disclosure about the issuer, its revenue sources, the use of the funds raised, and the characteristics of the bonds being issued. Other smaller, less frequent issuers in the municipal markets, however, continue to prepare less extensive official statements. At the extreme, the offering documents for some smaller municipal issues consist solely of a one or two page description and term sheet prepared by the managing underwriter for use in selling the offering.

It is inevitable that a range of disclosure practices will develop where disclosure is voluntary. In the absence of universal mandatory standards, disclosure quality is subject to

issuer judgments regarding the value of detailed disclosure with regard to the price received in the offering and the requirements of the antifraud provisions, versus the burden on issuer officials, legal costs, and the potential effect on the offering of negative disclosures. As municipal issuers come to differing conclusions regarding such factors, municipal offering documents can differ enormously in extent and detail.

B. Continuing Disclosure

Municipal issuers are not subject to any direct federal continuing disclosure requirements.[112] As a result, secondary trading in municipal bonds depends on information voluntarily provided by issuers on a periodic basis or when they return to the market with new offerings. Consequently, concern exists as to investors' ability to acquire the information necessary to allow them to make intelligent, informed investment decisions. This is especially true for individual investors, who now represent a large segment of the buyers in the market. Many of these investors rely on financial intermediaries, particularly municipal securities dealers, for investment advice.

The lack of continuing financial disclosure also could impair the efficiency of the secondary market. Without access to continuing disclosure information, both specific transactions and the market as a whole suffer from inefficiencies. Although municipal bonds have a fixed value at maturity and generally trade at a price correlated to their investment rating, continuing municipal issuer disclosure still is important to investors in municipal securities. For example, continuing disclosure is of value to the rating agencies in evaluating whether the initial bond rating should be revised over time, based on changes in the financial condition of the issuer. In addition, municipal securities dealers are unable to value securities accurately because of the lack of information on the financial status of the municipal issuer.[113] Market participants are aware that their transactions may be executed based on incomplete or erroneous information about the securities and take this into account in pricing transactions, thus inhibiting the accurate pricing of those securities and the general

efficiency of the market. Similarly, the reduced ability of municipal securities investors to obtain relevant information regarding the financial condition of the municipal issuer prevents them from accurately valuing the securities. In essence, customers and dealers alike are in the dark about the "true" market value of an issue.

The growing importance of individuals as both direct and indirect purchasers of municipal bonds increases the need for sound municipal dealer sales recommendations, and for sufficient current information on issuers so investors can make accurate price judgments. For example, registered open-end investment companies are required to price their holdings of securities at the end of each day, and to sell and redeem shares at their net asset value calculated based on these values. In pricing their holdings, investment companies rely on various pricing services, which in the absence of actual transaction information rely on matrices that estimate prices based on the trade prices of similarly situated and rated bonds. Greater issuer disclosure would allow more accurate matrix comparisons of securities, improving the reliability of the information provided by pricing services and providing a truer picture of the holdings of investment companies.

Furthermore, the creation of new forms of municipal securities and complex credit structures leads to a greater need for information that would allow investors to monitor ongoing developments with regard to these securities. For example, while housing bonds, i.e., short or long-term bonds issued by a local housing authority to finance the construction of low or middle-income housing, are similar to collateralized mortgage obligations ("CMOs")[114] issued by the Federal Home Loan Mortgage Corporation or private issuers, and are subject to many of the same risks, they are not subject to the same disclosure requirements as CMOs. In addition, the growth of a market in municipal derivative securities, which often involve pooling municipal securities that are trading in the secondary market, may be hindered by the lack of sufficient ongoing information concerning the issuers of underlying municipal securities.

In recognition of these concerns, the MSRB has indicated that the Board will begin this Fall to develop rules that would require dealers to provide customers with written disclosure about the availability and impact of continuing disclosure on their securities.[115]

In addition, there have been a variety of voluntary initiatives by different groups in the municipal securities community to remedy the lack of continuing financial disclosure. For example, the GFOA Guidelines were revised in 1991 to incorporate modifications resulting from the adoption of Rule 15c2-12[116] and to expand recommendations for continuing disclosure.[117] In essence, the GFOA Guidelines state that the most important goal in providing disclosure documents is to provide investors with a complete, accurate, and objective description of those facts relating to the securities being offered that are material to an informed investment decision. Other recent GFOA efforts include Illustrations and Examples of Disclosure, drafted with the NFMA, providing examples of worksheets for secondary market disclosure for general obligation, revenue, and special district bonds. The GFOA and the NFMA also are cooperating to revise the comprehensive annual financial reports ("CAFRs") produced by various governmental issuers.

In January, 1992, the NFMA instituted a Certificate of Recognition Program to commend municipal securities issuers that provide ongoing, audited financial statements and other information relevant to their outstanding securities. Similarly, the GFOA awards a Certificate of Achievement for Excellence in Financial Reporting, and encourages issuers to publish understandable CAFRs that satisfy both generally accepted accounting principles and legal requirements. As another example, the NFMA Model Language Resolution calls for official statements to disclose, at the time of sale, the extent, if any, of issuer commitments to provide secondary market disclosure of financial and credit information.[118] To date, nearly one hundred issuers have pledged to provide such ongoing information.[119]

With respect to efforts at the state and local level, the National Association of State Auditors, Comptrollers and Treasurers ("NASACT") has released a report on state and local

government securities secondary market information.[120] The report concludes that state agencies collect a considerable amount of information on state and local governments and their securities, but that this information may not always be easily accessible, and often is not stored in one location. In late 1992, NASACT also created a Blue Ribbon Committee on Secondary Market Disclosure ("Committee") to develop methods for streamlining and enhancing information collection within the states for secondary market purposes.[121] This Committee recently published its findings and recommendations.[122]

The American Bankers Association ("ABA"), representing bank trustees, published guidelines for bank trustees on continuing disclosure, the Disclosure Guidelines for Corporate Trustees ("ABA Guidelines").[123] The ABA Guidelines are designed to assist trustees in determining the content and timing of various types of disclosure on a voluntary basis. The ABA Guidelines state that the establishment of a central depository to receive disclosure information is the best way to provide equal access to information and is essential secondary market disclosure.

The Investment Company Institute is developing suggested secondary market disclosure guidelines for tax-exempt money market funds and tax-exempt bond funds. These guidelines would recommend that all tax-exempt funds have access to certain information, including a copy of the final official statement and enough current information for a fund to analyze the credit risks of purchase.[124]

In January, 1993, the MSRB began operation of its Continuing Disclosure Information Pilot System ("CDI System"), which is a central repository to accept and disseminate voluntary submissions of official continuing disclosure documents relating to outstanding issues of municipal securities.[125] The CDI System accepts disclosure information voluntarily submitted by municipal securities issuers, trustees of such issuers, or persons designated by issuers, and operates as part of MSIL.[126] The CDI System was created by the MSRB to provide a neutral, fair, and timely dissemination mechanism for disclosure

information. The CDI System was intended not only to increase the availability of municipal disclosure information, but to encourage voluntary efforts in the industry to improve the content and timing of continuing disclosure information.

The CDI System has not been used extensively to date. As of August 25, 1993, the MSRB has received a total of 656 submissions from 36 submitters of information, including 8 issuers and 28 trustees, 494 of which were broadcast to subscribers. As the CDI System was designed to accept 100 submissions each business day, this falls far short of its potential.[127]

It appears that the CDI System is not being used extensively for several reasons. First, the CDI System has technological limitations. During its initial pilot, the CDI System only has been able to receive financial reports from municipal security trustees of three or fewer pages in length, and only has accepted disclosure information from issuers of municipal securities since May 17, 1993.[128] Second, the CDI System has experienced ...chnical pro[illegible]ms during the pilot.[129] Finally, and most importantly, it appears that many municipal issuers have chosen not to engage in market oriented disclosure through the CDI System.

While many municipal issuers prepare periodic financial reports that can be obtained by the public directly from the government body or another state agency, few distribute periodic disclosures to bond holders or prepare their reports to inform the secondary trading markets. Many issuers suggest that providing ongoing information to the securities markets will result in undue costs, and an increased risk of antifraud liability for potential misstatements or omissions in their voluntary disclosures. It appears doubtful that these issuers would voluntarily prepare market oriented disclosures in the absence of a price differential that benefits those issuers that make information available.

V. The Municipal Securities Market: Options for Change

As described previously, the municipal market has many special characteristics. Like the market for government securities, the municipal market is a public market: the funds raised are used (with some exceptions) for public purposes such as schools, roads, and providing municipal services. Ultimately, most of these bonds are backed by the taxpayer or the user of the municipal service, and a costly or inefficient market raises the burden on users and taxpayers. Because of its public nature, the municipal market also has many small issuers, which may sell small par amounts of bonds on an infrequent basis. Larger municipal issuers, however, increasingly are selling complex municipal bonds involving structured payment flows or imbedded derivatives.

Because of the tax exempt nature of most municipal bonds, a large proportion of municipal investors are individuals, with varying degrees of sophistication. In addition, another large segment of the municipal investor market is municipal bond funds, which are predominantly owned by individual investors.

Because of these factors, the Staff believes that it is important that the regulation of the municipal market provides the fullest possible protection to investors, while avoiding any unnecessary costs to public issuers and remaining attuned to the special needs and attributes of the municipal market. After reviewing the current regulation of the municipal market, the Staff believes that increased attention, including both Congressional and Commission action, would be beneficial in several areas significant to investors and the operation of the market.

A. Political Contributions

Municipal broker-dealer practices in the sales of municipal securities represent an important element of the protection of investors and the maintenance of the integrity of the municipal securities market. The Staff is presently evaluating voluntary submissions from underwriters and financial advisers in response to an inquiry into the nature and extent of

campaign contributions and influence buying practices in connection with municipal offerings. In requesting these submissions, the Staff has also sought information about payments to consultants and other experts who participate with underwriters in municipal bond issuances.[130] As previously discussed, with respect to possible rulemaking in this area, the Staff is of the view that both the Commission and the MSRB have the authority to require disclosure of, and to some degree, regulate underwriters' political contributions and payments to obtain political influence. Because underwriter disclosure provisions traditionally have been imposed by the MSRB, however, the Staff is of the view that it would be best to defer to the MSRB on this issue, unless the MSRB fails to act by rulemaking in a reasonable time.

In August, 1993, the MSRB published for comment a proposed rule specifically directed at political contributions.[131] The MSRB proposed banning contributions by underwriters as a means of obtaining or retaining municipal securities business.[132] The proposal would apply to situations in which an official of an issuer has discretion to select a dealer, including dealers acting as negotiated underwriters, as well as financial advisors, placement agents, and negotiated remarketing agents.

The MSRB also proposed requiring public disclosure of underwriters' political contributions to issuers from which the underwriter has received underwriting contracts. Underwriters would be required to disclose to the MSRB, within 60 days of receiving a contract, political contributions to the issuer for the previous two years and to continue reporting semi-annually for the subsequent two years.[133] If the underwriter continues to do business with the issuer, the underwriter would continue reporting for two years after its business relationship with the issuer ceased. The MSRB would disseminate the information electronically to the public through MSIL.

When the MSRB files its proposal with the Commission, the Staff will review the proposal in light of Section 15B's directive that the MSRB's rules be designed to prevent

fraudulent and manipulative acts and practices and to promote just and equitable principles of trade. Preliminarily, the Staff believes that the MSRB's proposal represents a positive first step to address the misuse of political contributions. The proposal also would provide a method of disclosure directly to the market place that is not currently available through disclosure by political candidates by making information regarding political contributions available to investors. In addition, the proposal would provide a ready source of information to the NASD, the bank regulators, and the Commission for use in investigating specific abuses of underwriters' contributions to issuers.

B. Sales Practices

As discussed previously, the responsibility for examining for compliance with MSRB rules and enforcing those rules with respect to non-bank municipal dealers lies primarily with the NASD. This examination and enforcement activity, combined with the NASD's qualification and testing requirements for salespeople, is of great importance in assuring the integrity of the municipal market and the protection investors. On the whole, the municipal securities market appears to have a relatively low level of broker-dealer sales practice abuses. As Appendix D indicates, the Commission has brought some 55 enforcement actions in the municipal securities market over the past 10 years, of which approximately 15 involved broker-dealers specializing in municipal securities. In contrast, the Commission has brought over 600 enforcement actions involving broker-dealers generally during this period. Similarly, in the past 10 years the NASD has brought approximately 1030 formal actions against its members relating to municipal securities activities, compared to some 7,413 final disciplinary actions against its members for all types of securities activities.

The Staff does not believe that the relatively low number of sales practice violations prosecuted by the NASD should lull regulators or the investing public into believing that there are in fact few abuses in the municipal securities market. While the Commission's

market regulation oversight program has concluded that the NASD has a well-conceived examination program and conducts its examinations in a competent manner, the Staff believes that the lack of information available to the NASD regarding trading in the municipal market restricts the ability of the NASD to analyze fully potential problems or trading abuses in the market. Proposals to increase the information available in the market are discussed further below.

1. MSRB Fair Practice Rules

The Staff has and will continue to encourage the MSRB's effort to update its suitability and customer protection rules. In particular, the Staff believes that the MSRB's suitability requirements should be strengthened at the earliest possible date to reflect high professional standards. The increase of individuals as investors in the municipal securities market, the fluidity of municipal instruments, and the lack of current market information call for ongoing attention to municipal sales practices. The Staff is of the view that the MSRB should consider ways to increase customer awareness of factors important to an investment decision, such as the creditworthiness of an issuer. The Staff will remain attuned to these issues through broker-dealer examinations and review of NASD and MSRB activities, to ensure that sales practice abuses are minimized in the municipal securities market.

2. Mark-ups

The Staff believes that continuing attention should be given, in particular, to preventing excessive mark-ups in the municipal market. Excessive mark-ups are more likely to occur in a market where customers lack market information, such as current quotations or real-time last-sale prices, that allows them to assess independently the prices quoted to them by their salespersons. Thus, as discussed below, increasing transparency or regulatory reporting in the municipal market is important to better protect investors. It also would enhance the NASD's ability to enforce the existing customer protection rules of the Commission and the MSRB.

The Staff also is considering ways to provide investors with greater information regarding dealer mark-ups in municipal securities. In the equity markets, dealers are required to disclose on confirmations the mark-up in riskless principal transactions and in transactions subject to trade reporting. The disclosure of mark-ups allows investors to evaluate the transaction charges in trades with dealers. Although in the past the Commission has proposed mark-up disclosure requirements for riskless principal trades in municipal securities, it has never adopted such requirements. The Staff believes that mark-up disclosure on confirmations would be a valuable supplement to yield disclosure in debt securities. In particular, the Staff believes that disclosure of mark-ups in riskless principal trades in municipal and other debt securities should be required. Further consideration of ways of increasing disclosure of mark-ups in other trades as transparency improves also would be appropriate.

3. Continuing Education/Qualifications Testing

The Staff believes that efforts must be made to increase education about municipal securities products and appropriate municipal securities sales practices. In particular, efforts must be made to ensure that registered representatives and principals are familiar with the new products, such as derivatives, that continue to be developed based on municipal securities. Additionally, the Staff believes that current efforts to develop a comprehensive continuing education program must include more information on municipal securities.

C. Transparency

The Staff believes that the degree of transparency in the municipal securities market is not adequate, and should be increased to better inform investors in their dealings with broker-dealers and to make the market more efficient. While the Staff supports solutions developed and implemented by market participants, the Staff believes that the Commission or the MSRB should take steps to increase the availability of real-time municipal

information, to the fullest extent practicable, taking into account the cost of providing such information and its relative usefulness.

The Staff believes that the MSRB has extensive authority to require greater transparency. If the MSRB does not act, the Commission has authority, pursuant to Exchange Act Section 19(c), to add to or amend the MSRB's rules to require greater transparency in the municipal securities market for the purpose of implementing the goals and objectives of Section 15B, specifically those enumerated in Section 15B(b)(2)(C) and (F).[134]

In addition, the Staff believes that it currently has the authority under Section 17(a) of the Exchange Act to require municipal securities brokers and dealers to report publicly quotation and last sale information. Despite this existing authority, the Staff believes that legislation clarifying the Commission's authority to require quote and last sale reports regarding municipal securities under Section 11A of the Exchange Act would reinforce the Commission's ability to encourage private sector efforts, as well as those of the MSRB, to improve transparency in the market for municipal securities.

In this connection, Congress could amend Section 3(a)(12) of the Exchange Act to remove the exemption for municipal securities from Section 11A of the Exchange Act. Granting the Commission authority pursuant to Section 11A to require transaction reporting for municipal securities will provide the Commission with a clear mandate to encourage the development of market facilities analogous to those developed for other markets, such as the high yield debt market.

D. Audit Trails

In the Staff's view, a central flaw in the present regulatory system is the lack of an integrated audit trail in the municipal securities market of the type that exists in the stock and options markets. Because of the limited pricing information available in the secondary market for many thinly traded municipal securities, it is extremely difficult for the NASD to

assess the fairness of the prices being charged retail customers by municipal securities broker-dealers. The Staff believes that the MSRB, the NASD, and the banking agencies should work to create a cost-effective trade reporting system that will provide the regulators with an integrated audit trail of municipal securities and result in improved surveillance for all segments of the market. The development of such an audit trail would increase the NASD's ability to examine and enforce the existing customer protection rules of the Commission and the NASD.

E. Municipal Securities Transfer Agents

As discussed previously, the registration requirements for transfer agents currently do not apply to municipal transfer agents, although registered transfer agents that handle municipal securities must comply with the Commission's transfer agent regulations with regard to municipal securities. The Staff recommends that Section 17A of the Exchange Act be amended to require entities functioning as transfer agents exclusively for municipal securities to register with the Commission, and to be subject to the rules and regulations of the Exchange Act applicable to transfer agents. This would enable the Commission to facilitate the establishment of a more efficient system for the clearance and settlement of municipal securities transactions.

F. Municipal Issuer Disclosure

Another area deserving continued attention is municipal issuer disclosure. Comprehensive disclosure by issuers on an initial and ongoing basis is important to investors in evaluating offering prices, making decisions as to which bonds to buy, and deciding when to sell. Under the current system, the quality of municipal offering documents depends on the voluntary undertaking of individual issuers to prepare complete documents, and the competence of the advice issuers receive from financial advisors, underwriters, and counsel. As a result, complete and comprehensive disclosure of the financial condition of the issuer

and any credit enhancer,[135] the characteristics of the security, and investment risks, is not consistently available to investors.

Improved disclosure by municipal issuers could be established through a variety of means. As discussed above, voluntary efforts by the GFOA and others in the private sector to improve disclosure for both primary offerings and secondary trading have proved to be constructive.

Although these voluntary efforts should be encouraged, by their very nature, they are insufficient to address the inconsistencies in the quality of disclosure in the municipal securities market. In the Staff's view, comprehensive improvement of the existing system would require Congressional action. Congress, for example, could provide the Commission with direct statutory authority to set mandatory disclosure requirements for municipal issuers and authorize specifically the Commission to require continuing financial disclosure by municipal issuers. Congress could even rescind the exempt status of municipal bonds under the Securities Act and the Exchange Act, thereby subjecting them to the registration and continuous reporting obligations applicable to corporate and foreign government bond issuers. The system for corporate and foreign government bond issuer reporting could not be adopted wholesale, but would need to be adjusted to take into account the unique characteristics of the municipal securities market.

At a minimum, the Staff would support legislation requiring registration of all corporate obligations underlying municipal conduit securities. From an investment standpoint, these securities are identical to corporate bonds issued directly by the underlying obligor, except that the interest on the municipal instruments is tax-exempt. The Staff believes that investors should receive the same disclosure regarding the underlying non-municipal corporate obligor as they do for any other non-municipal entity. Therefore, the Staff believes that the securities laws should be amended to remove the registration exemption[136] for the corporate credit underlying municipal conduit securities.[137]

If Congress chooses not to provide the Commission with full authority to address the adequacy and consistency of disclosure in this market, the Staff believes that the Commission could explore ways to improve initial and secondary market disclosure under its existing authority. Specifically, the Staff will prepare a memorandum and draft release recommending that the Commission use its interpretive authority to provide guidance regarding the disclosures required by the antifraud provisions of the federal securities laws. Similarly, the Staff will recommend amending Rule 15c2-12, or adopting similar rules, to prohibit municipal securities dealers from recommending outstanding municipal securities unless the municipal issuer makes available ongoing information regarding the financial condition of the issuer of the type required in initial offerings. Given these alternatives for increased disclosure, the Staff does not believe that the legislative grant of additional authority to the MSRB, which would enable the Board to establish offering document standards for municipal issuers, is necessary.

The Staff strongly believes, however, that any Commission action in this area could not fully address the lack of complete disclosure in the municipal securities market. As noted above, comprehensive improvements to the existing system would require legislation.

G. Current Regulatory Structure

In their inquiry, Chairmen Dingell and Markey also solicited the views of the Staff regarding the current regulatory structure for municipal securities. In particular, they asked whether any change in the enforcement examination responsibilities might be appropriate.

The scheme of regulation for municipal securities formulated under the 1975 Amendments presents special challenges for financial regulators. Although the MSRB has been delegated broad rulemaking authority, its power to oversee fully the activities of municipal securities market participants is limited because of the division of inspection and enforcement powers between the NASD, the Commission, and the three bank regulatory agencies.[138] This structure reduces the MSRB's opportunities to develop staff expertise

because it does not routinely inspect dealers for compliance with and enforce its rules. Potentially, this structure could result in disparate enforcement of specific rules, depending upon whether or not a municipal dealer is a bank, as a result of contrasting philosophies and allocations of staff resources. For its part, however, the Commission has both rulemaking and enforcement authority regarding all municipal securities brokers and dealers.

The division of rulemaking and enforcement authority between the MSRB on the one hand and the NASD and the bank regulators on the other reflects a compromise struck in the 1975 Amendments.[139] To some degree, the conditions that influenced the design of municipal securities regulation in 1975 still exist today. There continue to be both bank and non-bank municipal securities dealers,[140] with the bank municipal securities activities primarily subject to the supervision of the bank regulators. In a number of instances, however, banks have transferred their municipal securities dealer activities to a so-called "Section 20" affiliate, registered with the Commission as a broker-dealer. Moreover, bank municipal securities dealers and non-bank municipal securities dealers differ little in operation; they differ principally in the manner they are regulated and supervised.

In light of these conditions, there are a variety of alternative structures for regulating municipal dealers, each with potential benefits and drawbacks. Among others, Congress could grant the MSRB examination and enforcement authority over all dealers;[141] require all municipal securities activities to be conducted by a non-bank dealer subject to NASD municipal rulemaking and enforcement authority;[142] or eliminate the MSRB and divide rulemaking authority for municipal securities among the various regulators.[143] In the final analysis, however, the most responsible approach would appear to be to keep the current scheme and improve communication and coordination among existing regulators.

On balance, there are significant reasons for retaining the present system of regulation for municipal securities. First, the Staff believes that the effort that would be required to overhaul the regulatory structure would be huge and most likely not

commensurate with the benefits likely attained. Second, the Staff believes that the substance of regulation, in this instance, is much more important than the form or structure in which it takes place.

The Staff is of the view, however, that the current structure can be enhanced through increased cooperation and coordination between the MSRB, the NASD, the Commission, and the bank regulatory agencies. More frequent, scheduled meetings among examiners to discuss the current problems, and better coordination among bank and non-bank dealer examiners, particularly regarding sales practice abuses, could enhance investor confidence and protection. In addition, the weaknesses in the present system can be reduced by vigorous enforcement by the responsible agencies, and as discussed above, improvements in transparency, customer protection provisions, and audit trails.

VI. Conclusion

The Staff appreciates the opportunity to assist the Chairmen, the Committee, and the Subcommittee as they consider the important and dynamic municipal securities market and options available to strengthen the market's efficiency and transparency, and the protection of investors.

ENDNOTES

1. Public Securities Association. In any given year, there are between 6,000 and 8,000 new issuances.

2. The term "municipal security" generally refers to securities issued by states, their political subdivisions, such as cities, towns, and counties, and specially created subdivisions, such as school districts or port authorities.

3. Public Securities Association. There are approximately 1.3 million classes of municipal securities spread across 150,000 different issuances of municipal securities. Id. By contrast, approximately $3.08 trillion in marketable government securities are outstanding. 79 Fed. Reserve Bull. A43 (July 1993) (Table 1.59). Individual investors (including households and mutual funds) hold $298 billion in corporate and foreign debt securities. Flow of Funds Accounts, First Quarter, 1993.

4. American Banker, The Bond Buyer 1993 Yearbook (1993) at 11.

5. Public Securities Association. This information is as of September 30, 1992.

6. Public Securities Association, Fundamentals of Municipal Bonds (4th ed. 1990) at 16 ("Fundamentals").

7. Id. at 2.

8. Id. As an example, a municipality may issue revenue bonds to finance a resource recovery facility that would not only process garbage and solid waste for a fee, but also use the waste to produce (and sell) an energy source for electricity production. If the municipality treats that facility as a revenue producing project, it may issue revenue bonds limited to repayment solely from revenues derived from the operation of the facility. See R. Fippinger, The Securities Law of Public Finance 18-19 (1993) (comparing revenue bonds and general obligation bonds). Another form of bond is the limited special assessment district bond. This type of bond may be issued to develop raw land, and therefore, may be supported by a very narrow tax basis. Though limited special assessment district bonds may be revenue bonds, they are, more frequently, structured in the form of general obligation bonds.

9. Fundamentals, supra note 6, at 19. For example, a municipal issuer will issue bonds to finance a facility that a private business will then buy on an installment lease. The private business will pay rent, which will be used to pay principal and interest on the bonds.

10. Id. Prior to 1968, Section 3(a)(2) of the Securities Act of 1933 ("Securities Act") and Section 3(a)(12) of the Securities Exchange Act of 1934 ("Exchange Act") were relied on to exempt from registration industrial development bonds. In response to concerns about the adequacy of disclosure provided to investors acquiring industrial development bonds, the Commission adopted Rule 131 under the Securities Act and Rule 3b-5 under the Exchange Act. See Securities Act Release No. 4896 (February 1, 1968) 33 FR 3143 (proposing); Securities Act Release No. 4921 (August 28, 1968) 33 FR 12648 (adopting); and Securities Act Release No. 5055 (March 31, 1970) 35 FR 6000 (amending). These rules set forth the analysis to be used in determining whether investors in effect are acquiring securities of a private company that could not be offered and sold in reliance on the exemptions for municipal securities.

In response to Rules 131 and 3b-5, Congress amended Section 3(a)(2) of the Securities Act and Section 3(a)(12) of the Exchange Act specifically to exempt certain industrial revenue bonds, the interest on which was exempt from federal income taxation, from the registration provisions of the Securities Act and to grant such securities exempted security status under the Exchange Act. See Section 401(c) of the Employment Security Amendments of 1970, Pub. L. No. 91-373, 84 Stat. 718 (1970).

In 1978, the Commission supported a bill that would have subjected industrial development bonds to registration under the Securities Act. See The 1978 Industrial Development Bond Act, S. 3323, 95th Cong., 2d Sess., 124 Cong. Rec. 21,639 (1978). The Commission considered industrial development bonds to be sufficiently distinct from other municipal securities to warrant treatment under a separate regulatory framework. No hearings were held, and this bill was never subject to a vote. See Letter from SEC Chairman Harold Williams to Senator Harrison Williams (May 1, 1978) reprinted at 124 Cong. Rec. 21,639 (July 19, 1978). See also Letter from SEC Chairman John Shad to Hon. Timothy E. Wirth, Chairman, Subcommittee on Telecommunications, Consumer Protection, and Finance (Mar. 12, 1985) at 10 ("Wirth Letter") (supporting registration requirements for industrial revenue bonds).

The Tax Reform Act of 1986, Pub. L. 99-514. 100 Stat. 2085 (1986) amended provisions of the Internal Revenue Code and, among other matters, eliminated the favorable tax treatment for certain industrial development bonds constituting private activity bonds. Therefore, following this amendment, Rules 131 and 3b-5 apply to a greater variety of industrial development bonds not qualifying for tax exemption under the Tax Reform Act of 1986 in determining whether registration of separate securities underlying such bonds is required.

11. Principal and interest strip securities are created by dividing, through a trust arrangement, municipal securities into as many as two dozen principal and interest income components. As an example, Lehman Brothers offers a product called "Strips & Pieces," which permits issuers to bundle their principal and interest obligations in various ways to satisfy particular investor objectives.

12. Detachable call options involve the division of a typical callable bond into two securities, the underlying debt security and a separate option to call the bond. This separate option may be retained by the issuer or sold to investors at the time the bonds are first sold or thereafter. Once sold, the option may be freely bought and sold by investors having no ownership interest in the underlying municipal debt. These securities have been designed primarily for institutional investors as a hedge against declining interest rates.

13. The new variable rate securities include inverse floating rate securities and securities with imbedded swaps. These new variable rate securities allow a municipal issuer to pay a constant fixed rate (at a reduced interest cost) while offering investors floating rate securities. They can be created through a trust structure, redirecting interest and principal flows between bondholders, or through swap arrangements with investment banks where the issuer's fixed rate is swapped for the floating rate, which is passed on to issuers.

14. See Appendix A.

15. See Appendix B.

16. Hearings on S. 1933 and S. 2474 Before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, 93d Cong., 2d Sess. 49 (1975) ("Hearings").

17. Id.

18. The Bond Buyer 1993 Yearbook, supra note 4, at 62. As of 1992, of the total debt outstanding of $1,145.6 billion, households held $598.4 billion, or 52% of total debt outstanding; mutual funds, $164.7 or 14%; property and casualty insurers, $138.8 billion or 12%; commercial banks, $98.9 billion or 8%; and money market funds, $91.6 billion or 7%. Due to changes in the tax treatment of municipal securities as a result of the Tax Reform Act of 1986, commercial bank ownership of municipal securities decreased by an estimated $136 billion during the years 1986-1990, an amount equal to 59% of their holdings at year-end 1985. Petersen, Innovations in Tax-Exempt Instruments and Transactions, Nat'l Tax J. (Dec. 1991) at 11, 13 n.8. ("Petersen"). Trading in the secondary market for municipal securities amounts to approximately $3 billion per day. Public Securities Association.

19. Investment bankers assert that negotiation is essential in complicated offerings because, to be successful, such offerings must be marketed aggressively and comprehensively. See e.g. "More Munis Seen Going to the Lowest Bidder," Investors Business Daily, June 9, 1993, at 1. At the time the Exchange Act was enacted, competitive bidding, in one form or another, was the most accepted method of financing used by municipalities and other public entities. L. Loss & J. Seligman, Securities Regulation 343 (1989). Negotiated underwritings, however, have become increasingly common, and now represent approximately 75% of all long-term municipal bond offerings. In 1961, 96.9% percent of all general obligation municipal bonds, and 60.9% of all municipal revenue bonds, were offered at competitive bidding. Id. By 1985, only 26% of long-term municipal bond offerings were competitively bid, and in 1992 this number had shrunk to a mere 19%. The Bond Buyer 1993 Yearbook, supra note 4, at 10-11. See also Ederington, Negotiated Versus Competitive Underwritings of Corporate Bonds, 31 Journal of Finance 17, (1976); Joehnk & Kidwell, Comparative Costs of Competitive and Negotiated Underwritings in the State and Local Bond Market, 34 Journal of Finance (1979); Braswell, Nosari & Sumners, A Comparison of the True Interest Costs of Competitive and Negotiated Underwritings in the Municipal Bond Market, 15 Journal of Money, Credit & Banking 102 (1983).

20. Petersen, supra note 18 at 13. Likewise, volatility in interest rates has been a source of uncertainty in the markets. Id. at 16. With fixed coupon rates, the only way an outstanding bond can be sold to a new investor to provide a current yield (when market rates of interest have risen) is to provide a discount in price, which results in a capital loss for existing bondholders. Id.

21. Section 3(a)(2) of the Securities Act, as finally adopted, exempts "[a]ny security issued or guaranteed . . . by the District of Columbia, or by any State of the United States, or by any political subdivision of a State or Territory, or by any public instrumentality of one or more states or territories . . . " from the provisions of the Securities Act.

22. Section 3(a)(12)(A)(iii) of the Exchange Act defines municipal securities as "exempted securities." The term "municipal securities" is defined, in relevant part, in Section 3(a)(29), as securities which are "direct obligations of, or obligations guaranteed as to principal or interest by, a State or any political subdivision thereof, or any instrumentality of a State or any political subdivision thereof, or any municipal corporate instrumentality of one or more

States . . . . " The definition of an exempt security in Securities Act Section 3(a)(2) is different from that of the Exchange Act in that Section 3(a)(2) exempts securities "issued or guaranteed . . . by any State . . . . "

23. S. Rep No. 75, Securities Exchange Act of 1975: Report of the Committee on Banking, Housing, and Urban Affairs, to Accompany S. 249, 94th Cong., 2d Sess. 43 ("1975 Act Report").

24. Pub. L. No. 94-29, 89 Stat. 131 (1975).

25. Municipal securities were traded by three types of entities: registered broker-dealers, who bought and sold municipal securities in addition to engaging in other securities activities; sole municipal brokers and dealers, who dealt exclusively in municipal securities and thus avoided registration with the Commission; and banks, which traded general obligation municipal securities pursuant to an exclusion from the Glass-Steagall Act for general obligation bonds. Despite the Glass-Steagall Act prohibition of bank securities activities generally, national banking associations are permitted under 12 U.S.C. § 24(7) (1988) to deal in, underwrite, and purchase for their own account "general obligation bonds of any State or any political subdivision thereof . . . . " General obligation bonds have been interpreted to include revenue bonds unconditionally guaranteed by an obligor possessing general powers of taxation, and, in some cases, revenue bonds backed by a bank letter of credit. See M. Capatides, A Guide to the Capital Markets Activities of Banks and Bank Holding Companies 31-34 (1993).

26. See e.g. Exchange Act Section 15(c)(1), Section 15(c)(2), Section 17(a), Section 17(b), Section 15B(c)(1), Section 15B(c)(2), Section 21(a)(1).

27. Ba[illegible], due to their limited involvement in securities activities in 1934 pursuant to the Glass-Steagall Act prohibitions, were not included in the broker-dealer registration provisions of the Exchange Act. The Commission long has maintained that bank securities activities, which have increased dramatically over the last decade, should be regulated in the same manner as non-bank securities activities, and that the exclusion for banks from broker-dealer registration requirements is no longer justified. See, e.g., Testimony of Richard Breeden, Chairman, SEC, Concerning S. 543 and S. 713, Before the Senate Committee on Banking, Housing and Urban Affairs (May 7, 1991). The Commission continues to believe that bank securities activities should be conducted outside the bank in a subsidiary or affiliate that, as a broker-dealer, is registered with the Commission.

28. Exchange Act Section 3(a)(30). Under Exchange Act Section 15B(b)(2)(H), however, Congress delegated to the MSRB the power to define by rule the manner of determining the separately identifiable department or division of a bank. MSRB rule G-1 sets forth a test for determining the separately identifiable department or division of a bank along functional lines.

29. Exchange Act Section 15B(b)(1).

30. Exchange Act Section 15B(b)(2).

31. Exchange Act Section 15A(b)(2), Section 15B(c)(5).

32. Exchange Act Section 15A(b)(7) requires the NASD to have rules providing for the discipline of members who violate the MSRB's rules. In addition, criminal sanctions are also possible. See, e.g., Securities Act Section 17(a)(1), Section 17(a)(2), Section 17(c).

33. See generally Exchange Act Section 15(b)(1), Section 15B(a)(2) (registration requirements); Section 15(b)(4)-(5), Section 15B(c)(2)-(3) (power to suspend, revoke or deny the registration of a broker or dealer or municipal securities dealer); Section 15(b)(4), Section 15B(c)(4) (power to impose appropriate limitations on the functions and activities of any person who violates the Exchange Act or rules and regulations promulgated thereunder); Section 15B(c)(2), Section 15B(c)(6) (authority to institute independent action against any municipal securities dealer that is a bank). See also 1975 Act Report, supra note 23 at 52-53.

34. Exchange Act Section 15B(c)(6)(A), Section 15B(c)(6)(B), Section 17(c).

35. Exchange Act Sections 15(c)(1) and 15(c)(2) prohibit the use, by a broker, dealer, or municipal securities dealer of fraudulent, deceptive or manipulative acts or practices to effect any transaction in the purchase or sale of municipal securities. The 1975 Amendments revised these sections to make clear that the Commission's rulemaking authority also applied to possible manipulative conduct by banks or departments of banks engaged in municipal securities transactions. Similarly, municipal securities dealers were added to the coverage of Section 17(a) of the Exchange Act. This section grants the Commission recordkeeping and reporting authority, and serves as the reference list for Section 17(b) of the Exchange Act, which confers examination authority.

36. 94th Cong., 1st Sess., 121 Cong. Rec. 10727 (1975) (remarks of Senator Tower).

37. In fact, the Tower Amendment added only Section 15B(d)(2), imposing disclosure limitations on the MSRB.

38. See The 1978 Industrial Development Bond Act, S. 3323, 95th Cong., 2d Sess., 124 Cong. Rec. 21,639 (1978). This Act was a Commission supported bill that would have subjected industrial development bonds to registration under the Securities Act. No hearings were held, and this bill was never subject to a vote. See also supra note 10.

39. Wirth Letter, supra note 10, at 14 (in response to questions relating to municipal securities regulation; recommending the repeal of the Exchange Act Section 15B(d)(2)).

40. See Washington Public Power Supply System: Financial Meltdown, Oversight Hearing Before the Subcommittee on Mining, Forest Management, and Bonneville Power Administration of the House Committee on Interior and Insular Affairs, 98th Cong., 1st Sess. (June 10, 1983); SEC, Staff Report on the Investigation In the Matter of Transactions in Washington Public Power Supply System Securities (Sept. 1988).

41. Wirth Letter, supra note 10, at 14. See also 24 Securities Regulation & Law Report 1033-34 (June 14, 1985).

42. Remarks of David S. Ruder, Chairman, SEC, to the Public Securities Association in Phoenix, Arizona (Oct. 23, 1987). See also 43 Securities Regulation & Law Report 1649 (October 30, 1987).

43. See infra notes 104-109 and accompanying text.

44. Similar problems may arise from the selection, in the same manner, of other bond experts including financial advisors and bond counsel.

45. Letter from William R. McLucas, Director, Division of Enforcement, SEC, to various brokers and dealers (June 4, 1993); Letter from Julie K. Lutz, Assistant Director, Division of Enforcement, SEC, to various brokers and dealers (July 9, 1993) (follow-up letter).

46. The MSRB has considered this issue previously. In 1991, the MSRB staff presented a memorandum to the Board discussing possible treatment of political contributions. In August of 1991, the Board issued a press release generally discouraging contribution practices that may be illegal or unethical. MSRB Reports (Sept. 1991) at 11.

47. Rule 15c2-12 was adopted pursuant to Sections 2, 3, 10, 15(c), 15B, 17, and 23 of the Exchange Act. See Exchange Act Release No. 26985 (June 28, 1989), 54 FR 28799.

48. Exchange Act Section 15B(b)(2)(C).

49. 1975 Act Report, supra note 23, at 47.

50. The antifraud provisions continue to apply to municipal securities, and practices such as excessive undisclosed mark-ups violate those provisions. See, e.g., Exchange Act Section 10(b), Exchange Act Rule 10b-5.

51. The MSRB was given explicit rulemaking authority regarding: standards of professional qualifications, sales practices, recordkeeping, the frequency of periodic compliance examinations, form and content of quotations relating to municipal securities, sales of new issue municipal securities to related portfolios during the underwriting period, and other aspects of the underwriting, trading, and sale of municipal securities. Exchange Act Section 15B(b)(2)(A)-(K).

52. The MSRB has reminded dealers of their duty of full disclosure under MSRB rule G-17, and periodically has pointed out specific items that should be disclosed to the customer. For example, in July, 1985, the MSRB stated that MSRB rule G-17 requires municipal securities brokers to advise customers on the taxability of "when-issued" securities, See MSRB Interpretation (July 29, 1985), MSRB Manual (CCH) at ¶ 3581; and in June, 1993, the MSRB published an educational notice regarding detachable call securities. See MSRB Reports (June 1993) at 17-18.

53. See MSRB Interpretation (March 4, 1986), MSRB Manual (CCH) at ¶ 3581.

54. Id.

55. Inquiries about the customer's financial situation generally are made at or before the opening of each customer account. MSRB rule G-8(a)(xi) requires municipal securities brokers and dealers to make and to keep current the information supplied in the customer account record to assist in monitoring compliance with the rule.

56. MSRB rule G-19 states that the dealer shall not recommend any specific transaction in a security unless the dealer has reasonable grounds, based on the information available from the issuer of the security or otherwise, for recommending a purchase, sale or other transaction in the security. See also MSRB rule G-32.

57. See Letter from Hon. John D. Dingell, Chairman, Committee on Energy and Commerce to Richard C. Breeden, Chairman, SEC (Jan. 16, 1991).

58. See letter from William H. Heyman, Director, Division of Market Regulation, SEC, to Christopher A. Taylor, Executive Director, MSRB (May 8, 1992). See also Remarks of Richard Y. Roberts, Commissioner, SEC, at the Public Securities Association, "Customer Protection and Political Contributions" (May, 26, 1993); and Remarks of Richard Y. Roberts, Commissioner, SEC, at the Municipal Forum of New York, "Modernize Customer Protection Rules Too" (April 21, 1993).

59. See MSRB Reports (Sept. 1992) at 3.

60. See MSRB Reports (June 1993) at 7.

61. In 1980, the MSRB provided additional guidance to dealers and enforcement agencies on how to determine the fairness and reasonableness of prices. The MSRB noted that the yield to a customer is the most important factor in judging fairness and reasonableness of price. The yield should be comparable to the yield on other securities of comparable quality, maturity, coupon rate and block size then available in the market. To date, the MSRB has not proposed any amendments to MSRB rule G-30 concerning fair pricing. See MSRB rule G-30, MSRB Interpretations (Sept. 1980), MSRB Manual (CCH) at ¶ 3646.

62. See Investment Planning, Inc., Securities Exchange Act Release No. 32687 (July 28, 1993); Donald T. Sheldon, Securities Exchange Act Release No. 31475 (November 18, 1992); Staten, 47 SEC 766, (1982); Powell & Assoc., 47 SEC 746, (1982); and Crosby & Elkin, Inc., 47 SEC 526, (1981).

As discussed, municipal securities are not exempt from the antifraud provisions of the Securities Act, the Exchange Act, or the Commission's antifraud rule, Rule 10b-5, adopted pursuant to Section 10(b) of the Exchange Act.

63. Id.

64. The Commission, the NASD, and the MSRB have combined efforts to prevent sales practice abuse in the municipal securities market. The antifraud provisions prohibit excessive undisclosed mark-ups; the MSRB's rules and policies prohibit excessive mark-ups whether or not disclosed. The NASD enforces MSRB rules and initiates disciplinary actions against member firms that charge excessive mark-ups in the sale of municipal securities.

65. The Commission has held that, absent countervailing evidence, a municipal securities dealer's contemporaneous cost is the best evidence of the current market. Powell & Associates, 47 SEC 746, 747 (1982). That standard has been accorded judicial approval, and, in the context of corporate securities, legislative approval. See Barnett v. SEC, 319 F.2d 340 (8th Cir. 1963). See also Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 931 (Oct. 15, 1990). See also Securities Exchange Act Release No. 24368 (April 21, 1987), 52 FR 15575, ("Zero-Coupon Securities Release").

66. Crosby & Elkin, Inc., 47 SEC 526 (1981).

67. Investment Planning, Securities Exchange Act Release No. 32687 (July 29, 1993). The Commission stated in this case that it did not intend to suggest that mark-ups under 4% may not be unfair.

68. NASD Rules of Fair Practice, Article III, Section 4.

69. Exchange Act Rule 10b-10(a)(8)(i)(A).

70. Exchange Act Rule 10b-10(a)(8)(i)(B). Moreover, Exchange Act Rule 15g-4, adopted in 1992, requires mark-up disclosure, based on a dealer's contemporaneous cost, both on customer confirmations and before the trade in penny stock transactions. See Exchange Act Release No. 30608 (April 28, 1992), 57 FR 18004.

71. In all municipal trades, Rule G-15 requires disclosure of the yield at which a transaction was effected and the resulting dollar price for transactions effected on a yield basis. For transactions effected on the basis of a dollar price, the confirmation must show the dollar price at which the transaction was effected and the lowest of the resulting yield to call, yield to par option, or yield to maturity. For transactions effected at par, the dollar price is required to be shown.

72. In 1976, the Commission proposed requiring customer confirmations to disclose mark-ups in riskless principal transactions in all debt and equity securities. Securities Exchange Act Release No. 12806 (Sept. 16, 1976), 41 FR 41432. In response to comments, in 1977 the Commission reproposed requiring disclosure on confirmations of mark-ups in riskless principal transactions in non-municipal debt securities. It did not apply its confirmation requirements to municipal securities to allow the MSRB to develop a confirmation rule for these securities, but noted that if the MSRB chose not to require mark-up disclosure for riskless principal trades, the Commission would revisit the question of applying its confirmation rule to municipal securities. Securities Exchange Act Release No. 13661 (June 23, 1977), 42 FR 33349 n. 7.

After specifically considering mark-up disclosure for riskless principal trades in two public hearings, on February 10, 1978, the MSRB informed the Commission that it believed that such disclosure was "unnecessary" and "inappropriate" for municipal securities. Letter from Gedale B. Horowitz, Chairman, MSRB, to Securities and Exchange Commission (Feb. 10 1978). On October 6, 1978, the Commission again proposed requiring confirmation disclosure of mark-ups in riskless principal transactions in all debt securities, Securities Exchange Act Release No. 15220 (Oct. 6, 1978), while adopting similar disclosure requirements for equity securities. Securities Exchange Act Release No. 15219 (October 6, 1978).

The riskless principal mark-up disclosure requirements for debt securities were withdrawn in 1982 on cost grounds, Securities Exchange Act Release No. 18987 (Aug. 27, 1982), 47 FR 37919, and yield disclosure requirements for confirmations for non-municipal securities were proposed. Securities Exchange Act Release No. 18988 (Aug. 27, 1982). The yield disclosure requirements were adopted in 1983. Securities Exchange Act Release No. 19687 (Apr. 18, 1983) 48 FR 17583.

73. Most qualifications testing is carried out under the auspices of the NASD or the NYSE.

74. See MSRB Reports (April 1993) at 17.

75. See supra note 3.

76. As noted in a recent MSRB proposal, the number of actively traded issues (issues with four or more inter-dealer trades on a given day) ranges from approximately 80 to 350 issues, with an average of 180 each day (based on a review of inter-dealer trading activity from August 1991 through January 1992). See MSRB, "Planned Pilot for Publishing Inter-Dealer Transaction Information," MSRB Reports (June 1993) at 3.

77. Approximately 4,800 subscribers receive the Blue List Bond Ticker, and 495 subscribe to the service electronically. Institutions may subscribe.

78. Bloomberg reaches approximately 30,000 terminals, Quotron reaches approximately 50,000 terminals, and Bridge Data approximately 8,000 terminals. Bloomberg terminals are actively used for municipal securities market information. Neither ADP nor Reuters provides any municipal securities quotation, last sale, or bid information.

79. The municipal securities market can be characterized as a "negotiated market." For the majority of municipal securities issues, municipal securities dealers publish a statement indicating "bid wanted" -- dealers list securities they are willing to sell without quotations. Dealers willing to buy the security would negotiate with the dealer that published the bid wanted.

80. Kenny maintains approximately 900 dealer accounts: 500 dealers are subscribers to their screens. Approximately 50 to 60 institutions subscribe to the Kenny screen.

81. For example, Kenny provides a municipal securities pricing service to dealers and institutions. Kenny prices many securities by evaluating, among other things, the prices of other securities with similar maturities, interest rates, and credit risk.

82. See MSRB Reports (June 1993) at 3-6. The MSRB published the proposal for public comment. The proposal has not been filed with the Commission.

83. Transparency is important for several reasons. First, transparency is crucial to efficient pricing mechanisms. Currently, municipal market participants, including investors and municipal securities brokers and dealers, lack access to buying and selling interest in the form of firm bid and ask quotations and last sale reports for the majority of municipal securities. (This is not to say, however, that real-time reporting is necessary for less actively traded municipal securities.) Without access to this information, market participants are at a disadvantage in assessing the value of securities they own or might consider purchasing in the secondary market. More widely available quotation and price information would encourage more competition between dealers because it increases their incentive to quote competitive markets.

Second, transparency permits investors to evaluate whether their brokers are treating them fairly by obtaining the best available price and by charging reasonable mark-ups and markdowns on their transactions. Without access to the prices that other market participants are paying for the same security, they cannot effectively determine whether they have paid a fair price. When quotation and last sale data are available on a real-time basis, investors can determine whether the price the broker indicates they will receive is the best price in the market at that time. Moreover, accurate quote and trade reports allow investors to better monitor the size of dealer mark-ups on their transactions.

Transparency also enhances the ability of regulatory authorities to carry out their responsibilities to prevent sales practice abuses in the municipal securities market. The antifraud provisions of the federal securities laws apply to municipal securities brokers and dealers. The lack of published quote and trade data necessarily makes surveillance of the municipal securities market more difficult. Abuses can go unnoticed, and even when noticed, investigation requires collecting data from multiple sources which may impede regulatory coordination and investor protection. The ability to gather complete quote and last sale reporting facilitates reconstruction of market activity, which is critical to investigating fraudulent or manipulative trading activity.

84. Real-time transaction reporting requires last sale reports to be disseminated within a reasonable period after the trade. For example, for equity securities within the National Market System, brokers and dealers are required to report transactions within 90 seconds of the trade. See Consolidated Tape Association Plan, Section VII. For high yield debt securities, the NASD's Fixed Income Pricing System ("FIPS") requires brokers and dealers to submit trade reports within 5 minutes after execution. See Exchange Act Release No. 32019 (March 19, 1993), 58 FR 16428.

85. Exchange Act Section 15B(b)(2)(F). Section 15B(b)(2)(F) provides the MSRB the authority to include provisions governing the form and content of quotations relating to municipal securities which may be distributed or published by any municipal securities broker, municipal securities dealer, or person associated with such a municipal securities broker or municipal securities dealer, and the persons to whom such quotations may be supplied. Rules relating to quotations shall be designed to produce fair and informative quotations, to prevent fictitious or misleading quotations, and to promote orderly procedures for collecting, distributing, and publishing quotations.

86. Exchange Act Section 15B(b)(2)(C).

87. Section 11A of the Exchange Act grants the Commission authority to oversee the development of a National Market System ("NMS") to implement certain specified congressional goals and objectives including:

> (i) economically efficient execution of securities transactions; (ii) fair competition among brokers and dealers, among exchange markets, and between exchange markets and markets other than exchange markets; (iii) the availability to brokers, dealers, and investors of information with respect to quotations for and transactions in securities; (iv) the practicability of brokers executing investors orders in the best market; and (v) an opportunity for investors' orders to be executed without the participation of a dealer.

Exchange Act Section 11A(a)(1)(C)(i)-(v).

88. Exchange Act Rules 11Aa2-1, 11Aa3-1, and Rule 11Aa3-2. Rule 11Aa2-1 (the "Designated Securities Rule") and Rule 11Aa3-1 (the "Tape Rule") designate the securities or classes of securities qualified for trading in the NMS. Before the adoption of Section 11A, the Commission originally adopted the Tape Rule pursuant to authority under Section 17(a). Rule 11Aa2-1 defines the term "national market security" to mean any reported security as defined under Rule 11Aa3-1. Rule 11Aa3-1(a) defines a reported security as any exchange listed security or NASDAQ security for which transaction reports are required to be made on a real-time basis pursuant to an NMS plan. Rule 11Aa3-1(b) requires exchanges and associations to file an NMS plan regarding transactions in listed equity securities and

NASDAQ/NMS securities. Rule 11Aa3-2 (the "Plan Rule") establishes procedures and requirements for NMS plans.

89. The Consolidated Tape Association ("CTA") provides for the dissemination of the consolidated last sale prices for NYSE and Amex listed stocks (and regional exchange issues that substantially meet Amex listing standards). The prices and volume of trades in these stocks, regardless of the market in which the trade takes place, are disseminated to vendors (such as Quotron and Bridge Data) over high speed data transmission lines. The Consolidated Quotation System ("CQS") consolidates quotations from all markets and market makers in exchange-listed stocks and disseminates them to vendors. The Intermarket Trading System ("ITS") facilitates intermarket trading in exchange-listed equity securities based on current quotation information emanating from the linked markets. The NASDAQ/NMS plan provides for the quotation and transaction reporting for the "upper tier" OTC securities. The Options Price Reporting Authority ("OPRA") disseminated transaction reports for exchange-listed options.

90. See Letter from Richard C. Breeden, Chairman, SEC, to Hon. Donald W. Riegle, Jr., Chairman, Committee on Banking, Housing and Urban Affairs (Sept. 6, 1991).

91. Exchange Act Release No. 32019 (March 19, 1993), 58 FR 16428.

92. Exchange Act Rule 17Ad-1 to Rule 17Ad-15.

93. Since the passage of the 1975 Amendments, in addition to the Commission, commentators have debated the issues related to disclosure in the municipal securities markets. Some commentators have argued that the voluntary disclosure scheme suggested by the GFOA Guidelines is a widely accepted, flexible industry standard. See [illegible]hern Municipal Society, Comprehensive Program for Market and Regulatory Action, Municipal Finance Journal (Spring 1991) at 71; R. Doty, "The Disclosure Process and Securities Laws," Chapter 8, Section 8.07 in D. Gelfland, State and Local Government Debt Financing (1986). Other commentators have argued that federally mandated affirmative rules of disclosure, however unnecessary they were considered to be in the past, are now essential. See Gellis, Mandatory Disclosure for Municipal Securities: Issues in Implementation 13 J. Corp. L. 65, 70 (Fall 1987).

94. Securities Act Section 3(a)(7); Exchange Act Section 3(a)(12).

95. The MSRB has no direct authority over issuers and is constrained from acting indirectly through municipal securities brokers and dealers by Exchange Act Section 15B(d)(2).

96. One commentator has suggested that because future sanctions for non-disclosure may occur well after a politician's term, or at least after re-election, the politician may discount the negative effects of such sanctions. Gellis, Mandatory Disclosure for Municipal Securities: A Re-evaluation, 36 Buffalo L. Rev. 15, 46-50 (1988). See also Craswell & Calfee, Deterrence and Uncertain Legal Standards, 2 J. L. Econ. & Org. 279, 280 (1986) (suggesting that when legal rules are uncertain regarding the probability of punishment, risk averse persons overcomply, but for risk preferring persons, uncertainty strengthens incentives to undercomply).

97. Government Finance Officers Association, Disclosure Guidelines for State and Local Government Securities (1991).

98. Other voluntary disclosure related efforts include: National Federation of Municipal Analysts, Disclosure Handbook for Municipal Securities, 1992 Update (1992); Public Securities Association, Recommendations for a Consistent Presentation of Basic Bond Provisions in Official Statements (Dec. 1989); National Association of State Auditors, Comptrollers and Treasurers, Municipal Disclosure Task Force Report (1990); Governmental Accounting Standards Board, Codification of Governmental Accounting and Financial Reporting Standards (2d ed. 1987); National Council of State Housing Agencies, Disclosure Format for Single-Family Mortgage Revenue Securities Issues (1990) (reproduced at GFOA Guidelines, Appendix F); National Council of Health Care Facilities Financing Authorities (project underway).

99. See Appendix C.

100. GFOA Guidelines, supra note 99 at i-viii.

101. MSRB rule G-32 was amended in 1984. Prior to the amendment, the rule required municipal brokers and dealers to furnish copies of official statements "upon request" to any broker, dealer or municipal securities dealer when new issue municipal securities were sold. To strengthen the rule, the MSRB amended rule G-32 to require that municipal securities dealers who purchased new issues automatically be provided with the rule G-32 disclosures prior to the time confirmation of the transaction is sent. MSRB rule G-32(b)(i).

102. See Exchange Act Release No. 26100 (Sept. 22, 1988), 53 FR 37778, 37785 ("Proposing Release");

103. See Exchange Act Release No. 26985 (June 28, 1989), 54 FR 28799 ("Adopting Release").

104. Adopting Release, supra note 103, at 54 Fed. Reg. 28800.

105. This time period runs from the time the official statement becomes available until the earlier of: (1) 90 days from the end of the underwriting period; or (2) the time when the official statement is available to any person from a nationally recognized municipal securities information repository ("NRMSIR"), but in no case less than 25 days following the end of the underwriting period.

106. Exchange Act Rule 15c2-12(c). The rule contains exemptions for primary offerings of municipal securities in authorized denominations of $100,000 or more, if such securities: (1) are sold to no more than 35 investors, each of whom the underwriter reasonably believes is capable of evaluating the investment and who is not purchasing with a view to distribution; (2) have a maturity of nine months or less or; (3) at the option of the holder may be tendered to an issuer at least as frequently as every nine months.

107. Proposing Release, supra note 102, at 53 Fed. Reg. 37779.

108. Proposing Release, supra note 102 at 53 Fed. Reg. 37787. The interpretation was modified slightly in the Adopting Release. See SEC v. Mathews & Wright Group, Inc. ("M&W"), Litigation Release No. 12072 (April 27, 1989). The Commission, among other actions, revoked the registration of M&W for engaging in over $1.3 million in invalid municipal bond underwritings as part of an effort to avoid the effect of scheduled changes in the tax laws. See also Donaldson, Lufkin & Jenrette Securities Corporation, Exchange Act Release No. 31207 (Sept. 22, 1992) (citing the Proposing and Adopting Releases).

Subsecuently, the Commission censured Donaldson, Lufkin & Jenrette Securities Corporation ("DLJ") for failing to disclose in the initial public offering for M&W, that the firm had conducted fraudulent closings of municipal bond offerings. In spite of learning of the fraudulent closings, DLJ's initial public offering team failed to undertake any evaluation or review of the arrangements or to disclose their existence in the registration statement. See also Appendix D, p. 8-9.

109. Letters from Richard G. Ketchum, Director, Division of Market Regulation, SEC, to: Joseph V. Riccobono, Executive Vice-President, American Banker-Bond Buyer (Jan. 4, 1990); J. Kevin Kenny, President, Chief Executive Officer, J.J. Kenny Co. (Jan. 4, 1990); and Michael R. Bloomberg, President, Bloomberg L.P. (January 11, 1990).

110. MSRB rule G-36 requires that brokers, dealers and municipal securities dealers that act as underwriters of municipal securities deliver to the MSRB, among other things, copies of final official statements, if such documents are prepared by or on behalf of the issuer.

111. The MSIL system was approved by the Commission on June 6, 1991. Exchange Act Release No. 29298 (June 13, 1991), 56 FR 28194. The Board also makes the documents available through its Public Access Facility.

112. The continuing disclosure scheme of the Exchange Act, which applies to publicly-held corporations, does not apply to municipal securities issuers.

113. In addition, the lack of secondary market transparency inhibits dealers from finding the market price of a municipal security.

114. CMOs were first introduced in 1983. The Tax Reform Act of 1986 allowed CMOs to be issued in the form of Real Estate Mortgage Investment Conduits ("REMICs"), creating certain tax and accounting advantages for issuers and for certain large institutional and foreign investors.

115. "Initiatives for Municipal Securities Market Announced," MSRB Press Release (August 4, 1993).

116. Exchange Act Rule 15c2-12. See also Adopting Release, supra note 103.

117. GFOA Guidelines, supra note 97 at 64-80 (guidelines for continuing disclosure).

118. In addition, some counsel in municipal offerings are advising issuers that they may have an obligation as part of their offering disclosures, to indicate whether or not they intend to provide continuing disclosure to bond holders and the market. See Stamas, "Issuers' Intentions on Secondary Disclosure Are Starting to Appear in Official Statements," The Bond Buyer, December 14, 1992, at 1.

119. See Stamas, "Issuers Intentions on Secondary Disclosure are Starting to Appear in Official Statements," The Bond Buyer (Aug. 11, 1993) at 5.

120. National Association of State Auditors, Comptrollers and Treasurers, Continuing Disclosure for State and Local Government Securities: A Fourteen State Study (Oct. 1992).

121. See Stamas, "Panel Is Formed to Help Out States In Their Collection of Continuing Data," The Bond Buyer, Nov. 16, 1992, at 1.

122. Blue Ribbon Committee on Secondary Market Disclosure, Report to the National Association of State Auditors, Comptrollers and Treasurers on Improving Secondary Market Disclosure (August 1993). The Committee found that approximately 80% of the dollar volume of state and local government securities have been issued by approximately 20% of the issuers, and considerable information is available about these issuers and their securities on a continuing basis. Little information is available on the issues that comprise the remaining 20% of state and local government securities currently outstanding. The Committee found that health care issues, state and local housing agency bonds, industrial development bonds, and conduit financings in general were the types of issues on which little information was available. The Committee found that while much information is available through states, there are deficiencies in the information collected. The Committee recommended that: (1) NASACT publish a compendium of information resources in each state; (2) states develop more comprehensive and timely approaches to the collection of information and establish central collection points for marketplace information; (3) NASACT establish an advisory body to provide ongoing assistance to states; and (4) NASACT take a leadership role in coordinating state action with respect to continuing information disclosure.

123. American Bankers Association Corporate Trust Committee, Disclosure Guidelines for Corporate Trustees (Oct. 1991).

124. Stamas, "Investment Company Panel Will Draft Secondary Market Disclosure Guidelines," The Bond Buyer, July 1, 1992, at 1.

125. The CDI System was approved by the Commission. Exchange Act Release No. 30556 (April 6, 1992), 57 FR 12534.

126. During the initial phase of the CDI System pilot, secondary disclosure information was only accepted from trustees of municipal securities issuers. Effective May 17, 1993, the CDI System began accepting disclosure information from issuers of municipal securities as well.

127. In the 151 business days of operation through August 25, 1993, the CDI System would have been capable of accepting 15,100 submissions.

128. After gaining experience with short disclosure notices, the MSRB plans to expand the system to accommodate longer documents. In June of this year, the GFOA and the NFMA agreed to cooperate to explore the possibility of the CDI System accepting longer document submissions by modem. MSRB Reports (June 1993) at 21.

129. These difficulties ranged from bad facsimile transmissions resulting in illegible reports to the failure of an "echo-back" feature that verifies the identity of the submitter. The MSRB plans to eliminate the echo-back feature.

130. See Letter from William R. McLucas, Director, Division of Enforcement, SEC to the Hon. John D. Dingell, Chairman, Committee on Energy and Commerce (Aug. 23, 1993) (noting that to the extent that bond counsel, consultants and other experts act as agents or at the direction of a municipal underwriting firm in making political contributions associated with the firm's municipal underwriting business, the Commissions's present inquiry seeks information regarding these activities).

131. MSRB Reports (Aug. 1993) at 5.

132. Id.

133. The MSRB proposed to phase in the disclosure requirements so that only those contributions made on or after the effective date of the proposal would be reported.

134. Exchange Act Section 19(c) provides the Commission the authority to, by rule, abrogate, add to, and delete from the rules of an SRO as the Commission deems necessary or appropriate to further the purposes of the Exchange Act.

135. For example, the GFOA Guidelines recommend that appropriate financial information about credit enhancers be provided in the official statement, but does not specify whether that information should be in the form of audited financial statements.

136. As discussed previously, the Commission in 1968 adopted Securities Act Rule 131 and Exchange Act Rule 3b-5 defining the credit underlying a municipal conduit security as a separate security subject to registration with the Commission. However, with subsequent changes to the federal securities laws and the federal tax laws, issuers of conduit securities may or may not be subject to registration with the Commission. Moreover, Congress subsequently amended the definition of municipal security to specifically exempt tax-exempt industrial development bonds from these requirements.

137. Although the Staff recognizes that difficult problems arise in defining conduit securities, the Commission previously has addressed these issues in Rules 131 and 3b-5 defining a separate security subject to registration, and they also have been addressed in the Industrial Development Bond Act of 1978. See supra note 10.

138. See Exchange Act Sections 15A(b)(2) (NASD powers); 15B(c)(3) and (5) (Commission and bank regulatory powers, respectively).

139. As the Senate Report on the 1975 Amendments explained:

> To a great extent, the debate on this pivotal issue was shaped by the diverse character and heterogeneous nature of the municipal securities industry, composed as it is of commercial banks subject to direct regulation of the federal banking agencies; diversified investment banking firms, subject to regulation by the NASD and the Commission; and firms which deal solely in municipal bonds and other exempt securities, presently subject to no federal regulation.

1975 Act Report, supra note 23, at 46.

140. In August 1977 there were 333 bank municipal securities dealers. Today there are 233.

141. Granting the MSRB examination and enforcement authority over both bank and non-bank dealers has several advantages. It would give the MSRB increased information about the operation of its rules in practice and the levels of compliance with these rules by municipal dealers. This information would strengthen the MSRB's rulemaking process. Consolidating examination and enforcement of these rules in the MSRB would result in a greater emphasis being given to these activities, and it should assure that consistent enforcement standards are applied across the full range of dealers. At the same time, giving the MSRB examination and enforcement authority could create overlapping examination functions with the NASD and the bank regulators. In addition, duplicating the examination and enforcement staffs already maintained by the NASD and the bank regulators would cost the MSRB, and ultimately the municipal securities industry, substantial amounts on an

ongoing basis. These additional costs do not appear to be justified in terms of the resulting benefits.

142. Requiring all municipal securities to be conducted by a non-bank dealer has the advantages of consolidating examination and enforcement in one entity, the NASD. It also furthers the goal of functional regulation of securities activities, which the Commission has long supported. Indeed, the Commission supported H.R 797, introduced in the last Congress by Congressmen Dingell, Lent, Markey, and Rinaldo, which would have eliminated the exclusion from broker-dealer registration for banks selling municipal securities, and required bank municipal securities activities to be conducted in a separate registered broker-dealer affiliate. See Testimony of Richard Breeden, Chairman, SEC, Concerning H.R. 797, the "Securities Regulatory Equality Act of 1991" before the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce (June 20, 1991). This alternative, however, implicates broader issues regarding financial system restructuring, which may not be resolved easily.

143. Dividing rulemaking authority among the NASD and the bank regulators has serious drawbacks, as seen in the current administration of the registration requirements under Section 12(i) of the Exchange Act for securities issued by banks. See Testimony of Richard C. Breeden, Chairman, SEC, Concerning H.R. 797, the "Securities Regulatory Equality Act of 1991" before the Subcommittee on Telecommunications and Finance of the Committee on Energy and Commerce (June 20, 1991) at 8-10. This approach is likely to result in divergent rules and interpretations for banks and non-banks. Not only could this result in varying investor protection standards and unfair competitive advantages for particular types of municipal dealers, but the uniformity of operational practices currently mandated by MSRB rules, such as MSRB rule G-12 prescribing uniform practice and MSRB rule G-33 prescribing uniform calculations, could be lost.

APPENDIX A

THE MUNICIPAL SECURITIES MARKET

A HISTORICAL OVERVIEW

Municipal securities were granted special status in 1933 in the Securities Act and in 1934 in the Exchange Act, due to the financial expertise of institutional investors, the then typical purchasers of municipal securities,[1] and the lack of perceived abuses in the municipal securities market as compared to the market for corporate securities.[2] Further, Congress was concerned that constitutional issues might arise if it attempted to subject municipal issuers to federal regulation.[3] Former SEC Chairman James M. Landis in his later writings commented that, originally, the drafters of the legislation had contemplated no exemptions at all for municipal securities, though in the end, municipal securities were exempted from coverage of the registration provisions of the Securities Act "for obvious political reasons."[4]

Drafters of the Securities Act included an exemption for municipal securities in the original legislation.[5] As a result, the legislative history of the Securities Act contains little public debate over the exemption. Misrepresentations by municipal issuers were apparently rare, though not unknown.[6] In spite of the lack of problems in the municipal securities markets, disclosure was argued by some to be as necessary for investors in municipal securities as it was for those who purchased corporate securities.[7] Congress resolved these competing concerns by approving the bill with a broad exemption for municipal securities from all provisions of the Securities Act except for the antifraud provision of Section 17(a).[8] This exemption is codified at Section 3(a)(2) of the Securities Act.[9]

During the consideration of the Exchange Act the next year, debate on the issue of the exemption for municipal securities was more lively. Unlike the Securities Act, the Exchange Act did not originally provide any exemption for municipal securities.[10] Consequently, extensive testimony was heard on the issue of the exemption of municipal securities from the coverage of the Exchange Act.

Municipal securities professionals argued that provisions of the bill regarding dealers

in securities would be onerous or unworkable when applied to municipal securities dealers.[11] Municipal securities professionals also argued that voluntary compliance with the Investment Bankers Code of the Investment Bankers Association, which required certain disclosure to customers, would provide sufficient safeguards to customers.[12]

Municipal securities professionals strenuously argued that including municipal securities within the provisions of the Exchange Act would not enhance their safety or their value because, unlike the market for corporate securities, there were few problems in the market for municipal securities.[13] For example, they argued that because municipal bonds frequently were sold by the issuer on the basis of competitive bids to bond dealers, banks, or local individuals, there was little opportunity for manipulation.[14] It also was argued that subjecting municipal securities to Exchange Act requirements would increase the costs of issuance.[15]

Municipal securities were exempted from most of the provisions of the Exchange Act.[16] Municipal securities were not, however, exempted from Section 10(b) of the Exchange Act, which makes it unlawful for any person to use manipulative or deceptive devices or contrivances in connection with the purchase or sale of any securities in contravention of rules adopted by the Commission.

In 1938, Congress considered amendments to the federal securities laws in what became the Maloney Act, and the issue of regulation of participants in the municipal securities markets again came to the fore. The Maloney Act established a scheme of self-regulation of the over-the-counter markets, through registration and empowerment of national securities associations. Once again, members of the municipal securities industry opposed any regulation, based on the position that any such regulation was unnecessary. Senator Maloney, in responding to the opposition, went so far as to argue on a nationwide radio broadcast that exemptions for municipal securities dealers could not be justified on any principled basis.[17] In spite of his efforts, the Maloney Act passed without the inclusion of

municipal securities. Indeed, national securities associations were specifically precluded from regulating the municipal securities activities of their members.[18]

Congress again returned to municipal securities regulation in the 1970s in response to the growth of the municipal securities markets, the increasing role in this market of individual investors who were not necessarily highly sophisticated or wealthy, and instances of dealer sales practice abuses. For example, during the early 1970s, the Commission brought seven injunctive actions against 72 municipal securities professionals for a variety of abusive practices, including excessive mark-ups, churning of customers' accounts, misrepresentations concerning the nature and value of municipal securities, disregard of suitability standards, and high pressure sales techniques.[19]

The Congressional response to these problems in the municipal market was the promulgation, as part of the Securities Acts Amendments of 1975 ("1975 Amendments"),[20] of a regulatory scheme for municipal securities dealers.[21] That scheme included mandatory registration of municipal securities brokers and dealers, and creation of the Municipal Securities Rulemaking Board ("MSRB") with authority to promulgate rules governing the sale of municipal securities. In addition, the 1975 Amendments granted the Commission broad rulemaking and enforcement authority over all municipal securities brokers and dealers.[22]

The 1975 Amendments amended the definition of the term "exempted security" in Section 3(a)(12) of the Exchange Act to provide that a municipal security is not an exempted security for purposes of Section 15, the section requiring registration of broker-dealers. As a result, firms that dealt only in municipal securities, and that operated on an interstate basis, were required to register with the Commission as broker-dealers. Although the exclusion for banks from the general broker-dealer definitions[23] continued to apply after the 1975 Amendments, these amendments added the definition of municipal securities dealer that included any person engaged in the buying or selling of municipal securities for its own

account, including a separately identifiable department or division of a bank.[24] Municipal securities dealers were required to register under Section 15B of the Exchange Act. Thus, for the first time, banks were required to register with the Commission, and became subject to the broad regulatory examination and enforcement authority of the Commission. In addition to banks, firms dealing in municipal securities on an intrastate basis, which were not previously subject to Exchange Act registration requirements, were required to register as municipal securities dealers.

Section 15B of the Exchange Act also established the MSRB as a self-regulatory organization ("SRO") for brokers and dealers in municipal securities. The Board of the MSRB has 15 members that represent two categories of municipal securities market professionals, as well as members of the public. Five members represent non-bank broker-dealers, and another five represent bank dealers. The remaining five, which may not be associated with any broker, dealer, or municipal securities dealer, represent the public.[25] One of these public representatives must represent issuers. The MSRB, unlike other SROs, was not given inspection or enforcement powers, nor was it created as a membership organization.

In establishing the MSRB, Congress created a single rulemaking body whose rules applied equally to banks and non-banks. The MSRB, under the Commission's supervision, was given rulemaking authority over municipal securities brokers and dealers in the areas, among others, of professional qualifications, recordkeeping, quotations, and advertising.[26]

Congress divided responsibility for enforcement of MSRB rules. Bank regulatory agencies were granted enforcement authority regarding these rules over bank municipal securities dealers.[27] The National Association of Securities Dealers, Inc. ("NASD") was granted enforcement authority over non-bank firms registered pursuant to Section 15(a) or Section 15B(a)(1) of the Exchange Act.[28] The 1975 Amendments make clear, however, that the Commission has broad disciplinary authority over all municipal securities brokers,

dealers, and their associated persons.[29] Enforcement activities regarding municipal securities dealers must be coordinated by the Commission, the NASD, and the appropriate regulatory agency.[30] The 1975 Amendments also extended the Commission's specialized broker-dealer antifraud, recordkeeping, and reporting rulemaking authority to municipal securities dealers.[31]

The 1975 Amendments did not create a regulatory regime for municipal issuers or impose any new requirements on these municipal issuers. Indeed, Section 15B expressly limited the Commission's and the MSRB's ability to establish municipal issuer disclosure requirements. Section 15B(d)(1) of the Exchange Act prohibits the Commission and the MSRB from requiring municipal securities issuers, either directly or indirectly, to file any application, report or document with the Commission or MSRB prior to any sale by the issuer. This section does not, by its terms, preclude the Commission from promulgating disclosure standards in municipal offerings, although there is no express statutory authority contained in the Exchange Act over disclosure by municipal issuers. Section 15B(d)(2) of the Exchange Act prohibits the MSRB, either directly or indirectly, from requiring issuers to furnish investors or the MSRB with any "report, document, or information" not generally available from a source other than the issuer. This section was intended to make clear that the legislation was not designed to subject states, cities, counties, or any other municipal authorities, to any disclosure requirements that might be devised by the MSRB.[32] These sections collectively are known as the "Tower Amendment."[33]

During the last 18 years, several attempts were made to increase the amount of disclosure available in the municipal securities market. No changes ultimately resulted. In 1976, after New York City defaulted on its outstanding securities,[34] Senator Thomas Eagleton proposed a bill which would have removed the exemption in Section 3(a)(2) of the Securities Act for securities of municipal issuers, thus subjecting municipal issuers to the registration and other provisions of the Securities Act.[35] The Commission opposed that bill,

which was overshadowed by a concurrent bill, the Municipal Securities Full Disclosure Act of 1976.[36] This bill, introduced by Senators Harrison A. Williams and John Tower,[37] would have required municipal issuers to provide initial as well as ongoing disclosure through "distribution statements" and annual reports. While the bill provided that distribution statements would be made available to brokers and dealers for prospective purchasers, and would be filed at a central repository, it contained no "prefiling" requirements.[38] Moreover, it made no provision for a Commission review process of issuer disclosures. While the Commission supported this bill, the bill was opposed by municipal securities issuer groups as too far-reaching,[39] and died in Committee.

The bill was resurrected in 1977, modified, and re-introduced to Congress by Senators Williams, Proxmire, and Javits as "The Municipal Securities Full Disclosure Act of 1977" (the "1977 MSFDA bill").[40] Under the 1977 MSFDA bill, as under the Municipal Securities Full Disclosure Act of 1976, all municipal issuers would have been required to prepare an offering document to be used in the public sale of securities. The 1977 MSFDA bill went further, however, and granted the Commission authority to promulgate disclosure rules (within certain parameters) and to adopt differential requirements for various sizes and types of issuers and offerings. This grant of authority may have been in response to testimony of then-Chairman Hills that the Commission believed the "creation of standards for disclosure" in municipal offerings was an appropriate Commission role.

The 1977 MSFDA bill also would have required municipal issuers with more than $50 million principal amount in securities outstanding to prepare annual reports and reports of events of default. Further, the 1977 MSFDA bill would have granted the Commission broad authority to specify the form and manner in which the required financial information would be prepared and audited. No hearings were held, and no vote was ever taken on this bill.

In 1979, Senator Williams introduced the State and Local Government Accounting

and Financial Reporting Standards Act of 1979,[41] a bill that would have created nationally recognized accounting and financial reporting standards. The bill would have created the Institute for State and Local Government Accounting and Financial Reporting Standards ("Institute"). Compliance with standards, promulgated by the Institute, would have been voluntary, and the bill would not have empowered any entity to enforce the Institute's standards. Substantially the same bill was reintroduced in 1981 by Senator Williams as the State and Local Government Accounting and Financial Reporting Standards Act of 1981.[42] No hearings were held on either bill, nor was either the subject of a vote.

The Commission also has recommended legislative changes and, in particular, questioned the wisdom of Exchange Act Section 15B(d)(2).[43] In 1985, the Commission advocated the repeal of Exchange Act Section 15B(d)(2) in the aftermath of the default on bonds issued by the Washington Public Power Supply System ("WPPSS").[44] The 1983 default on $2.25 billion of bonds issued between 1977 and 1981 by the WPPSS was the largest non-payment default in municipal bond history. A Commission investigation into the circumstances of the default highlighted the deficient disclosure made to investors in WPPSS securities.[45] The Commission suggested that deletion of Exchange Act Section 15B(d)(2) was a way to strengthen municipal securities disclosure, and was the "least intrusive" means of improving the flow of information to investors.[46] In 1987, Chairman David Ruder again called for repeal of Exchange Act Section 15B(d)(2), prompted by a concern that issuers were not making copies of disclosure statements available to underwriting syndicates.[47] The Commission subsequently acted directly to address the issues highlighted by Chairman Shad and Chairman Ruder in its adoption of Exchange Act Rule 15c2-12 and accompanying interpretation concerning the due diligence obligation of municipal securities underwriters.

ENDNOTES

1. Hearings on S. Res. 84, S. Res. 56, and S. Res. 97 Before the Senate Committee on Banking and Currency, 73d Cong., 2d Sess. 7443 (1934).

2. H.R. Rep. No. 85, 73d Cong., 1st Sess. 7 (1933).

3. Id. at 14. The framers of the Constitution were concerned with creating a system in which power would not be unduly concentrated in the federal government. Thus, while the Constitution provides that certain powers may be exercised only by the federal government, it also reserves certain powers to the states, and provides that some powers may be exercised concurrently and independently by both the federal government and the states. See L. Tribe, American Constitutional Law ¶ 2-2 (2d ed. 1988). See also Hoke v. United States, 277 U.S. 308 (1913). The framers' concern was underscored by the Tenth Amendment to the Constitution, which provides that all powers that are not otherwise delegated to the federal government or prohibited to the states, are reserved either to the states, respectively, or to the people. U.S. Const. amend. X.

While numerous federal laws have been challenged as violative of the Tenth Amendment, the Supreme Court generally has sustained laws that affect matters otherwise controlled by the states when such laws were enacted pursuant to power delegated to the federal government by the Constitution. See, e.g., Monell v. Department of Social Services, 436 U.S. 658 (1978) (holding that local governments could be held liable for civil rights violations pursuant to 42 U.S.C. § 1983); Fry v. United States, 421 U.S. 542 (1975) (holding that the Tenth Amendment was not violated by the enactment of the Economic Stabilization Act of 1970, which authorized orders and regulations to stabilize salaries, even though such actions could restrict the wages of state employees); United States v. Oregon, 366 U.S. 643 (1961) (holding that a federal law which provided that the property of intestate veterans without heirs who died in U.S. veterans' hospitals would escheat to the federal government, rather than to the state as provided by state law, did not violate the Tenth Amendment). See also New York v. Richardson, 473 F.2d 923 (2d Cir.), cert. denied 412 U.S. 950 (1973) (holding that provisions of the Social Security Act requiring state and local governments to share in fiscal responsibility for welfare payments did not violate the Tenth Amendment by depriving states of funds that could otherwise be used for purely state purposes); Oklahoma v. Civil Service Commission, 330 U.S. 127 (1947) (holding that the application of the Hatch Political Activity Act to employees of state and local governments did not violate the Tenth Amendment when such employees' principal employment was financed, in whole or in part, by federal loans or grants). Cf. National League of Cities v. Usery, 426 U.S. 833 (1976) (sharply divided Court held that the Commerce Clause did not empower Congress to enforce the minimum-wage and overtime provisions of the Fair Labor Standards Act against the states "in areas of traditional governmental functions"), overruled by Garcia v. San Antonio Metropolitan Transit Authority, 469 U.S. 528 (1985).

Recently, in South Carolina v. Baker, 485 U.S. 505 (1988), the Supreme Court held that the Tenth Amendment had not been violated by a federal tax code provision that removed the federal income tax exemption for interest earned on certain state and local bonds unless such bonds were issued in registered (as opposed to bearer) form. Since both parties agreed that this provision effectively forced state and local governments to issue all their bonds in registered form, for the purposes of its Tenth Amendment analysis, the Court treated the law as directly prohibiting the issuance of bearer bonds. Citing Garcia, supra, the Court stated that the Tenth Amendment limits on Congress' authority to regulate state activities "are structural, not substantive -- i.e., that States must find their protection from

congressional regulation through the national political process, not through judicially defined spheres of unregulable state activity." South Carolina v. Baker, 485 U.S. at 512 (citing Garcia, 469 U.S. at 537-554). While noting that the State had not alleged it had been denied of its right to participate in the political process, but rather argued the law was "imposed by the vote of an uninformed Congress relying on incomplete information," the Court stated:

> [N]othing in Garcia or the Tenth Amendment authorizes courts to second-guess the substantive basis for congressional legislation. . . . Where, as here, the national political process did not operate in a defective manner, the Tenth Amendment is not implicated.

South Carolina v. Baker, 485 U.S. at 513 (emphasis in original) (citation omitted). After the Court's decision in South Carolina v. Baker, it is unlikely that a constitutional challenge to Congress' authority to enact legislation pertaining to municipal securities would be successful.

4. Landis, The Legislative History of the Securities Act of 1933, 28 Geo. Wash. L. Rev. 29, 39 (1959). He also noted that "the mayors of our various cities rose up en masse when we tried to bring the issuance of municipal securities under the 1933 Act." J. Seligman, The Transformation of Wall Street (1982) at 65 (citing letter to Manuel Cohen from James Landis, Cohen SEC Papers. vol. 41, item 7.)

5. See S. 875 (Confidential Committee Print), 73d Cong., 1st Sess. 21 (Mar. 13, 1933). Section 11(a) of the bill exempted from registration any security issued or guaranteed by the United States or any territory or insular possession thereof, or by the District of Columbia or by any state of the United States or political subdivision or agency or institution of any state or states.

6. Hearings on S. 875 Before the Senate Committee on Banking & Currency, 73d Cong., 1st Sess. 232 (1933) (testimony of M. H. MacLean, Vice President, Harris Trust and Savings Bank, Chicago, Illinois).

7. Id. at 65 (testimony of Col. A. H. Carter, Chairman of the New York State Society of Certified Public Accountants).

8. Section 17(a) of the Securities Act prohibits the making of false or misleading statements in connection with the offer or sale of securities. This antifraud provision of the Securities Act applies to municipal securities by virtue of Section 17(c), which states that exemptions from Section 3 of the Securities Act shall not apply to Section 17. Municipal securities transactions are not subject to Section 11 of the Securities Act, which imposes liability on persons for misstatements or omissions of material fact in a registration statement, or Section 12(2) of the Securities Act, which imposes liability on those who offer or sell securities through the use of misstatements or omissions of a material fact in a prospectuses or oral communication.

9. Section 3(a)(2) of the Securities Act, as finally adopted, exempts "[a]ny security issued or guaranteed . . . by the District of Columbia, or by any State of the United States, or by any political subdivision of a State or Territory, or by any public instrumentality of one or more states or territories . . . " from the provisions of the Securities Act.

10. Stock Exchange Practices: Hearings on S. Res. 84, S. Res. 56 and S. Res. 97 Before the Senate Committee on Banking and Currency, 73d Cong., 1st Sess. 7037 (1934).

11. Id. at 7037-46 (Statements of Archibald B. Roosevelt, President, Roosevelt & Weigold, Inc., and George B. Gibbons, President, George B. Gibbons & Co., Inc.; municipal bond dealers, New York, New York). Specifically, Messrs. Roosevelt and Gibbons noted the deleterious effect on the municipal securities industry of provisions in the bill concerning, among others, limitations on dealer commitments of net capital, separation of broker and dealer functions, and requirements of independent audits and SEC registration.

12. Id. at 7040-7041.

13. Id. at 7443, 7445.

14. Id. at 7444.

15. S. Rep. No. 75, Securities Exchange Act of 1975: Report of the Committee on Banking, Housing and Urban Affairs, to Accompany S. 249, 94th Cong., 2d Sess. 42 (1975) ("1975 Act Report").

16. Section 3(a)(12)(A)(iii) of the Exchange Act defines municipal securities as "exempted securities." The term "municipal securities" is defined, in relevant part, in Section 3(a)(29), as securities which are "direct obligations of, or obligations guaranteed as to principal or interest by, a State or any political subdivision thereof, or any instrumentality of a State or any political subdivision thereof, or any municipal corporate instrumentality of one or more States . . . . " The definition of an exempt security in Securities Act Section 3(a)(2) is different from that of the Exchange Act in that Section 3(a)(2) exempts securities "issued or guaranteed . . . by any State . . . . " See also supra note 9.

17. Seligman, supra note 4, at 187.

18. The Maloney Act, Pub. L. No. 719, 52 Stat. 1070 (1938), added Section 15A to the Exchange Act. See Exchange Act Section 15A(f)(1).

19. 1975 Act Report, supra note 15, at 43.

20. Pub. L. No. 94-29, 89 Stat. 131 (1975).

21. Municipal securities were traded by three types of entities: registered broker-dealers, who bought and sold municipal securities in addition to engaging in other securities activities; sole municipal brokers and dealers, who dealt exclusively in municipal securities and thus avoided registration with the Commission; and banks, which traded general obligation municipal securities pursuant to an exclusion from the Glass-Steagall Act for general obligation bonds. Despite the Glass-Steagall Act prohibition of bank securities activities generally, national banking associations are permitted under 12 U.S.C. § 24(7) (1988) to deal in, underwrite, and purchase for their own account "general obligation bonds of any State or any political subdivision thereof . . . . " General obligation bonds have been interpreted to include revenue bonds unconditionally guaranteed by an obligor possessing general powers of taxation, and, in some cases, revenue bonds backed by a bank letter of credit. See M. Capatides, A Guide to the Capital Markets Activities of Banks and Bank Holding Companies 31-34 (1993).

22. See, e.g., Exchange Act Section 15(c)(1), Section 15(c)(2), Section 17(a), Section 17(b), Section 15B(c)(1), Section 15B(c)(2), Section 21(a)(1).

23. Banks, due to their limited involvement in securities activities in 1934 pursuant to the Glass-Steagall Act prohibitions, were not included in the broker-dealer registration provisions of the Exchange Act. The Commission long has maintained that bank securities activities, which have increased dramatically over the last decade, should be regulated in the same manner as non-bank securities activities, and that the exclusion for banks from broker-dealer registration requirements is no longer justified. See, e.g., Testimony of Richard Breeden, Chairman, SEC, Concerning S. 543 and S. 713, Before the Senate Committee on Banking, Housing and Urban Affairs (May 7, 1991). The Commission continues to believe that bank securities activities should be conducted outside the bank in a subsidiary or affiliate that, as a broker-dealer, is registered with the Commission.

24. Exchange Act Section 3(a)(30). Under Exchange Act Section 15B(b)(2)(H), however, Congress delegated to the MSRB the power to define by rule the manner of determining the separately identifiable department or division of a bank. MSRB rule G-1 sets forth a test for determining the separately identifiable department or division of a bank along functional lines.

25. Exchange Act Section 15B(b)(1).

26. Exchange Act Section 15B(b)(2).

27. Exchange Act Section 15A(b)(2), Section 15B(c)(5).

28. Exchange Act Section 15A(b)(7) requires the NASD to have rules providing for the discipline of members who violate the MSRB's rules. In addition, criminal sanctions are also possible. See, e.g., Securities Act Section 17(a)(1), Section 17(a)(2), Section 17(c).

29. See generally Exchange Act Section 15(b)(1), Section 15B(a)(2) (registration requirements); Section 15(b)(4)-(5), Section 15B(c)(2)-(3) (power to suspend, revoke or deny the registration of a broker or dealer or municipal securities dealer); Section 15(b)(4), Section 15B(c)(4) (power to impose appropriate limitations on the functions and activities of any person who violates the Exchange Act or rules and regulations promulgated thereunder); Section 15B(c)(2), Section 15B(c)(6) (authority to institute independent action against any municipal securities dealer that is a bank). See also 1975 Act Report, supra note 15, at 52-53.

30. Exchange Act Section 15B(c)(6)(A), Section 15B(c)(6)(B), Section 17(c).

31. Exchange Act Sections 15(c)(1) and 15(c)(2) prohibit the use, by a broker, dealer, or municipal securities dealer of fraudulent, deceptive, or manipulative acts or practices to effect any transaction in the purchase or sale of municipal securities. The 1975 Amendments revised these sections to make clear that the Commission's rulemaking authority also applied to possible manipulative conduct by banks or departments of banks engaged in municipal securities transactions. Similarly, municipal securities dealers were added to the coverage of Section 17(a) of the Exchange Act. This section grants the Commission recordkeeping and reporting authority, and serves as the reference list for Section 17(b) of the Exchange Act, which confers examination authority.

32. 94th Cong., 1st Sess., 121 Cong. Rec. 10727 (1975) (remarks of Senator Tower).

33. In fact, the Tower Amendment added only Section 15B(d)(2) imposing disclosure limitations on the MSRB.

34. Just after the consideration of the 1975 Amendments, New York City experienced a fiscal crisis of major proportions. See SEC, Final Report in the Matter of Transactions in Securities of the City of New York, Submitted to Senate Committee on Banking, Housing and Urban Affairs, 96th Cong., 1st Sess. (Comm. Print 1979) ("Final Report"). From October 1974 through March 1975, the city issued approximately $4 billion in short-term debt securities, reaching record levels of outstanding debt. Increasing concern about New York City's solvency led to the city's inability to place any further debt in the public markets. By November 1975, the city was unable to meet its maturing obligations as they came due. As New York State attempted to remedy the crisis through legislation, the prices of New York City securities fell sharply, causing public investors who sold their securities to incur substantial losses. See Final Report at 1-2. See also Shalala & Bellamy, A State Saves A City: The New York Case, 1976 Duke L. J. 1119, 1127-32 (describing various funding mechanisms to save the City from default).

The Commission staff prepared a comprehensive report, resulting from its 19 month investigation into the conduct of persons participating in the events leading to the city's fiscal crisis, which concluded that the city's budgetary, accounting, and financing practices provided a distorted picture of the City's financial condition. Securities and Exchange Commission Staff Report on Transactions in Securities of the City of New York, Subcommittee on Economic Stabilization, House Committee on Banking, Finance and Urban Affairs, 95th Cong., 1st Sess. (Comm. Print 1977) at Chapters Two and Three. ("Staff Report"). The Staff Report also concluded that underwriters, bond counsel, and rating agencies had failed to meet their responsibilities to the investing public in the sale of New York City securities. Staff Report at Chapters Four, Five, and Six. The Staff Report stated that "[t]he City's securities offerings were carried out without adequate disclosure. As a result, the public's principal source of information, besides the stream of confusing and contradictory statements in the press, was the representations by the City and the underwriters attesting to the safety and security of City notes." Id. at Chapter Four, p. 74. Further, the Staff Report concluded that "[b]ased upon the record of this investigation, it appears that both [the rating agencies] Moody's and S&P failed, in a number of respects, to make either diligent inquiry into data which called for further investigation, or to adjust their ratings of the City's securities based on known data in a manner consistent with the standards in which prior ratings had been based." Id. at Chapter Five, p. 31. Finally, the Staff Report found that "when put on notice of circumstances that called into question matters basic to the issuance of their opinion, bond counsel should have conducted an additional investigation." Id. at Chapter Six, p. 81.

The Commission, after completing its investigation, determined that no enforcement proceedings should be instituted. The Commission based this decision on a number of factors, including the change in the City's administration, and various remedial actions taken by the City. Final Report at 5. The Commission did, however, conclude that "the public interest [would] best be served by Commission efforts in support of legislative solutions to the complex problems existing in the municipal securities field." Id. See also id. at 15-23. (noting the Commission's support of the 1978 Industrial Development Bond Act, and reviewing other legislative efforts). The New York City crisis did, however, spawn a great deal of litigation. See In re New York Securities Litigation (S.D.N.Y. 1980), Fed. Sec. L. Rep. ¶ 97,258 (1980); Comment, Municipal Bonds: If Default is Here, Can Disclosure Be Far Away?, 41 Albany L. Rev. 545 (1977).

35. S. 2574, 94th Cong., 1st. Sess., 121 Cong. Rec. 33,907 (1975).

36. S. 2969, Municipal Securities Full Disclosure Act of 1976, 94th Cong., 2d Sess., 122 Cong. Rec. 3319 (1976).

37. At the time, Senators Williams and Tower were the Chairman and ranking member, respectively, of the Senate committee charged with overseeing the Commission.

38. A "prefiling" requirement is one which mandates that the issuer file disclosure documents with the Commission prior to the sale of the securities described therein.

39. This bill was opposed by the National League of Cities, the United States Conference of Mayors, and Municipal Finance Officers Association (later re-named the Government Finance Officers Association). See Municipal Securities Full Disclosure Act of 1976: Hearings on S. 2969 and S. 2574 Before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, 94th Cong., 2d Sess. (1976); Municipal Securities Full Disclosure Act of 1976: Hearings on H.R. 15205, H.R. 10523, H.R. 10530, H.R. 10606, H.R. 11534 Before the Subcommittee on Interstate and Foreign Commerce of the House Committee on Interstate and Foreign Commerce, 94th Cong., 2d Sess. (1976). H.R. 15205, introduced by Congressman John M. Murphy, was identical to S. 2969. The Subcommittee never voted on the bill.

40. S. 2339, Municipal Securities Full Disclosure Act of 1977, 95th Cong., 1st Sess., 123 Cong. Rec. 19272 (December 1, 1977).

41. S. 1236, State and Local Government Accounting and Financial Reporting Standards Act of 1979, 97th Cong., 2d Sess. (1979).

42. S. 610, State and Local Government Accounting and Financial Reporting Standards Act of 1981, 99th Cong., 2d Sess. (1981). The Governmental Accounting Standards Board was created in 1984.

43. See The 1978 Industrial Development Bond Act, S. 3323, 95th Cong., 2d Sess., 124 Cong. Rec. 21,639 (1978). This Act was a Commission supported bill that would have subjected industrial development bonds to registration under the Securities Act. No hearings were held, and this bill was never subject to a vote.

44. Letter from SEC Chairman John Shad to Hon. Timothy E. Wirth, Chairman, Subcommittee on Telecommunications, Consumer Protection, and Finance (Mar. 12, 1985) at 14 ("Wirth Letter") (in response to questions relating to municipal securities regulation; recommending the repeal of the Exchange Act Section 15B(d)(2)).

45. See Washington Public Power Supply System: Financial Meltdown, Oversight Hearing Before the Subcommittee on Mining, Forest Management, and Bonneville Power Administration of the House Committee on Interior and Insular Affairs, 98th Cong., 1st Sess. (June 10, 1983); SEC, Staff Report on the Investigation In the Matter of Transactions in Washington Public Power Supply System Securities (Sept. 1988).

46. Wirth Letter, supra note 44, at 14. See also 24 Securities Regulation & Law Report 1033-34 (June 14, 1985).

47. Remarks of David S. Ruder, Chairman, SEC, to the Public Securities Association in Phoenix, Arizona (Oct. 23, 1987). See also 43 Securities Regulation & Law Report 1649 (October 30, 1987).

APPENDIX B

MUNICIPAL BOND DEFAULTS

AN OVERVIEW

Historically, municipal securities have had significantly lower rates of default[1] than corporate and foreign government bonds.[2] Moreover, the risk of ultimate non-payment for municipal debt is slight, both when compared to total municipal debt outstanding and total municipal debt in default.[3]

Municipal debt default rates vary considerably with the type of bonds issued. General obligation bonds typically experience the lowest incidence of default. As one study demonstrated, during the period from 1980 through 1991, of 726 defaulted municipal issues representing $8.63 billion in principal amount, no general obligation bond defaults were reported.[4] In addition, rated bonds tend to have much lower rates of default than non-rated bonds.[5] Although larger issues tend to have fewer defaults than smaller issues, this apparently is because there are fewer larger issues.[6] As one industry group study has shown, the default rate for municipal bonds issued between 1986 and 1991 is higher for issues greater than $10 million but less than $100 million, than for issues outside those ranges.[7]

In addition, municipal debt default rates vary depending upon the purpose for which bond proceeds are used. While health care related financings have the largest incidence of default, industrial development bonds and housing related bonds also have high default rates.[8] Commentators have speculated that the incidence of default is inversely related to the extent to which the funded project is associated with traditional municipal functions.[9]

ENDNOTES

1. A default occurs when an issuer fails to pay interest or principal on its securities. Thus, a default may be only a brief interruption of payments, or payment from a reserve fund, and may not indicate that repayment of the underlying debt is in doubt.

2. For example, in 1932, before the enactment of either the Securities Act or the Exchange Act, approximately 1.8 percent of all municipal bonds were in default while 3.5 percent, 7.2 percent, and 19.4 percent of railroad bonds, industrial bonds, and foreign bonds, respectively, were in default. J. Seligman, The SEC and Future of Finance 297 n.17 (1985) (citing J. Spiotto, "Municipal and Corporate Bonds: Analysis of Defaults and Remedies," in J. Spiotto, Bonds: Defaults and Remedies (PLI Real Estate Law and Practice Course Handbook Series No. 206 (1982)). While default rates have varied considerably over the years, municipal bonds have consistently had a lower default rate than corporate bonds. While the rate of municipal defaults averaged .25 percent between 1945 and 1975, the default for corporate bonds was approximately .40 percent in the 1940s and 1950s, .03 percent in the 1960s, and .02 percent in the 1970s. Id. (citations omitted). Corporate defaults reached a record high in 1991, with 88 issuers defaulting on an estimated $25.5 billion in debt. Standard & Poors Creditreview, Corporate Default, Rating Transition Study Updated 1 (Jan. 25, 1993). In contrast, a total of 121 municipal bond issues defaulted in 1991, representing approximately $2.5 billion in debt. Municipal Bond Defaults - The 1980's: A Decade in Review 17 (J.J. Kenny Co., Inc. 1993) ("Kenny Default Report").

3. Historically, the amount of permanent losses on municipal debt is small when compared to the amount of municipal defaults. For example, permanent losses on principal and interest for the period 1945-1965 were less than .01 percent of the total debt outstanding in 1965. Of the $13.5 billion of municipal bonds in default in 1932, only $200 million, or 1.48 percent of the bonds in default, were permanent losses. See A. Gellis, Mandatory Disclosure for Municipal Securities: A Reevaluation, 36 Buffalo L. Rev. 15, 26 n.30 (1987) (citing J. Petersen, The Rating Game 110, 111 (1974); G. Hempel, Postwar Quality 19-21 (1971); J. Seligman, Municipal Disclosure, 9 Del. J. Corp. L. 647, 651-52 n.17 (1984)); A. Gellis, Mandatory Disclosure for Municipal Securities: Issues in Implementation, 13 J. Corp. L. 65, 85 n. 76 (1987) (citing J. Petersen, The Rating Game 2 111 (1974); W. Smith, The Appraisal of Municipal Credit Risk 244 (1978)).

4. Kenny Default Report, supra note 2, at 1-2.

5. Id. According to the Kenny Default Report, of the total municipal bond defaults between January 1, 1980 and December 31, 1991, 98 were rated issues and 628 were non-rated issues. Approximately 1.93 percent ($2.99 billion) of the total dollar volume ($155.31 billion) of non-rated bonds sold between 1980 and 1991 defaulted during that period, representing approximately 2.12% (522) of the total number of non-rated issues (24,603) sold during that period. In contrast, approximately 0.27 percent ($3.36 billion) of the total dollar volume ($1.24 trillion) of rated bonds sold during this period defaulted, or approximately 0.08% (53) of the number of rated issues (69,656) sold during that period. Id. at 1. Moreover, the study showed that the average time to default for rated bonds (90.61 months) was approximately 57 percent greater than the average time to default on non-rated bonds (57.83 months). Id. See also Public Securities Association, An Examination of Non-Rated Municipal Defaults 1986-1991 4 (Jan. 8, 1993) ("PSA Default Report"), showing that approximately 2 percent ($1.28 billion) of the dollar volume ($64.3 billion) of non-rated bonds sold between 1986 and 1991 defaulted. The conclusions of this study have been criticized, however, as being skewed toward finding fewer than actual defaults, in light of a

finding by the Kenny Default Report that the average time of default for an unrated municipal security is slightly less than six years after issuance. See, e.g., B. Stein, Minus Munis - New Light is Shed on Default Rates, Barron's, May 31, 1979, at 22. The PSA Default Report itself seems to support this analysis, in that it shows a 6.2 percent default rate for bonds issued in 1986, compared to 2.7 percent, 2.2 percent, 1.8 percent, 0.5 percent, and 0.0 percent default rates for bonds issued in 1987, 1988, 1989, 1990, and 1991, respectively. PSA Default Report at 4.

6. Kenny Default Report, supra note 2, at 1-2. According to the Kenny Default Report, almost 90% of all the non-rated defaults between 1980 and 1991 occurred on issues that were less than $10 million in size. See also PSA Default Report, supra note 5, at 6-8, showing that 79% of the non-rated municipal bond defaults between 1986 and 1991 were on issues of less than $10 million.

7. PSA Default Report, supra note 5, at 6-8. Specifically, the PSA Default Report showed that the default rate in this time period (calculated by number of issues) were 1.0% for issues of $10 million or less, 2.5% for issues between $10 and $100 million, and 1.6% for issues greater than $100 million. When calculated by dollar volume, the default rates were 2.0%, 2.1%, and 1.7%, respectively.

8. PSA Default Report, supra note 5, at 4-5 (showing that the default rate between 1986 and 1991 was 6.3% for health care issues, 2.7% for industrial related issues, and 2.6% for housing related issues). See also Kenny Default Report, supra note 2, at 2 (showing that approximately 76% of all non-rated defaults between 1980 and 1991 by dollar volume were on health-care bonds (46%) and industrial development bonds (30%).

9. Kenny Default Report, supra note 2, at 2, noting "the incidence of default among all bonds in the study appeared to be inversely related to the 'essentiality' of the bond-financed projects." In the authors' view, a utility project is more "essential to the proper functioning of a municipality than is a housing project, factory, or nursing home." Moreover, the authors stated that they found evidence that many non-rated defaults occurred on projects of a highly speculative nature, such as nursing homes, rather than on less speculative projects, such as those for local utilities. Id.

APPENDIX C

A COMPARISON OF THE GFOA GUIDELINES

AND

CORPORATE DISCLOSURE REQUIREMENTS

As discussed in this Report, the disclosure provided in municipal official statements commonly is less comprehensive than that required of corporate issuers under Commission registration rules. Even municipal disclosures that fully follow the Government Finance Officers Association's ("GFOA") Disclosure Guidelines for State and Local Government Securities ("GFOA Guidelines")[1] would differ from those required of corporate issuers in a number of respects. These include disclosure of compensation and material relationships,[2] related party transactions,[3] financial statement reporting,[4] accounting,[5] and auditing standards[6], and information on credit enhancers.[7] In addition, the antifraud provisions of the federal securities laws, which are the only current federal laws governing disclosure by municipal issuers, do not provide specific guidelines concerning what disclosure is required of issuers.[8]

ENDNOTES

1. Government Finance Officers Association, Disclosure Guidelines for State and Local Government Securities (1991).

2. The Commission requires disclosure of material relationships between an issuer and an underwriter or underwriting syndicate, while the GFOA Guidelines contain no suggestion that such disclosure should be provided. See Item 508 of Regulation S-K. Further, the Commission's rules set forth specific disclosure requirements designed to elicit meaningful disclosure of compensation of the issuer's executives as well as compensation of the underwriters. Under the Commission's rules, a company must disclose discounts and commissions to be allowed or paid to the underwriters, and all other items that would be deemed by the NASD to constitute underwriting compensation for purposes of the NASD's Rules of Fair Practice. See Item 508(e) of Regulation S-K. The GFOA Guidelines suggest only that contractual arrangements with the underwriter and compensation arrangements with executive officers be described. See GFOA Guidelines, supra note 1, at Section XII(B); Section VI(3) ("state their direct and indirect compensation . . . and describe their participation in retirement or pension plans"). There is no suggestion that compensation arrangements of principal officials of a governmental issuer be disclosed.

3. The Commission's rules require extensive disclosure of related party transactions and conflicts of interests between the issuer and any director, executive officers, beneficial owners of five percent or more of the company's securities, and any family member of the foregoing. Item 404 of Regulation S-K. The GFOA Guidelines suggest that this disclosure should be provided only where the issuer is a conduit issuer. No such disclosure is recommended where the issuer is a government enterprise.

4. The GFOA Guidelines recommend that the relevant issuer or fund present financial statements of the issuer for two fiscal years. GFOA Guidelines, supra note 1, at Section IX(B); Section X(B). The Commission requires financial statements for three years for most issuers. See Item 3-02 of Regulation S-X. With respect to interim period financial statements, the GFOA Guidelines recommend summarized interim information of governmental enterprises and conduit issuers for the latest practicable date if the official statement is dated more than 120 days after the latest year-end. GFOA Guidelines, supra note 1, at Section IX(A)(1). The Commission ordinarily requires that the latest balance sheet be as of a date within 135 days of the effective date of the registration, except that third quarter operating results ordinarily will suffice until 90 days after fiscal year-end. Item 3-12(b) of Regulation S-X. Financial statements of the comparable prior year's interim period are required by the Commission, but are not discussed in the GFOA Guidelines. Item 10-01(c) of Regulation S-X.

5. With respect to accounting, the GFOA Guidelines recommend that financial statements be prepared in accordance with generally accepted accounting principles ("GAAP"). GFOA Guidelines, supra note 1, at Section IX(B); Section X(B). The GFOA Guidelines recognize the Governmental Accounting Standards Board as the promulgator of GAAP applicable to governmental entities, and are silent as to the authority for GAAP applicable to nongovernmental entities. GFOA Guidelines, supra note 1, at Section IX(B) n.36. The Commission considers accounting standards promulgated by the Financial Accounting Standards Board ("FASB") to be GAAP for public companies, except in the very limited circumstances where the Commission establishes a different rule. (The Commission has not considered what GAAP is for governmental entities. GASB and FASB are both financed

through the Financial Accounting Foundation, which elects the members of the two Boards and has general oversight powers and responsibilities over their structures.) The GFOA Guidelines would permit presentation of financial statements on a basis in conformity with laws applicable to the issuer, if the significant differences between GAAP and the principles used are discussed and, if practicable, quantified. GFOA Guidelines, supra note 1, at Section IX(B). The Commission generally would not accept a departure from GAAP in the financial statements of a public company, even with disclosure.

With respect to format, footnotes, and supplemental disclosure, the GFOA Guidelines do not supplement the general requirements of GAAP. Commission rules, particularly Regulation S-X, prescribe disclosure of specified categories of balance sheet and income statement amounts, depending on the issuer's type of business, and establish a presumption of materiality with respect to certain disclosures in footnotes or supplemental schedules. Exampies of Commission specified disclosure include: separate caption presentation for amounts that exceed specified percentages of their respective asset, liability, revenue or expense totals; condensed parent-only financial statements (in some circumstances); and audited supplemental schedules detailing the components and/or activity for specified financial statement captions such as marketable security investments, property, plant and equipment, short-term borrowings, and asset valuation accounts. See generally Regulation S-X.

6. The GFOA Guidelines recommend that audits of annual financial statements be conducted in accordance with generally accepted auditing standards ("GAAS"), but would accept deviations if disclosure of the nature of the audit and how it differs are disclosed. GFOA Guidelines, supra note 1, at Section IX(B). An audit report on a public company that noted a limitation of scope or similar deviation from GAAS would not satisfy the Commission's requirements. In addition to independent public accountants acceptable under Commission rules, the GFOA Guidelines permit the audit to be conducted by an independent governmental audit organization. GFOA Guidelines, supra note 1, at Section IX(B) n.37. The GFOA Guidelines do not specify any rules governing the assessment of an auditor's independence. The Commission established such rules, which are more restrictive than the rules developed by the profession itself. Codification of Financial Reporting Policies, Section 600, reported in Federal Securities Laws (CCH) at ¶ 38,331. The GFOA Guidelines recommend that the auditor's consent be obtained for the use of its report, but failure to obtain consent would be accepted if the absence and reasons therefore are disclosed. GFOA Guidelines, supra note 1, at Section IX(B); Section X(B). In the case of a conduit issuer, the GFOA Guidelines recommend that disclosure of the circumstances and reasons for a change of auditors within the past two years be disclosed. The Commission established detailed rules governing disclosures of changes in auditors during the last two fiscal years and most recent interim period. Required disclosures include instances of consultation with other auditors regarding matters of disagreement with the prior auditors, and letters from the auditors that confirm the accuracy and completeness of disclosures. Commission rules require the issuer to obtain the auditor's consent in all cases.

7. The GFOA Guidelines recommend that appropriate financial information about the assets, revenues, reserves, and results of operations of credit enhancers be provided in the official statement, but does not specify whether that information should be in the form of audited financial statements. GFOA Guidelines, supra note 1, at Section IV. If the credit enhancement is deemed a security within Section 2(1) of the Securities Act, the Commission ordinarily would require complete audited financial statements of the issuer of the enhancement in the same manner as any other issuer of a security. Item 3-10 of Regulation S-X. In circumstances where the enhancement is not deemed a security, the Commission

staff requests sufficient information about the party providing the enhancement to permit investors to evaluate the party's ability to fund the enhancement. Publicly available Memorandum from Felicia Smith, Special Counsel, Division of Corporation Finance, SEC, to Professional Staff, Division of Corporation Finance, SEC, regarding "Guidelines for Disclosure by Guaranty and Third-Party Credit Enhancement Providers," CF Staff Memo 33-90 (Dec. 4, 1990) at 5. In determining the extent of disclosure, the staff considers (i) the amount of the enhancement relative to the party's income and cash flows; (ii) conditions precedent to application of the enhancement; (iii) duration of the enhancement; and (iv) other factors indicating a material relationship between the enhancement and the investor's anticipated return.

8. See, e.g., Letter from Richard G. Ketchum, Director, Division of Market Regulation, SEC, to H. Keith Brunnemer, Jr., Chairman, MSRB (June 24, 1983) (misleading for issuer to reserve optional redemption rights in bonds escrowed to maturity without disclosing this fact in defeasance notice and official statement for refunding bonds).

MUNICIPAL SECURITIES CASES

The Securities and Exchange Commission has filed injunctive actions and instituted administrative proceedings in a broad range of cases involving municipal securities. Enforcement cases have been brought to remedy a variety of frauds in the purchase and sale of municipal securities, as well as regulatory violations by brokers and dealers specializing in municipal securities. Brokers and dealers regulated by the Commission are required by the Bank Secrecy Act[1] to file currency transaction reports ("CTRs") with the Department of the Treasury; the Commission has exercised its authority to enforce compliance by brokers and dealers with this reporting requirement. Section 15B(c)(1) of the Exchange Act also requires brokers, dealers and municipal securities dealers to comply with the rules of the Municipal Securities Rulemaking Board ("MSRB"), and enforcement action has been taken on numerous occasions based on alleged violations of such rules.

The following summary of cases involving municipal securities was prepared by the staff of the Division of Enforcement in response to the request of Chairman Dingell and Chairman Markey.[2]

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[1] 31 U.S.C. § 5311, et seq. (1988).

[2] See Letter from Hon. John D. Dingell, Chairman, Committee on Energy and Commerce and Hon. Edward J. Markey, Chairman, Subcommittee on Telecommunications and Finance to Mary L. Schapiro, Acting Chairman, SEC; Christopher A. Taylor, Executive Director, MSRB; and Joseph R. Hardiman, President and CEO, NASD (May 24, 1993). The Committee's letter requested "statistics for the past 10 years on enforcement cases and disciplinary actions involving municipal securities, including number of cases, violations charged, and sanctions imposed." The Commission does not maintain statistics on municipal securities cases as such, and, as our case descriptions illustrate, the Commission's investigations often result in related injunctive and administrative actions involving multiple defendants and charges, as well as remedies tailored to specific violative conduct. The narrative summaries were thus prepared in response to the Committee's request.

MUNICIPAL SECURITIES CASES [1]

I. FRAUD VIOLATIONS

A. DISCLOSURE

1. SEC v. Edward L. Scherer, et al., Litigation Release No. 13340 (Aug. 20, 1992)

The Commission alleged that Edward Scherer, a former analyst in the high yield department of Merrill Lynch, Pierce, Fenner & Smith, Inc., used nominee accounts to purchase municipal bonds supported by certain guaranteed investment contracts while he was participating in the preparation of a favorable Merrill Lynch research recommendation concerning those bonds. Scherer allegedly failed to disclose his personal financial interest in the bonds at the time he was participating in formulating the firm's recommendation or during the time the report was disseminated by Merrill Lynch. The complaint alleged violations of Section 10(b) and 17(a) of the Exchange Act and Rules 10b-5 and 17a-3. This matter is still in litigation as to Scherer.

2. In the Matter of Hereth, Orr & Jones, Inc., et al., Exchange Act Release No. 24217 (Mar. 16, 1987)

The Commission alleged that registered representatives associated with Hereth, Orr & Jones, Inc., made material misstatements and omissions to customers in connection with the firm's underwriting of $53,170,000 worth of Polk County (Florida) Industrial Development Authority First Mortgage Health Care Facilities Revenue Bonds, Series 1982. The Commission alleged that Hereth Orr and its registered representatives violated Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5, and that Jack Hereth, David May and Alan Holman failed reasonably to supervise the registered representatives. Hereth Orr, Hereth, May and Holman consented to the entry of an order by which the firm's registration was revoked and the individuals were suspended from association in a proprietary or supervisory capacity for twelve months.

3. In the Matter of Donald T. Sheldon, et al., Exchange Act Release No. 23058 (March 24, 1986)

The Commission alleged violations by Donald T. Sheldon and other persons associated with Donald Sheldon & Co., Inc., a municipal securities dealer and/or Donald Sheldon Government Securities, a government securities dealer. Among other things, the Commission alleged that the respondents made material misstatements and omitted to disclose material facts in connection

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[1] Defendants or respondents who consented to settlement of the actions described herein did so without admitting or denying the factual allegations contained in the complaint or order instituting proceedings.

with transactions in municipal securities issued by the Washington Public Power Supply System ("WPPSS"), the Louisiana Westside Habilitation Center and the city of Vanceburg, Kentucky and/or in transactions in U.S. Government-backed securities. Joseph A. Jennings, Douglas J. Ebbitt, Paul A. Streets, and Joseph H. Stafford, all registered representatives, consented to suspensions from association for periods ranging from forty-five to seventy-five days. Mary A. Schad consented to a bar from association with any broker, dealer, investment adviser, or municipal securities dealer. Marvin Feldman consented to a suspension for ninety days and a bar from association in a supervisory capacity. Jonathan Smith was barred from association by default. Following litigated proceedings, Sheldon and Bruce Reid were barred, and Gregory Pattison was suspended for forty-five days.

4. In the Matter of Investors Portfolio Management, Inc., Investment Advisers Act Release No. 1236 (June 26, 1990)
In the Matter of Lance M. Brofman, Exchange Act Release No. 23673 (Oct. 2, 1986)

The Commission alleged that Investors Portfolio Management, Inc., a wholly-owned subsidiary of Donald Sheldon Group and the adviser to two municipal bond funds, made misrepresentations with respect to the yield on the funds' shares and with respect to the tax exempt status of dividends. The respondent also aided and abetted violations by the funds involving, among other things, the sale and redemption of shares at prices that did not reflect current net asset value. The order alleged violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5, Sections 206(1), 206(2) and 206(4) of the Investment Advisers Act and Rule 206(4)-1, and Sections 12(b) and 31 of the Investment Company Act and Rules 12b-1 and 31a-1(b). Following litigated proceedings, the respondent's registration as an investment adviser was revoked. In related proceedings, Lance Brofman, the president and director of Investors Portfolio and the president, treasurer and portfolio manager for the funds was charged with the above violations and violations of Sections 13(a)(2), 13(a)(3), 18(f) and 22(c) of the Investment Company Act and Rule 22c-1; Brofman consented to the entry of an order by which he was suspended for three months, prohibited from serving as an officer, director or trustee of an investment company or investment adviser for two years, and required to comply with certain other limitations for a period of five years.

5. SEC v. Coastal Securities Corporation, Mark D. Seigel and John J. Graffeo, Litigation Release No. 10757 (May 17, 1985)
In the Matter of Mark D. Seigel and John J. Graffeo, Exchange Act Release No. 23230 (May 14, 1986)

The Commission alleged that Coastal Securities Corporation, a municipal bond broker-dealer, aided and abetted by two of its officers, violated the net capital, customer protection and reporting provisions of the Exchange Act. In addition, the Coastal officers, Mark Seigel and John Graffeo, were charged with antifraud violations arising from the conversion of customer funds, withdrawn at the rate of $250,000 per week from Coastal's account from March 1985. The complaint alleged violations of Sections 10(b), 15(c)(1), 17(a)(1), and Rules 10b-5, 15c3-1, 15c3-3, 17a-3, 17a-4, 17a-5, and 17a-11.

The defendants consented to the entry of injunctions. In the related administrative proceedings, Graffeo was barred from association with any broker, dealer, municipal securities dealer, investment adviser, or investment company. Seigel was barred from association with such entities in a proprietary, supervisory, or financial principal capacity, and was suspended for one year from any association.

6. SEC v. MV Securities, Inc., a/k/a Multi-Vest Securities, Inc., et al., Litigation Release No. 10517 (Sept. 7, 1984)
In the Matter of James R. Stephens, Exchange Act Release No. 21296 (Sept. 7, 1984)
In the Matter of Joseph A. Geraci, III, Exchange Act Release No. 21181 (Jul. 27, 1984)
In the Matter of Samuel William Sigler, Exchange Act Release No. 21882 (May 14, 1985)

The Commission alleged that MV Securities, Inc., a municipal securities dealer, James R. Stephens, its president, and Joseph Geraci, its sales manager, engaged in high pressure sales techniques, training and encouraging inexperienced and unregistered sales personnel to tell customers false and misleading stories concerning the price, safety and availability of municipal bonds. The Commission further alleged that MV Securities sold highly speculative bonds issued by the Washington Public Power Supply System (WPPSS) to investors, including retirees, seeking secure and safe investments. The complaint alleged violations of Section 17(a)(1) of the Securities Act and Sections 10(b), 15(c)(1), 15B(c)(1) and 17(a) of the Exchange Act and Rules 10b-5 and 17a-3. The defendants consented to the entry of injunctions. In the related administrative proceedings, Stephens and Geraci consented to bars from association with any broker, dealer, municipal securities dealer or investment company.

In the administrative proceedings against Samuel Sigler, the Commission alleged that Sigler made materially misleading statements and omitted to disclose material facts to at least 20 customers of MV Securities with respect to the ratings, financial condition, safety and/or risk of investment, and government guarantees of payment of certain municipal securities, for which MV Securities recommended purchase while Sigler recommended sale. Sigler also recommended the purchase and sale of such municipal securities without regard to the suitability of the transactions for his customers' needs and objectives. The alleged misstatements and omissions involved WPPSS securities, among others. The order alleges violations of Section 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5, and MSRB rules G-17 (deceptive practices) and G-19 (suitability of transactions). Sigler consented to the entry of the order suspending him from association with any broker, dealer or municipal securities dealer for six months, and limiting his contacts with retail customers for one year after reassociation.

7. SEC v. Jack L. Dlugash and Regina Dlugash, Litigation Release No. 10637 (Dec. 20, 1984)

The Commission alleged that Jack Dlugash and Regina Dlugash traded municipal securities for themselves and others without complying with the

broker-dealer registration requirements of the Exchange Act. The defendants failed to disclose to investors their role as broker-dealers, their profits, or information concerning the suitability of investments. The complaint alleged violations of Section 17(a) of the Securities Act and Section 10(b) and 15(c) of the Exchange Act and Rule 10b-5. The defendants consented to the entry of injunctions, and an order requiring the payment of $36,294 to certain purchasers of municipal securities.

8. In the Matter of Robert D. Peterson, Frederick W. Channer, Michael J. Wyvill and Channer-Newman Securities Company, Exchange Act Release No. 19764 (May 13, 1983)

The Commission alleged that Robert Peterson, a registered representative associated with Channer-Newman Securities Company, caused municipal bonds and confirmations of sales of municipal bonds to be sent to customers who had not ordered the securities. Peterson induced customers to purchase unordered municipal securities by agreeing that Channer-Newman would repurchase the securities either at a profit or at no loss to the customer, while failing to disclose that such agreements were prohibited by firm policy. Peterson was alleged to have violated, or aided and abetted violations of, Section 17(a) of the Securities Act and Sections 10(b), 15(c)(3), 15B(c)(1), and 17(a) of the Exchange Act and Rule 10b-5, and MSRB rules G-8 (books and records), G-15 (confirmation, clearance and settlement), G-17 (conduct of municipal securities business) and G-25(b) (improper use of assets). Frederic Channer, Michael Wyvill and Channer-Newman were alleged to have failed reasonably to supervise Peterson. Peterson consented to the entry of an order by which he was suspended from association with any broker, dealer, municipal securities dealer, investment adviser, or investment company for ninety days. Channer, Wyvill and Channer-Newman consented to the entry of orders by which they were censured and Channer-Newman was ordered to comply with undertakings to review and revise its procedures regarding extensions of settlement dates and cancellation of orders.

B. MARKUPS

1. In the Matter of Anderson & Strudwick, Inc, George W. Anderson, and J. Douglas Gordon, Jr., Exchange Act Release No. 22089 (May 29, 1985)

The Commission alleged that Anderson & Strudwick, a broker-dealer, and George Anderson and J. Douglas Gordon, two of the firm's officers and directors, sold municipal securities at prices not reasonably related to the prevailing market price and to the firm's contemporaneous cost. Anderson & Strudwick charged markups of between 5 and 19 percent on certain transactions. The order alleged violations of Sections 17(a)(2) and 17(a)(3) of the Securities Act, Section 15B(c)(1) of the Exchange Act, and MSRB rules G-17 and G-30. Anderson & Strudwick and Anderson consented to censures. Gordon consented to a twenty-day limitation on engaging in municipal securities transactions or receiving compensation for such transactions. In addition, Anderson & Strudwick was ordered to comply with its undertakings

to reimburse customers for excessive markups and to review its markup policies and procedures to prevent a recurrence of violations.

2. In the Matter of Hanauer, Stern & Co., Inc., Robert E. Demary, Paul R. Konsig and Eugene L. Stern, Exchange Act Release No. 21313 (Sept. 11, 1984)

The Commission alleged that Hanauer, Stern & Co. and three of its officers engaged in a scheme of adjusted trading with a bank, to permit a bank official to conceal material losses in the bank's portfolio. Hanauer purchased municipal securities from the bank at prices materially higher than the market value of the securities, and, in offsetting transactions, also sold municipal securities to the bank at prices materially higher than market prices. Hanauer also charged excessive markups on municipal securities in eleven transactions with various customers. The firm's books and records failed to reflect agreements by at least two customers to repurchase certain municipal bonds at predetermined prices thirty days after selling the bonds to Hanauer. The order alleged violations of Section 17(a) of the Exchange Act and Rule 17a-3 and MSRB rule G-8. The respondents consented to the entry of the order by which Hanauer was censured and the three officers were suspended for thirty days from association with any broker, dealer or municipal securities dealer.

3. In the Matter of Professional Capital Management, Inc. Peter A. Massaniso, G. Bruce Douglas, Joseph G. Blanton, Investment Advisers Act Release No. 856 (Apr. 22, 1983)

The Commission alleged, among other things, that Professional Capital Management did not set forth on customer confirmations of municipal securities transactions with non-ERISA clients the time of execution or a statement that the time would be furnished upon request. The order alleged, with respect to this violation, that Professional Capital Management, aided and abetted by the other respondents, violated Section 15(B) of the Exchange Act and MSRB rule G-15 (confirmations). The respondents consented to the entry of an order by which Professional Capital Management was censured and ordered to comply with certain undertakings, and the individual respondents were suspended from association with any broker, dealer, investment company, investment adviser or municipal securities dealer for ten business days.

C. FALSE CLOSINGS

1. SEC v. Matthews & Wright Group, Inc., et al., Litigation Release No. 12072 (Apr. 27, 1989)
In the Matter of Arthur Abba Goldberg, Exchange Act Release No. 28593 (Nov. 2, 1990)

The Commission brought an action against Matthews & Wright Group, Inc. ("M&W"); Matthews & Wright, Inc.("M&W, Inc."); George W. Benoit, M&W's president and chairman; Arthur Abba Goldberg, M&W's executive vice president; Roger J. Burns, M&W's chief financial officer; and Bernard A. Althoff, M&W's outside counsel. M&W and M&W, Inc., which specialized in municipal securities transactions, engaged in over $1.3 million

in invalid closings in municipal bond underwritings as part of an effort to avoid the effects of scheduled changes in the tax laws. The complaint alleged violations of Section 17(a) of the Securities Act and Sections 10(b), 13(a), 13(b)(2)(A), 13(b)(2)(B), 15B(c)(1), and 15(c)(1) of the Exchange Act and Rules 10b-5, 12b-20, 13a-1, 13b2-1, 13b2-2, 15c1-2, and MSRB rules G-8 (books and records), G-9 (preservation of records), G-14 (reports of sales or purchases), and G-17 (conduct of municipal securities business). Each of the defendants consented to the entry of injunctions. In connection with the injunctive action, Althoff was barred from appearing or practicing as an attorney before the Commission for two years. In separate administrative proceedings, M&W Inc.'s registration as a broker-dealer was revoked, and Benoit, Goldberg, and Burns were barred from association with any broker, dealer, investment adviser or municipal securities dealer.

2. In the Matter of Donaldson, Lufkin & Jenrette Securities Corporation, Exchange Act Release No. 31207 (Sept. 22, 1992)

The Commission alleged that Donaldson, Lufkin & Jenrette Securities Corporation, a broker-dealer, provided offerings to Matthews & Wright Group, Inc. that were part of the improper closings conducted by Matthews & Wright. The order alleged violations of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5. Donaldson Lufkin consented to the entry of a cease and desist order by which it was also censured.

D. INTERPOSITIONING

1. SEC v. Robert Schwarz, Inc., and Robert G. Schwarz, Litigation Release No. 12602 (Aug. 31, 1990)
In the Matter of Robert Schwarz, Inc., and Robert G. Schwarz, Exchange Act Release No. 28400 (Aug. 31, 1990)

The Commission alleged that Robert Schwarz, Inc., an investment adviser, and Robert Schwarz, the adviser's president and sole shareholder, used a corporate checking account to purchase municipal bonds from retail broker-dealers which were then resold to the adviser's clients. The scheme permitted the adviser and Schwarz to obtain approximately $84,500 in undisclosed commissions. The Commission further alleged that the adviser was not registered with the Commission as a broker-dealer, and failed to provide written notice of municipal bond transactions effected as a broker-dealer. The complaint alleged violations of Sections 206(1), (2) and (3), 207 and 204 of the Investment Advisers Act, and Rules 204-1 and 204-2, and MSRB rule G-15. The adviser and Schwarz consented to the entry of injunctions and an order requiring the disgorgement of $84,500. In the related administrative proceedings, the adviser was suspended for 30 days from conducting business (except to service pre-existing client accounts for no fee), and ordered to review its practices and procedures to ensure future compliance. Schwarz also was suspended for 30 days from association with any broker, dealer, municipal securities dealer, investment adviser, or investment company, except to service client accounts for pre-existing clients of the adviser for no fee, and was ordered to cause the adviser to review its policies and procedures.

2. SEC v. Robert L. Ridenour, Litigation Release No. 12178 (Jul. 25, 1989)
In the Matter of Robert L. Ridenour, Exchange Act Release No. 285?6 (Nov. 7, 1990)

The Commission alleged that Ridenour, while a registered representative associated with a broker-dealer, engaged in a fraudulent scheme to interpose a secret account under his control between his customers and the true market. Ridenour's scheme generated profits of over $400,000 on his clients' transactions in U.S. Government and municipal securities. The complaint alleged violations of Section 17(a) of the Securities Act and Sections 10(b) and 15(a)(1) of the Exchange Act and Rule 10b-5. Ridenour was enjoined following a trial, and ordered to disgorge $470,287.23, plus prejudgment interest.

E. MISAPPROPRIATION OF CUSTOMER FUNDS OR SECURITIES

1. SEC v. FSG Financial Services, Inc. and Joan S. Kantor, Litigation Release No. 13422 (Nov. 3 & 10, 1992)
In the Matter of Joan S. Kantor, Exchange Act Release No. 31429 (Nov.10, 1992)

The Commission alleged in the civil action against FSG Financial Services and its principal, Joan Kantor, that the defendants sold non-existent municipal bonds to investors. The complaint alleged violations of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5. FSG and Kantor consented to the entry of injunctions and orders requiring them to disgorge $20 million and $490,000, respectively, plus prejudgment interest. In the related administrative proceedings, Kantor consented to a bar from association with any broker, dealer, municipal securities dealer, investment adviser or investment company.

2. SEC v. Michael J. Liskiewicz and Superior Capital Corporation, Litigation Release No. 13020 (September 30, 1991)

The Commission alleged that Michael Liskiewicz and Superior Capital Corporation misappropriated funds received from investors for the purchase of a variety of securities, including municipal bonds. The complaint alleged violations of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5. The defendants consented to the entry of injunctions.

3. In the Matter of David D. Carey, Exchange Act Release No. 22428 (Aug. 4, 1987)

The Commission alleged that David Carey was convicted for, among other things, the misappropriation of certain bearer bonds in the custody of his employer, which he then used as collateral in connection with the purchase and sale of securities. During the relevant period, Carey was registered with the Office of the Comptroller of the Currency as a municipal securities representative, and was employed by a bank that was registered as a

municipal securities dealer. Carey was convicted for violations of 18 U.S.C. 656 (misapplication of securities entrusted to a bank) and Section 10(b) of the Exchange Act and Rule 10b-5. Based on the conviction, Carey was barred, by consent, from association with any broker, dealer or municipal securities dealer.

4. SEC v. John G. Kenning and John M. Carpenter, Litigation Release No. 11378 (Mar. 24, 1987)
In the Matter of John M. Carpenter, Exchange Act Release No 24131 (Feb. 24, 1987)

The Commission alleged that John Kenning and John Carpenter, registered representatives associated with a broker-dealer, engaged in a ponzi scheme. Among other things, the defendants falsely stated that investor funds were being used to purchase municipal bonds or participatory interests in a pool of municipal bonds in an account controlled by the defendants, when in fact investor funds were being misappropriated. The complaint alleged violations of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act. The defendants consented to the entry of injunctions. Kenning also consented to an order requiring him to disgorge $50,000. Carpenter, who was ordered to pay $8 million as restitution in related criminal proceedings (see U.S. V. John G. Kenning and John M. Carpenter, Litigation Release No. 11660 (Feb. 9, 1988), was required to file an accounting in the Commission's civil action. In the related administrative proceedings, Carpenter consented to a bar from association with any broker, dealer, municipal securities dealer, investment adviser or investment company.

5. SEC v. Charles J. Ascenzi, et al., Litigation Release No. 10541 (Sept. 25, 1984)

The Commission alleged that three individuals engaged in a scheme involving the offer and sale of City of West Memphis, Arkansas, Industrial Development Revenue Bonds, Maphis Chapman Project, Series A and B. The complaint alleged that the defendants presented false invoices totalling $1.7 million to the bond trustee, purporting to represent equipment purchased for the project. Approximately $1.2 million of the bond funds received from the trustee were in fact used for the personal financial benefit of the defendants. The complaint alleged violations of Section 17(a) of the Securities Act and Section 10(b) of the Exchange Act and Rule 10b-5. Two of the defendants consented to the entry of injunctions; the third defendant was enjoined by default.

6. SEC v. Executive Investment Corp. and John H. Kimmel, III, Litigation Release No. 9973 (May 18, 1983)
In the Matter of Executive Investment Corp. and John H. Kimmel, III, Exchange Act Release No. 20379 (Nov. 16, 1983)

The Commission alleged, among other things, that Executive Investment Corp. and John Kimmel falsely represented to investors that funds would be invested in securities, including municipal bonds and money market fund shares, when in fact such investments either did not exist or were not made. Defendants also, among other things, issued false account statements and

confirmations to investors and converted investor funds. The complaint alleged violations of Sections 5(a), 5(c), and 17(a) of the Securities Act, Section 10(b) of the Exchange Act and Rule 10b-5, and Sections 105, 106(1), 206(2) and 207 of the Advisers Act and Rule 206(4)-2. The defendants consented to the entry of injunctions. In the related administrative proceedings, Executive Investment Corp. and Kimmel consented to the entry an order by which the firm's registration as an investment adviser was revoked, and Kimmel was barred from association with any broker, dealer or investment adviser.

7. In the Matter of Steven R. Grayson, Exchange Act Release No. 19978 (July 15, 1983)

The Commission alleged that Steven Grayson, a municipal securities salesman, obtained $150,000 worth of municipal securities from his employer on the representation that they would be delivered to a customer; in fact, the bonds were never delivered and never returned to the firm. The Commission further alleged that Grayson induced customers to turn over at least $305,000 worth of municipal bearer bonds on the representation that he would upgrade the bonds and return them to the customers. Instead, the bonds were sold through a nominee account and neither the proceeds nor any new bonds were returned to the customers. Following contested proceedings, Grayson was barred from association with any broker or dealer.

8. In the Matter of Stalvey & Associates, Inc., et al., Exchange Act Release No. 19553 (Feb. 28, 1983)

The Commission alleged that Stalvey & Associates, Inc., a broker-dealer, Guilford Sam Stalvey, Jr., its president, and Charles Randall Bell, its vice-president, converted customer funds and securities, misrepresented that securities were bought and sold for customers, misrepresented that funds and securities sent by customers had been used to purchase securities pursuant to customer instructions and misrepresented that funds sent customers were proceeds from the receipt of interest payments on bonds that Stalvey & Associates claimed to have purchased. Among other things, Stalvey & Associates, aided and abetted by Stalvey, sent false and misleading written confirmations of municipal securities transactions. The Commission alleged violations of Section 17(a) of the Securities Act and Sections 10(b), 15(c)(3) and 17(a) of the Exchange Act and MSRB rule G-15 (confirmations). Orders entered by default against the respondents revoked the firm's registration and barred Stalvey and Bell from association with any broker, dealer, municipal securities dealer, investment adviser or investment company.

II. CTR VIOLATIONS

1. In the Matter of Herbert L. Cantley, Exchange Act Release no. 27628 (Jan. 16, 1990)

Cantley was convicted of aiding and abetting the operation of a multi-state illegal gambling business. Cantley used his position as a registered representative associated with a broker-dealer to open two nominee accounts that were used to purchase municipal bonds with currency obtained through

the gambling business. Based on the conviction, Cantley was barred, by consent, from association with any broker, dealer, municipal securities dealer, investment company or investment adviser.

2. In the Matter of Andrew Amadio Tarantini, Exchange Act Release No. 26972 (June 26, 1989)

The Commission alleged that Andrew Tarantini, while a registered representative associated with a broker-dealer, received cash payments from customers for the purchase of municipal bonds, executed the purchases through inactive accounts and accounts of deceased customers, generated false confirmation slips of the transactions and caused the purchases to be improperly reflected on the broker-dealer's books and records. The order alleged that Tarantini aided and abetted violations of Section 17(a) of the Exchange Act and Rule 17a-3. Tarantini was convicted of violating 31 U.S.C. 5313 and 5322(a) (Currency Transaction Reporting provisions of the Bank Secrecy Act). Tarantini consented to the entry of the Commission's order by which he was censured and suspended from association with any broker, dealer, municipal securities dealer, investment adviser or investment company for ninety days.

3. In the Matter of Brian J. Lareau, Exchange Act Release No. 26038 (Aug. 29, 1988)

The Commission alleged that Brian Lareau, while a registered representative associated with a broker-dealer, opened customer accounts under false names and social security numbers, and assisted customers in structuring transactions to evade currency transaction reporting requirements. Municipal securities were purchased with funds placed in the accounts. The order alleged that Lareau aided and abetted violations of Section 15B(c)(1) of the Exchange Act and MSRB rules G-8 (books and records) and G-19(a) (suitability of investments). Lareau also was convicted of violating 42 U.S.C. 408(g)(2) (false social security numbers) and 31 U.S.C. 5322(a)(2) (currency transaction reporting). Lareau was barred from association with any broker, dealer, municipal securities dealer, investment company or investment adviser.

4. In the Matter of E.F. Hutton & Company, Inc., and John A. Pliakas, Exchange Act Release No. 25054 (Oct. 22, 1987)

The Commission alleged, among other things, that six customers of E.F. Hutton & Company, Inc., structured deposits for themselves in their Hutton accounts, which contained incorrect or incomplete customer information in violation of MSRB rules. Brian J. Lareau was the account executive for two of these customers. The order alleged violations by Hutton of Sections 15B(c)(1) and 17(a) of the Exchange Act and Rules 17a-3 and 17a-8, and MSRB rules G-8 (books and records) and G-19(a) (suitability of recommendations and transactions). Hutton was censured and ordered to comply with its undertakings with respect to procedures for clearing cash payments by customers in excess of $1,000, review of its compliance with currency transact ion reporting requirements, and adoption of surveillance procedures to monitor multiple deposits of bank checks. Pliakas was suspended from association with any broker, dealer, municipal securities

dealer, investment company or investment adviser for a period of thirty days and suspended from acting in a managerial, supervisory or proprietary capacity with such entities for ninety days.

5. SEC v. First Miami Securities Inc., Litigations Release No. 9919 (Mar. 7 & Apr. 26, 1983)
In the Matter of First Miami Securities Inc., Exchange Act Release No. 19552 (Feb. 28, 1983)

The Commission alleged that First Miami Securities Inc, a municipal securities dealer, received currency from at least twenty-one customers in connection with purchases of municipal securities without complying with the reporting and recordkeeping provisions of the Bank Secrecy Act. In four instances, First Miami recorded single payments in excess of $10,000 as multiple payments, each of which was less than $10,000. First Miami also opened customer accounts with false, inaccurate and incomplete account information. The complaint alleges violations of Sections 17(a) of the Securities Act, Sections 15(c)(1) and 17(a) of the Exchange Act and MSRB rules G-8 (books and records), G-26 (customer account transfers), and G-30 (prices and commissions). First Miami consented to the entry of an injunction. In related administrative proceedings, the Commission further alleged that James Klotz aided and abetted First Miami's violations, and that Paul Feinsilver failed reasonably to supervise. The respondents consented to the entry of the order by which First Miami and Feinsilver were censured and Klotz was suspended from association with any broker, dealer, or municipal securities dealer for twenty business days.

6. In the Matter of R.W. Peters, Rickel & Co., Inc., Robert W. Peters and Kenneth D. Rickel, Exchange Act Release No. 20173 (Sept. 13, 1983).

The Commission alleged violations of Sections 15B(c)(1) and 17(a) of the Exchange Act and Rule 17a-8 and MSRB rules G-8 (books and records) and G-26 (account information). Respondents consented to the entry of an order by which R.W. Peters was censured and ordered to comply with its undertakings to maintain certain supervisory procedures. Peters and Rickel consented to suspensions from association with any broker, dealer, investment company, investment adviser, or municipal securities dealer for thirty days, the sanctions upon them being suspended on condition that R.W. Peters comply with its undertakings.

III. INSIDER TRADING

1. SEC v. N. Donald Morse II, LItigation Release No. 13280 (June 24, 1992)

The Commission alleged that N. Donald Morse, the secretary/treasurer of the Kentucky Infrastructure Authority, engaged in insider trading in securities issued by his employer. Morse was responsible for selecting certain bonds for redemption by the agency; while in possession of material, non-public information regarding the quantity of bonds that the agency needed to repurchase, Morse obtained bonds selling at 94 which he then tendered,

through a local bank to conceal his identity, at 99 7/8, the highest amount paid to any tendering bondholder. When his bonds were purchased by the agency, Morse failed to disclose either his ownership or the fact that bonds were available at a lower price. The complaint alleged violations of Section 10(b) of the Exchange Act and Rule 10b-5. Morse consented to the entry of an injunction and an order requiring him to disgorge $6,462, plus pre-judgment interest.

IV. FINANCIAL DISCLOSURE, NET CAPITAL AND OTHER VIOLATIONS

1. SEC v. William Kinzel and William Erwin Zilys, Litigation Release No. 12624 (Sept. 20, 1990)
In the Matter of William Edward Kinzel, Exchange Act Release No. 28949 (Mar. 11, 1991)
In the Matter of William Erwin Zilys, Exchange Act Release No. 28494 (Sept. 28, 1990)

The Commission alleged, among other things, violations of the net capital, customer protection and financial reporting rules in connection with the offer and sale of securities in MBK Municipal Participation Pool. In addition, the complaint alleged that William Kinzel violated the antifraud provisions in connection with the purported sale of municipal bonds to an investor. The complaint alleged violations of Sections 5(a), 5(c), and 17(a) of the Securities Act, Sections 10(b), 15(b)(8), 15(c)(3) and 17(a)(1) of the Exchange Act and Rules 10b-5, 15c3-1, 15c3-3, and 17a-11. The defendants consented to the entry of injunctions. In the related administrative proceedings, Kinzel was barred from association with any broker, dealer, municipal securities dealer, investment adviser or investment company, and Zilys was barred from association with such entities in a supervisory capacity and suspended from any association for six months.

2. In the Matter of Benchmark International Investment Corporation and David Paul Chiodo, Investment Advisers Act Release No. 1184 (Aug. 4, 1989)

This action was filed against a firm seeking registration as an investment adviser. The order alleged that David Chiodo, the firm's president, had, among other things, aided and abetted violations by a broker-dealer of the recordkeeping, financial reporting and net capital rules, and the fee and disclosure rules of the MSRB. With respect to the MSRB violations, the order alleged that Chiodo aided and abetted the broker-dealer's violation of MSRB rule A-12 (fees and disclosure) by effecting transactions in municipal securities without having paid to the MSRB an initial fee accompanied by a written statement identifying the broker-dealer. The respondents consented to the entry of an order by which Benchmark's application for registration was denied and Chiodo was barred from association with any investment adviser or investment company.

3. In the Matter of E.F. Hutton Group, Inc., Exchange Act Release No. 25524 (Mar. 29, 1988)

In these administrative proceedings pursuant to Section 15(c)(4) of the Exchange Act, the Commission alleged reporting and internal accounting control violations by E.F. Hutton Group, Inc., arising from the firm's underwriting of a municipal security (an "upper floater") with a variable rate coupon designed to reduce price volatility. Hutton's management subsequently determined to maintain the market for upper floaters at or near par with respect to downgraded issues, to meet expectations developed by sales staff and customers. The firm failed, however, to ensure that its accounting staff was aware of this commitment, and, as a result, Hutton failed adequately to evaluate the risk of liability arising therefrom. The order alleged violations of Sections 13(a) and 13(b)2(B)(ii) of the Exchange Act and Rules 13a-1, 13a-13 and 12b-20 and Regulation S-X. The order required Hutton to comply with Section 13(a) and Rules thereunder, and with its undertakings to, among other things, include a discussion of the proceedings in its Form 10-K for fiscal year 1987, and file a Form 8-K attaching a copy of the order.

4. SEC v. Collins Securities Corporation, Litigation Release No. 10728 (Apr. 24, 1985)

The Commission alleged that Collins Securities Corporation, a broker-dealer engaged primarily in sales of government and municipal securities, continued to transact business at a time when it failed to maintain the required minimum net capital. The firm was unable to meet its net capital requirement because of the failure of a second firm to honor repurchase agreements of government securities which failure was in turn caused by the failure of Bevill, Bresler and Shulman Asset Management Corporation to honor repurchase agreements with the second firm. The Commission's amended complaint added David A. Collins, the firm's former chief executive officer, as a defendant, and alleged that the Collins Securities violated the customer protection rule. Following the entry by consent of a preliminary injunction and an order appointing a receiver, Collins Securities was liquidated in separate proceedings filed by the Securities Investor Protection Corporation (SIPC). Collins consented to the entry of a permanent injunction. In related administrative proceedings, Collins was barred from association with any broker, dealer, investment adviser, investment company, or municipal securities dealer.

5. SEC v. California Municipal Investors, Inc., Litigation Release No. 10277 (Feb. 6, 1984)

The Commission alleged that California Municipal Investors, Inc., violated the net capital and customer protection provisions of the federal securities laws. The complaint alleged violations of Section 15(c)(3) of the Exchange Act and Rules 15c3-1 and 15c3-3. Following the entry by consent of a temporary restraining order and an asset freeze, California Municipal Investors was liquidated in separate proceedings filed by SIPC.

6. In the Matter of Halpert, Oberst and Company and Alan P. Halpert, Exchange Act Release No. 21080 (June 21, 1984)

The Commission alleged violations of Sections 15(c), 17(a), 17(e), 17(f) and 15B(c)(1) of the Exchange Act and Rules 15c3-3 (customer protection), 17a-4

(recordkeeping), 17a-5 (financial reporting), 17a-13 (quarterly security count) and 17f-2 (fingerprinting) and MSRB rules G-7 (information concerning associated persons) and G-8 (books and records). The respondents consented to the entry of an order by which the respondents were censured and Halpert Oberst was required to comply with its undertakings to maintain compliance procedures and to retain an independent public accountant to file four semi-annual compliance reports.

VI. INVESTMENT COMPANY VIOLATIONS

1. In the Matter of the Bank of California, N.A., Investment Company Act Release No. 19545 (June 28, 1993)

The Bank of California was the fund accountant for the investment portfolios of The HighMark Group, a registered investment company. For a five-week period, the Bank incorrectly priced a municipal bond in one of HighMark's funds, and, as a result, the shares in that fund were sold and redeemed at a price other than at the fund's correct net asset value per share. The Commission alleged that the Bank's internal control procedures and systems were inadequate in that they allowed the pricing problem to occur and remain undetected for a substantial period of time. The order alleged that the Bank caused the fund to violate Sections 22(c) and 31(a) of the Investment Company Act and Rules 22c-1 and 31a-1. The Bank consented to the entry of a cease and desist order.

2. SEC v. TEP Fund, Inc., Litigation Release No.10244 (Dec. 23, 1983)

The Commission alleged that TEP Fund, Inc., a closed-end investment company, purchased municipal securities during the existence of an underwriting or selling syndicate, where an affiliate of its investment adviser was acting as principal underwriter. The complaint alleged violations of Sections 10(f) and 31(a) of the Investment Company Act and Rules 31a-1(b)(1), (b)(2)(iii), (b)(2) and (b)(8). TEP Fund consented to the entry of an injunction.

VII. RULE 2(e) PROCEEDINGS

1. In the Matter of Frederick S. Todman & Company and Victor M. Marchioni, CPA, Exchange Act Release No. 29895 (Nov. 4, 1991) In the Matter of Andrew L. Epstein, CPA, Exchange Act Release No. 29894 (Nov. 4, 1991)

The Commission alleged in proceedings pursuant to Rule 2(e) of the Rules of Practice that the accounting firm of Frederick S. Todman & Company and one of its partners, Victor M. Marchioni, engaged in improper professional conduct during the 1984 audit of Bevill, Bresler and Schulman, Incorporated, a broker-dealer primarily involved in the trading of government and municipal securities. Todman and Marchioni consented to the entry of the order by which they were censured. In addition, Marchioni was suspended from appearing or practicing before the Commission for six months and was required to practice with a firm that was a member of the SEC Practice Section of the American Institute of Certified Public Accountants (AICPA).

Todman was required to remain a member of AICPA's SEC Practice Section as long as it practices before the Commission, and was ordered to comply with requirements of the SEC Practice Section. In separate Rule 2(e) proceedings, Andrew L. Epstein consented to the entry of an order by which he was censured, and denied the privilege of appearing or practicing before the Commission, with the provision that he could apply after three years to resume appearing or practicing before the Commission.

2. In the Matter of Stanley I. Goldberg, Exchange Act Release No. 20209 (Sept. 22, 1983)

The Commission alleged that Stanley Goldberg, an certified public accountant, engaged in improper professional conduct in the audit of J.B. Hanauer & Co., a broker-dealer specializing in the sale of municipal securities. Goldberg consented to the entry of the order by which he was denied the privilege of appearing or practicing before the Commission for a period of thirty days. In addition, Goldberg was ordered to comply with his undertakings to undergo special review procedures with respect to his audits of broker-dealer firms for a period of twelve months, and to complete forty continuing professional education credits with the SEC Practice Section of AICPA.