



OFFICE OF
THE CHAIRMAN

UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

September 22, 1988

The Honorable William Proxmire
Chairman
Committee on Banking, Housing
and Urban Affairs
SD-534 Dirksen Senate Office Building
Washington, D.C. 20510

The Honorable John D. Dingell
Chairman
Subcommittee on Oversight and Investigations
House Committee on Energy and Commerce
2323 Rayburn House Office Building
Washington, D.C. 20515

Re: In the Matter of Transactions in Washington
Public Power Supply System Securities

Dear Chairmen Proxmire and Dingell:

I am pleased to transmit a report by the Commission's staff In the Matter of Transactions in Washington Public Power Supply System (WPPSS) Securities. The Staff Report contains a comprehensive discussion of the facts and circumstances that led to the largest default of publicly issued securities in the history of our capital markets.

With the release of the Staff Report, the Commission has determined to close its investigation into transactions in WPPSS securities without initiating any enforcement actions. ^{1/} This decision was made after considering the facts set forth in the Staff Report in the context of applicable legal standards and industry practices, the potential costs and benefits that would be associated with Commission enforcement

^{1/} The decision to terminate the investigation without enforcement action was approved by Commissioner Cox, acting as duty officer, with my concurrence. The other members of the Commission recused themselves from participation in this decision.

action, and the extent to which the WPPSS matter reflects systematic characteristics of the regulatory framework for municipal securities that might be addressed more appropriately by regulatory or legislative initiatives.

The Staff Report discusses several areas in which the disclosures made to investors in WPPSS securities were deficient. As the Staff Report indicates, the parties involved in the WPPSS project and its financing included the Washington Public Power Supply System, financial advisers, engineers, bond counsel, system participants (various participating utilities), the Bonneville Power Administration, underwriters, various unit investment trusts, and rating agencies. In reaching its conclusion to close its investigation, the Commission considered, among other factors, the difficulty of assigning responsibility for disclosure deficiencies in a highly complicated factual situation under the federal securities law antifraud provisions applicable to exempt offerings. In addition, many of the disclosure deficiencies do not relate directly to the precipitating factor in the default, the Washington Supreme Court's decision invalidating contractual agreements between WPPSS and certain public utilities.

The Commission also notes that the WPPSS matter has been the subject of extensive private class action litigation attempting to establish responsibility in this matter. Private class actions and a bond trustee action, which are consolidated in federal multi-district litigation (MDS-551), have been brought against all the major participants in the sale of WPPSS securities. Tentative settlements have been reached with several defendants in this case, and a trial involving the remaining defendants has commenced this month. The pendency of the private litigation means that the issues and claims will be exposed in a judicial forum even without institution of a Commission action.

The private litigation also provides an indication of the extensive resources that might be consumed by a Commission enforcement action in the WPPSS matter. The factual record in the MDL litigation may well be the largest ever compiled in a case brought under the federal securities laws. It has been reported that the attorneys for the bondholders' trustee alone have been paid \$76 million, with the trial having commenced just this month. Without suggesting that the Commission

The Honorable William Proxmire
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would be required to expend anything approaching that amount, I believe that the Commission's enforcement resources would be more effectively devoted to other matters.

Finally, Commissioner Cox and I determined that the responsibilities of participants in offerings of municipal securities might more effectively be addressed by regulatory measures that would apply to all participants in the municipal securities markets, and not just to the participants in offerings of WPPSS securities. Therefore, I have directed the Commission staff to review the regulatory framework applicable to municipal securities transactions and prepare appropriate recommendations for consideration by the full Commission.

Certain staff recommendations, including rule proposals, will be considered by the full Commission at an open meeting today. Following consideration by the full Commission, I will forward to you the text of any Commission action taken at that meeting, together with a Commission Report that will place these matters in a more complete context.

I believe it extremely important that steps be taken to enhance investor protection in the municipal securities markets, and I believe the Commission is pursuing the course appropriate to accomplishing that goal.

Sincerely yours,



David S. Ruder
Chairman

Enclosure

REPORT OF
THE SECURITIES AND EXCHANGE COMMISSION
ON
REGULATION OF MUNICIPAL SECURITIES
September 22, 1988

I. INTRODUCTION AND EXECUTIVE SUMMARY

The Commission is issuing this Report of the Securities and Exchange Commission on Regulation of Municipal Securities (Report) in order to put into perspective certain of its decisions concerning the municipal securities markets.

The Commission today, September 22, 1988, is transmitting to Congress its staff's report on the findings of the staff's investigation In the Matter of Washington Public Power Supply System Securities (the Supply System Staff Report or Staff Report). The Commission is advising Congress that it has decided to close that investigation without authorizing any enforcement actions. ^{1/} The letter accompanying the Supply System Staff Report states that the Commission's decision was made after considering: (1) the facts set forth in the Staff Report in the context of applicable legal standards and industry practices; (2) the potential costs and benefits associated with Commission enforcement actions in this context; and (3) the extent to which

^{1/} Commissioners Grundfest and Fleischman did not participate in the decision to authorize transmittal of the Supply System Staff Report to Congress or to terminate the Commission's investigation of the sale of Washington Public Power Supply System securities without enforcement action. Commissioners Grundfest and Fleischman did not participate because law firms with which they were previously affiliated represent parties involved in Supply System-related litigation. They did, however, review the information in the Staff Report in the process of considering the regulatory actions discussed in this Report.

the circumstances involved in the Supply System transactions reflect systematic characteristics of the regulatory framework for municipal securities that might more appropriately be addressed by regulatory or legislative initiatives. 2/

The Commission has decided to undertake regulatory initiatives pursuant to its existing authority that are designed to enhance substantially the protection of investors in the municipal securities markets. By exercising its existing authority, the Commission is able to take prompt action within its broad mandate to protect investors. As a means of improving the quality and availability of information in the municipal securities markets, the Commission is publishing for public comment a proposed rule that would require underwriters to obtain disclosure documents and make them available to investors. The Commission is also publishing an interpretation emphasizing underwriter responsibilities in municipal securities offerings. 3/ In addition, the Commission is concurrently undertaking a special project to inspect unit investment trusts (UITs) in order to identify any need for possible regulatory changes, as more fully described in the Division of Investment

2/ Letters to Honorable William Proxmire, Chairman, Committee on Banking, Housing and Urban Affairs, and to Honorable John D. Dingell, Chairman, Subcommittee on Oversight and Investigations, House Committee on Energy and Commerce, from David S. Ruder, Chairman, Securities and Exchange Commission (September 22, 1988) (Transmittal Letter) (Attachment A).

3/ Securities Exchange Act Rel. No. 26100 (Sept. 22, 1988) (Attachment B).

Management's Memorandum on the Regulation and Operation of Unit Investment Trusts (UIT Memorandum). ^{4/}

In reaching the conclusions described in this Report, the Commission examined the information contained in the Staff Report, as well as the existing regulatory framework applicable to the issuance and sale of municipal securities and the rationale for that framework. The Commission also reviewed its report and actions relating to the 1975 New York City fiscal crisis, as well as industry and regulatory developments since then relating to the issuance and sale of municipal securities.

While there have been important regulatory and structural developments in the markets for municipal securities since the Commission last comprehensively considered the applicable regulatory framework, it now appears appropriate to consider regulatory changes. In considering measures to enhance municipal securities disclosure, the Commission has sought to minimize the costs and burdens imposed, while seeking to provide benefits to investors and the markets.

II. WASHINGTON PUBLIC POWER SUPPLY SYSTEM DEFAULT

Between 1977 and 1981, the Supply System ^{5/} issued tax-exempt municipal revenue bonds to finance the construction of two

^{4/} Memorandum on the Regulation and Operation of Unit Investment Trusts (September 22, 1988) (Attachment C).

^{5/} The Supply System is a municipal corporation and joint operating agency created in 1957 under Washington State Law for the purpose of building electric power generating facilities.

nuclear power plants, Nuclear Projects Nos. 4 and 5. 6/ Construction of Projects 4 and 5 was terminated in June 1982 due to cost overruns, to the Supply System's inability to continue to sell bonds to finance construction costs, and to growing skepticism regarding the need for the power to be provided by the Projects. Although eighty-eight public utilities in the Pacific Northwest (the "participating utilities") had agreed to provide funds sufficient to pay the bonds whether or not the Projects were ever completed, the Washington Supreme Court invalidated the obligations of the Washington utilities, which accounted for the majority of the revenues needed to repay the bonds. 7/ Following that decision, the Idaho Supreme Court invalidated the obligations of five Idaho cities. 8/ Subsequently, the Washington Supreme Court upheld a Washington trial court's decision to release all other utilities not covered by the decision in Chemical Bank from any obligation under their respective agreements. 9/ Because the utilities were the

6/ During the 1970s, the Supply System issued bonds to finance three other nuclear power projects, Projects Nos. 1, 2, and 3. Unlike the Project Nos. 4 and 5 bonds, payment on the Project Nos. 1, 2, and 3 bonds was, in effect, guaranteed by the Bonneville Power Administration.

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

8/ Asson v. City of Burley, 670 P.2d 839 (Idaho 1983).

9/ Chemical Bank v. Washington Public Power Supply System, 691 P.2d 524 (Wash. 1984), cert. denied sub nom., Haberman v.

(continued...)

principal source of funds to repay the bondholders, in 1983 the Supply System defaulted on \$2.25 billion in principal.

A. The Investigation and Its Termination

On January 11, 1984, the Commission issued a formal order of investigation relating to the Supply System default. The purpose of the investigation, which covered a period beginning in the early 1970's to the default in 1983, was to determine whether the Supply System or any of the other participants in the issuance and sale of Supply System bonds violated the federal securities laws. ^{10/} In conducting the investigation, the staff reviewed more than seven million pages of documents and took the testimony of approximately 170 witnesses. The staff also reviewed a substantial amount of testimony and exhibits generated from private litigation. ^{11/}

As indicated above, the Commission members participating in the decision to terminate the investigation ^{12/} noted the

^{9/}(...continued)

Chemical Bank, 471 U.S. 1065 (1985), and Chemical Bank v. Public Utility Dist. No. 1, 471 U.S. 1075 (1985). Contra DeFazio v. Washington Public Power Supply System, 679 P.2d 1316 (Or. 1984) (overturning Oregon Court of Appeals decision declaring the participation of Oregon public entities in the agreements ultra vires, void, and invalid).

^{10/} See Securities Act Rel. No. 6503 (January 11, 1984).

^{11/} Private class actions and a bond trustee action, which are consolidated in Federal Multidistrict Litigation (MDL-551), have been brought against all the major participants in the sale of Supply System 4 and 5 bonds. While the actions against certain parties including the Supply System, one of its consulting engineers, underwriters, bond and special counsel, and certain participating utilities have been settled, trial began against the remaining defendants on September 7, 1988.

^{12/} See note 1, supra.

existence of extensive private litigation. Thus, the issues and claims involved will be exposed in a judicial forum even without a Commission action. They also noted the resources that might be expended should the Commission institute such an action, and decided that other means might more effectively address the responsibilities of those participating in offerings of municipal securities. ^{13/} Therefore, those Commissioners determined to terminate the Supply System investigation without enforcement action, and to release a Staff Report that would inform Congress, investors, and other interested parties of the staff's information concerning the circumstances that led to the default. Chairman Ruder directed the Commission staff to review the regulatory framework applicable to municipal securities transactions and to prepare appropriate recommendations.

B. The Staff Report

The Staff Report makes available the information developed by the staff during its investigation, and responds to Congressional inquiries regarding the Supply System investigation. ^{14/} The Staff Report raises serious questions concerning whether the official statements for Supply System

^{13/} See Transmittal Letter, supra n. 2.

^{14/} See, e.g., Letter from Senator Alfonse D'Amato to Chairman Shad (July 28, 1983); letter from Senator William Proxmire, Chairman, Senate Committee on Banking, Housing, and Urban Affairs, to Chairman Ruder (June 28, 1988); and letters from Congressman John Dingell, Chairman, Subcommittee on Oversight and Investigations of the Committee on Energy and Commerce, to Chairman Shad (October 19, 1984, February 10, 1987, and July 6, 1987) and to Chairman Ruder (June 2, 1988).

bonds adequately disclosed significant facts related to Projects Nos. 4 and 5. Among other things, the Staff Report describes facts that call into question the Supply System's disclosure regarding the estimated cost to complete the Projects, the ability of the Supply System to meet its growing financing needs, the projected demand for power in the Pacific Northwest, and the extent to which the participating utilities continued to support the Projects. The Staff Report also indicates that the official statements concerning the guarantees of the participating utilities failed to disclose uncertainties with respect to the validity and enforceability of many of the agreements between the Supply System and the participating utilities. Given the importance of the participating utilities' commitments, however, the Report does not contend that disclosure on other subjects would have prevented most of the bond offerings from going forward.

The Staff Report raises questions about the role played by representatives of the Supply System and others who participated in the preparation of the official statements, particularly in the later Supply System offerings. It indicates that representatives of the participating utilities knew some of the information that was not disclosed to investors. In addition, the Staff Report states that underwriters may have been aware of some problems with the Projects being constructed by the Supply System, but did not conduct inquiries into the disclosures being made by the Supply System. The Staff Report states that

sponsors of unit investment trusts used generally nonspecific quality evaluation procedures that relied on rating agency ratings, and continued to purchase Project 4 and 5 bonds at a time when problems associated with the Projects may have been known. The Staff Report also states that limitations in the rating process may have contributed to the continued high ratings of the Supply System bonds. Finally, the Staff Report indicates that bond counsel did not take steps similar to those they had taken in connection with other projects for the purpose of determining the validity and enforceability of the participating utilities' agreements, and that bond counsel did not disclose that certain issues had caused them to exclude sixteen participating utilities' agreements (accounting for 4.06 percent of project capacity) from their opinions, including agreements of ten utilities excluded on authority grounds.

III. NEW YORK CITY FISCAL CRISIS AND REGULATORY RESPONSES

A. New York City Fiscal Crisis.

The Commission's Supply System investigation and the Staff Report raise several issues regarding the roles of parties participating in the sale of municipal securities that are similar to those raised as a result of the Commission's investigation in In the Matter of Transactions in the Securities of the City of New York. From October 1974 through March 1975, New York City issued approximately \$4 billion of short-term debt securities. The market for New York City securities eventually became saturated, and after March 1975 the public capital markets

refused to purchase debt instruments issued by the City. By November 1975, the City was unable to meet its fiscal obligations. As a result of the City's fiscal crisis, prices of certain short-term notes at one point declined to 55 percent of their face amount.

New York City's fiscal crisis resulted in large part from the City's resort to the sale of short-term debt securities in an attempt to finance increasing operating deficits and to appear to comply with the legal requirement that it balance its operating budget. On March 31, 1975, the City had over \$14 billion in outstanding debt, approximately half of which was short-term debt that was theoretically secured by tax receipts or other city revenues. At least the last \$4 billion of that short-term debt was issued as the City systematically overstated its revenues through the accrual of prospective federal and state aid, city taxes, and real estate taxes that were in fact not collectible. The City also systematically understated its expenses and liabilities by delaying recognition of expenses beyond the period in which they were incurred, charging expenses to the City's capital budget, and using a 364-day year. These distortions obscured the City's precarious financial situation, and in large part made possible the sale of the \$4 billion in short-term debt issues between October 1974 and March 1975.

B. The New York City Final Report.

Following a Commission investigation into the activities and practices of those engaged in the offer and sale of New York

City securities, the Commission staff prepared a report, which concluded that New York City had employed budgetary, accounting and financing practices that distorted its true financial condition. 15/ The New York City Staff Report also concluded that, in varying degrees, the participants in the underwriting process, including the principal underwriters, bond counsel, and rating agencies, had failed to meet their responsibilities to the investing public.

The Commission issued its Final Report in In the Matter of Transactions in the Securities of the City of New York on February 5, 1979. 16/ In the New York City Final Report, the Commission took note of certain voluntary efforts to improve disclosure. The Commission indicated that, "[t]o the extent that issuers comply with the MFOA [Municipal Finance Officers Association] guidelines, substantial improvements in the quality of municipal disclosure have been achieved." 17/ However, the Commission also noted that the quality of disclosure varied widely and that disclosure of financial information was

15/ Securities and Exchange Commission Staff Report on Transactions in Securities of the City of New York, Subcomm. on Economic Stabilization of the House Comm. on Banking, Finance and Urban Affairs, 95th Cong., 1st Sess. (Comm. Print 1977) (New York City Staff Report).

16/ Securities and Exchange Commission Final Report in the Matter of Transactions in the Securities of the City of New York, Committee on Banking, Housing and Urban Affairs, 96th Cong., 1st Sess. (Comm. Print 1979) (New York City Final Report).

17/ Id. at 24. See infra p. 16-18 (discussing current Guidelines).

inconsistent, making it difficult for investors to make meaningful comparisons. The Commission therefore indicated that reliance on purely voluntary efforts was not an adequate response to the need for increased investor protection.

The New York City Final Report stated that the New York City matter demonstrated "the compelling need for a statutory framework which would provide the basis for a clearer understanding by issuers and other participants in the municipal securities markets of their responsibilities and which would seek to assure that public disclosures by municipalities are reliable and accurate." 18/ In the Commission's view, the most critical need was in the area of disclosure concerning municipal accounting and financial reporting. The Commission suggested that legislation designed to standardize the methods used in the preparation of municipal accounts and the form and content of municipalities' financial statements should be developed. 19/

C. Proposed Legislative Solutions.

The New York City Final Report was prepared against a background of legislative efforts pending before Congress. For example, the Municipal Securities Full Disclosure Act ("MSFDA") 20/ would have required that municipal issuers prepare an offering document to be used in the public sale of municipal securities. That bill would have authorized the Commission to

18/ New York City Final Report at 8.

19/ Id. at 25.

20/ S.2339, 95th Cong., 1st Sess.

promulgate disclosure rules within certain parameters and to specify the form and manner in which financial statements contained in municipal offering statements would be prepared and audited. In addition, the Commission had proposed a bill that would have eliminated most of the registration and reporting exemptions of the Securities Act and the Exchange Act that are applicable to industrial development bonds ("IDBs"). ^{21/} That bill would, however, have preserved the existing exemptions in the federal securities laws for IDBs issued essentially for government projects.

Additional legislative efforts were made following the New York City Final Report. The State and Local Government Accounting and Financial Reporting Standards Act of 1979 was introduced seeking to establish a body to set nationally recognized accounting and financial reporting standards for state and local governments. ^{22/} Compliance with the standards set by this body would have been voluntary. Although the New York City Final Report contemplated a legislative solution to the municipal securities disclosure problems it had identified, none of these legislative efforts was successful. No federal legislation to enhance issuer disclosure regarding municipal securities was enacted.

^{21/} S.3323, 95th Cong., 2d Sess.

^{22/} S.1236, 96th Cong., 1st Sess. A substantially similar bill was introduced in 1981. S.610, 97th Cong., 1st Sess.

IV. THE CURRENT REGULATORY ENVIRONMENT

A. Municipal Securities Regulatory Framework

While the offer and sale of municipal securities are subject to the antifraud provisions of both the Securities Act of 1933 (the Securities Act) 23/ and the Securities Exchange Act of 1934 (the Exchange Act), 24/ municipal securities are expressly exempt from most of the substantive provisions of the Securities Act. 25/ Municipal securities are not required to be registered under the Securities Act. Securities Act Sections 11 and 12, 26/ which impose civil liability for false statements made in registration statements and for misleading statements in prospectuses and other communications, do not apply to municipal securities. In addition, the periodic reporting requirements applicable to corporate issuers under Exchange Act Sections 12, 13(a), and 15(d) 27/ do not apply to municipal issuers.

Although municipal securities are exempt from the registration and reporting provisions, certain important requirements in the Exchange Act apply to persons in the business of purchasing and selling municipal securities and to

23/ Section 17(a) of the Securities Act, 15 U.S.C. 77q(a).

24/ Section 10(b) of the Exchange Act, 15 U.S.C. 78j(b) and Rule 10b-5 thereunder, 17 C.F.R. 240.10b-5; and Section 15(c) of the Exchange Act, 15 U.S.C. 78o(c).

25/ See Section 3(a)(2) of the Securities Act, 15 U.S.C. 77c(a)(2) (defining exempted securities.)

26/ 15 U.S.C. 77k and 77l.

27/ 15 U.S.C. 78l, 78m(a), and 78g(d).

the municipal securities markets. 28/ In part as a result of concerns raised by a number of actions against municipal securities brokers and dealers based on fraudulent trading and selling practices, Congress enacted a system of regulation and registration for municipal securities brokers and dealers as part of the Securities Acts Amendments of 1975 ("1975 Amendments"). 29/ The 1975 Amendments provided for Commission registration and regulation of municipal securities brokers and municipal securities dealers (including bank dealers). In addition, Congress created the Municipal Securities Rulemaking Board ("MSRB"), a self-regulatory organization designed to regulate the activities of municipal securities brokers and dealers.

The MSRB has broad rulemaking authority, and is charged with proposing and adopting rules relating to, among other things, standards of professional qualifications, rules of fair practice, recordkeeping, the scope and frequency of compliance inspections, the form and content of quotations relating to municipal securities, and sales of new issues. 30/ The MSRB's rules (except for administrative rules) must be approved by the Commission prior to becoming effective. 31/ The 1975 Amendments

28/ See, e.g., Sections 15(a), (b), and (c) of the Exchange Act, 15 U.S.C. 78q(a), (b), and (c) (broker-dealer regulation); and Section 17 of the Exchange Act, 15 U.S.C. 78p (recordkeeping requirements).

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

30/ Section 15B(b)(2) of the Exchange Act, 15 U.S.C. 78q-4(b)(2).

31/ Section 19(b) of the Exchange Act, 15 U.S.C. 78s(b).

gave inspection and enforcement authority to the Commission, the National Association of Securities Dealers, and (for bank municipal securities dealers) the three federal bank regulatory agencies, and not to the MSRB. 32/

While the 1975 Amendments greatly expanded the regulatory authority available with respect to the municipal securities markets, those amendments prohibit the Commission and the MSRB from requiring, directly or indirectly, the filing of any document with the Commission or the MSRB before the sale of a municipal security. 33/ The 1975 Amendments also prohibit the MSRB from directly or indirectly requiring a document or information to be furnished to prospective purchasers (unless the document or information is generally available from a source other than the issuer). 34/ The legislative history of the 1975 Amendments reflects that these provisions "were designed to make it clear that [the 1975 Amendments] will not be a means of subjecting states, cities, counties or villages to any

32/ See Sections 15A(b)(2), 15 U.S.C. 78o-3(b)(2) (NASD powers); and 15B(c)(3) and (c)(5), 15 U.S.C. 78o-4(c)(3) and (c)(5) (Commission and bank regulatory powers, respectively).

33/ Section 15B(d)(1) of the Exchange Act, 15 U.S.C. 78o-4(d)(1).

34/ Section 15B(d)(2) of the Exchange Act, 15 U.S.C. 78o-4(d)(2). See S. Rep. No. 75, 94th Cong., 1st Sess. 44-45 (1975).

unnecessary disclosure requirements which could be promulgated by the [MSRB]." 35/

B. Government Finance Officers Association Voluntary Guidelines.

As indicated in the New York City Final Report, the Municipal Finance Officers Association, now known as the Government Finance Officers Association ("GFOA"), approved in 1976 a set of voluntary guidelines for public offerings of municipal securities designed to provide greater protection to investors through increased disclosure. The Guidelines, which were updated in January 1988, recommend that municipal issuers publish an official statement prior to the issuance of the securities, as well as such further reports as are necessary to provide timely information on a continuing basis. A 1984 survey, based on the then current 1979 Guidelines, indicates that since 1975 local government issuers of tax-exempt general obligation debt are providing "increased levels of information to prospective investors." 36/

35/ 121 Cong. Rec. S6189 (daily ed. Apr. 17, 1975), 94th Cong., 1st Sess. (Remarks of Senator Tower).

36/ Forbes and McGrath, Disclosure Practices in Tax-Exempt General Obligation Bonds; An Update, 7:3 Mun. Fin. J. 207, 220 (Summer 1986). For example, almost 80 percent of the issues surveyed provided a current and formal statement of operating revenues and expenditures. Id. at 211. In addition, over 54 percent of the survey included audited financial statements, over 80 percent of the sample reported detailed balance sheets for the most recent fiscal year, and 47 percent of the sample included formal operating statements for any prior years. Id.

While the GFOA Guidelines suggest that the official statement should disclose information in certain specified areas, they also note that certain types of issuers or circumstances might require the disclosure of information not suggested in the Guidelines. On the other hand, the Guidelines recognize that there may also be cases in which some of the information suggested by the Guidelines is unnecessary or irrelevant.

The Guidelines suggest that the official statement disclose information describing the securities being offered, as well as the authorizing and governing documentation. This includes, among other things: a description of the use of proceeds; guarantee provisions and other sources of payment for the securities; any optional, mandatory or extraordinary redemption or prepayment features; and state constitutions, statutes, or resolutions that authorize or limit the issuance of the securities.

The Guidelines suggest disclosure of information regarding the issuer (which would normally be applicable to offerings of general obligation or special tax securities that are payable from ad valorem taxes or other taxes) and information regarding the enterprise (which would normally be appropriate in offerings of securities whose payment is secured by the revenues of an enterprise). The Guidelines suggest disclosure of various factors related to the debt structure of the issuer or enterprise, including its authority to incur debt, limitations on debt, debt trends, the size of prospective debt burden, and rates

of retirement. The Guidelines also suggest disclosure of information related to the financial condition and results of operations of the issuer or enterprise.

In addition, the Guidelines recommend that all financial statements be prepared in accordance with generally accepted accounting principles ("GAAP") as established by the Government Accounting Standards Board ("GASB") ^{37/} and audited in accordance with generally accepted auditing standards ("GAAS"). Disclosure documents prepared in accordance with the Guidelines would include a description of any pending legal proceedings "that may materially affect the issuer's or enterprise's ability to perform its obligations to the holders of the securities being offered, including the effects of the legal proceedings on the securities being offered and on the source of payment therefor." The Guidelines also suggest the disclosure of all ratings of the securities being offered and the names of the rating agencies, as well as a description of the contractual arrangements between the issuer and underwriters and financial advisors.

C. Government Accounting Standards Board.

In 1984, the Financial Accounting Foundation established the GASB in cooperation with the GFOA, the National Association of State Auditors, Comptrollers and Treasurers, and other organizations representing elected state, local, and county officials. In 1987, the GASB issued a codification of

^{37/} See infra (discussing the relationship between GAAP and the GASB).

Governmental Accounting and Financial Reporting Standards which sets forth the application of GAAP for state and local governmental entities. ^{38/} The GASB codification establishes standards for comprehensive annual financial reports and general purpose financial statements.

Although the GASB has issued its interpretation of the application of GAAP to state and local governmental entities, not all state and local governments require that financial statements be prepared in accordance with GAAP or that an independent accountant examine those statements in accordance with GAAS. A recent GASB study, however, concluded that many current local government regulations require conformity with GAAP and that a large number of local governments currently are being audited for conformity with GAAP. ^{39/} Specifically, approximately 70 percent of the local governmental units responding to the survey indicated that their regulations require financial statements to

^{38/} Government Accounting Standards Board, Codification of Governmental Accounting and Financial Reporting Standards (2d ed. as of June 15, 1987) (GASB Codification). The GASB Codification is drawn from GASB Statements, Interpretations, Technical Bulletins, and concept Statements, and Statements and Interpretations of the National Council on Government Accounting ("NCGA") and the American Institute of Certified Public Accountants ("AICPA") Industry Audit Guide, Audits of State and Local Government Units (1974), as amended by subsequently issued AICPA Statements of Position.

^{39/} R. Ingram & W. Robbins, Financial Reporting Practices of Local Governments 26 (1987). The data in the study were obtained from a mail survey which was sent to a sample of 642 cities, 265 counties, and 254 school districts drawn from U.S. Census Bureau files. The researchers received responses from 352 of the cities (54.8%), 86 of the counties (32.5%), and 129 of the school districts (50.89%).

be prepared in conformity with GAAP. 40/ Approximately 40 percent of respondents from all types of governments indicated that accounting practices had changed significantly in the last five years and of that 40 percent a majority responded that "changes were toward increased GAAP compliance." 41/ With respect to local government audits, 85 percent of cities, 65 percent of counties, and 75 percent of school districts are audited by an independent certified public accountant. 42/ According to the study, nearly all of the remaining governmental units are audited by a state auditor. A few of the responding governments are unaudited, although the study concluded that the percentage of local governments that are unaudited appears to have decreased significantly since the mid-1970s. 43/

D. Municipal Securities Rulemaking Board.

In October 1978, the Commission approved MSRB Rule G-32, which sets forth certain disclosure-related requirements for new issues. 44/ On August 30, 1985, the Commission approved an amendment to that rule which requires municipal securities dealers to deliver a copy of any final official statement to the customer by settlement of the transaction. 45/ Specifically,

40/ Id. at 13.

41/ Id.

42/ Id. at 16.

43/ Id.

44/ Securities Exchange Act Rel. No. 15247 (Oct. 19, 1978).

45/ Securities Exchange Act Rel. No. 22374 (Aug. 30, 1985).

Rule G-32 requires that, if an official statement is prepared by or on behalf of the issuer, it must be delivered to investors. ^{46/} The rule also requires disclosure of an underwriter's compensation in connection with a negotiated sale of new issue securities. On March 9, 1988, Rule G-32 was amended to define the "underwriting period" in new issue distributions made by sole underwriters, thus identifying the transactions that are subject to the provisions of Rule G-32. ^{47/} On October 14, 1987, Rule G-8 was amended to require all municipal securities dealers to maintain records of deliveries to customers of disclosure documents under Rule G-32 in order to assist enforcement of Rule G-32. ^{48/}

E. State Regulatory Efforts.

Certain states have taken steps toward increasing disclosure in the municipal finance area. During its 1987 legislative session, Florida passed legislation denying registration exemptions to state and local government bonds where the issuer or guarantor has been in default at any time since 1975 on any obligations, unless extensive disclosure requirements are

^{46/} As indicated, supra at 14-15, the MSRB's ability to require information to be furnished to prospective purchasers is restricted by Exchange Act Section 15B(d)(2).

^{47/} MSRB Manual (CCH) ¶ 10,522.

^{48/} MSRB Manual (CCH) ¶ 10,515. On May 13, 1987, the MSRB requested comments on a draft rule requiring delivery of official statements to customers in secondary market transactions upon request. MSRB Manual (CCH) ¶ 10,503.

satisfied. 49/ New Jersey securities laws deny an exemption from registration to any state or local government bond where the issuer or guarantor is currently in default. Disclosure does not cure the loss of the exemption. 50/ Minnesota amended its definition of exempt security to exclude from that definition securities of public bodies. 51/

In addition, a bill is pending in the New York General Assembly 52/ that would create civil liability and a private right of action for injured parties in the purchase and sale of municipal securities. Liability would be based on a negligence standard. The bill also includes disclosure requirements for all municipal securities other than general obligation bonds.

V. ANALYSIS AND REGULATORY ACTIONS

A. Problems.

Perhaps the most disturbing aspect of the Supply System problems is that they arose after the New York City Report, after the subsequent voluntary improvements in municipal disclosure, and after most of the additional regulatory actions discussed above. Events such as the Supply System default inevitably focus attention on the adequacy of the current regulation of the municipal securities markets.

49/ Section 517.051 of the Florida Securities and Investor Protection Act and Fla. Admin. Code Ann., Rule 3E-400.003.

50/ Section 49:3-50 of the New Jersey Uniform Securities Law.

51/ Section 80A.15 of the Minnesota Statutes.

52/ A.8100/S.6093.

Three factors were cited in the legislative history of the federal securities laws as the basis for the original exemptions for municipal securities from all but the antifraud provisions of the federal securities laws: first, the absence of "recurrences of demonstrated abuses;" 53/ second, the fact that purchasers of municipal securities were generally banks, insurance companies, and other institutional investors with expertise in financial and investment matters; 54/ and third, governmental comity. 55/

While it may be difficult to demonstrate a widespread pattern of "demonstrated abuses" in the municipal securities markets, the Supply System and New York City Staff Reports and the actions relating to municipal securities brought by the Commission demonstrate a potential for abuse in this area. Moreover, the amounts of money involved in municipal financings are enormous. For example, at the time of its 1975 default, New York City had \$14 billion of debt outstanding. The 1983 Supply System default exceeded the largest corporate default in history, 56/ and there have been additional smaller defaults in

53/ H.R. Rep. No. 85, 73rd Cong., 1st Sess. 7 (1933).

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

55/ See Landis, The Legislative History of the Securities Act of 1933, 28 Geo. Wash. L. Rev. 29, 39 (1959).

56/ Gellis, Mandatory Disclosure for Municipal Securities: A Reevaluation, 36 Buffalo L. Rev. 15, 27 (1987). At the time of its financial collapse in April 1975, New York City had over \$14 billion of debt outstanding, of which approximately one-half was short term debt. Id. at 18.
(continued...)

municipal securities, 57/ as well as downgrades in ratings that adversely affect investors. On balance, this information leads the Commission to believe that, while the municipal securities default rate remains lower than the rate for corporate debt, 58/ experience indicates that there remains potential for abuse in the municipal securities area. Action should be taken to address that potential abuse.

The Commission also observes that there has been significant change since 1933 in the nature of investors who purchase municipal securities. When Congress passed the 1975 Amendments, it recognized that the municipal securities markets were no longer the same kind of institutional markets they were at the

56/ (...continued)

The Supply System facts involved a default on \$2.25 billion in principal and approximately \$5 billion in interest on revenue bonds. The largest corporate debt default, that of Penn Central Company in 1970, involved \$618.8 million. Id. at 19 n. 15.

57/ In the period from 1972 to 1983, there were eleven defaults involving general obligation instruments, 25 defaults involving non-conduit revenue bonds, and at least 82 private purpose (conduit) bond defaults. Advisory Commission on Intergovernmental Relations, Bankruptcies, Defaults, and Other Local Government Financing Emergencies, (March 1985) at 20. Moreover, the Bond Investors Association indicates that, from 1983 to the first quarter of 1988, over 300 municipal issuers defaulted on their obligations.

58/ See Seligman, The Municipal Disclosure Debate, 9 Del. J. Corp. L. 647, 651-52 (1984). Figures obtained from the Bond Investors Association indicate that the current default rate for municipal debt is approximately 0.7 %. The default rate for corporate issues is estimated at approximately 1.1 %. Public Securities Association, Municipal Securities Disclosure Task Force Report: Initial Analysis of Current Disclosure Practices in the Municipal Securities Market (June 1988).

time the securities laws were initially enacted. 59/ In 1974, while commercial banks were the largest purchasers of municipal securities, 60/ the magnitude of individual investor participation had increased greatly as a result of growth in the dollar amount of municipal securities outstanding. 61/ The legislative history of the bill that became the 1975 Amendments indicated that

In 1973 and 1974, households increased their holdings of municipal bonds by \$4.3 and \$11.8 billion, respectively. It would thus appear that the "tight money" situation of recent years forcing a significant rise in municipal bond interest rates and yields has resulted in a major surge in private investor interest in these securities. 62/

This trend toward greater individual investor participation in the municipal securities market continued after 1975, and banks and insurance companies no longer dominate the purchase of municipal securities. 63/ In recent years, households (including unit investment trusts) have on average accounted for slightly over one-third of holdings of municipal securities.

59/ S. Rep. No. 75, 94th Cong., 1st Sess. 3 (1975).

60/ In 1974, commercial banks held \$99.8 billion or 48% of outstanding issues and households held \$62.3 billion or 30%. Id. at 41.

61/ Id.

62/ Id. at 41-42.

63/ As of March 1987, commercial banks held \$197.1 billion or 27% of outstanding issues and property casualty insurance companies held \$89 billion or 12.2%.

Households also own up to an additional twenty-one percent of municipal holdings in the form of mutual fund shares. 64/

In making its regulatory decisions, the Commission believes that governmental comity continues to be a very important consideration. The importance of municipal financing to state and local governments requires all reasonable attempts to avoid placing costs and burdens on municipal issuers. Nevertheless, the importance of investor protection and the federal interest implicated by the current environment for the purchase and sale of municipal securities suggest that the adoption of regulatory measures that may impose additional indirect costs on municipal securities issuers may be necessary and appropriate, if commensurate benefits to investors can be expected.

When the securities laws were first enacted, the market for municipal securities primarily involved limited geographic regions. This arguably enabled local investors to be aware of factors affecting the issuer and its securities. 65/ Since that time, however, the markets for primary offerings of municipal securities have become nationwide in scope, and a national secondary market for trading of municipal securities now exists. 66/ The national scope of the municipal securities markets implicates the federal interest in full and fair disclosure such that

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

65/ See New York City Final Report at 6-7.

66/ Id.

investors in these securities have sufficient information. Moreover, as Congress has noted, issuers themselves recognize that protection of investors through regulatory efforts that do not create impediments to issuers' ability to raise capital will actually strengthen and preserve the municipal securities markets. 67/

B. Regulatory Actions.

In addressing the current need for reform in the regulation of the municipal securities markets, the Commission has considered various steps it could take in order to enhance protection of investors in municipal securities. In doing so, the Commission notes that during the past ten years substantial improvements have been made in governmental financial accounting and that the voluntary efforts of groups such as the GFOA and the GASB to improve disclosures regarding municipal securities have been valuable. At the same time, the Supply System facts indicate that a voluntary system of disclosure can fall short of providing full investor protection. The Commission believes that additional regulatory measures as discussed below could improve disclosure in municipal securities offerings without subjecting municipal issuers to the full range of filing and reporting requirements that apply to corporate issuers.

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

The Commission has decided to exercise its rulemaking authority 68/ and to publish for comment a rule requiring that underwriters of issues of municipal securities having an aggregate offering price in excess of ten million dollars obtain and review a nearly final official statement 69/ before bidding for or purchasing the securities. The proposed rule would also require that underwriters of such municipal offerings contract with the issuer, or its agents, to obtain final official statements 70/ in sufficient quantities to make them available to purchasers in accordance with rules established by the MSRB. Underwriters would also be required to provide copies of preliminary and final official statements to any person upon request.

68/ Pursuant to the Commission's authority to regulate the activities of municipal brokers and dealers, the Commission has the authority to promulgate rules "reasonably designed to prevent, such acts and practices as are fraudulent, deceptive, or manipulative." Section 15(c)(2) of the Exchange Act. The proposed rule also relies on the Commission's rulemaking authority in Sections 2, 3, 10, 15B, 17, and 23 of the Exchange Act.

69/ Specifically, the proposed rule would require the underwriter to obtain, prior to the time it bids for or purchases securities of the issuer, an official statement that is final except for the omission of information relating to the offering price, interest rate, selling compensation, amount of proceeds, delivery dates, other terms of securities depending on such factors, and identity of the underwriter.

70/ The proposed rule would define "final official statement" as a document prepared by the issuer or its representatives setting forth, among other matters, information concerning the issuer and the proposed issue of securities that is complete as of the date of the final agreement to purchase or sell municipal securities for or on behalf of an issuer or underwriter.

The Commission is also publishing an interpretation (on which it has requested comment) of the legal standards applicable to municipal underwriters, based upon judicial decisions and previous administrative actions, emphasizing that the underwriters must, in conjunction with review of offering documents, have a reasonable basis for believing the key representations concerning any municipal securities that they underwrite. This interpretation stresses that municipal securities broker-dealers are subject to high standards of conduct, and emphasizes the municipal underwriters' responsibility to have a reasonable basis for belief in the truthfulness and completeness of the key representations made in any disclosure documents used in the offering.

By participating in an offering, an underwriter makes an implied recommendation concerning the securities. Because the underwriter holds itself out as a securities professional, and especially in light of its position with respect to the issuer, this recommendation implies that the underwriter has a reasonable basis for believing the truthfulness and completeness of the key representations made in disclosure documents used in the offering. An underwriter's failure to live up to the responsibility implied by its participation may give rise to liability under the antifraud provisions of Securities Act Section 17(a) and Exchange Act Sections 10(b), 15(c)(1), and 15(c)(2).

While municipal underwriters generally appear to recognize an obligation to assess the accuracy of disclosure documents used in negotiated offerings, the Commission is not convinced that the practice is universally recognized or followed in those negotiated offerings. Moreover, some underwriters in competitively bid underwritings apparently consider themselves to have virtually no responsibility regarding confirmation of the accuracy of the offering disclosure documents. The Commission's interpretation, summarized in the three following paragraphs, articulates basic guidelines as to the efforts required of municipal securities underwriters in both negotiated and competitively bid offerings in order to meet their obligation to their customers.

While the reasonableness of an underwriter's belief in the accuracy and completeness of key representations made in disclosure documents, as well as the extent of the review necessary to arrive at this belief, will depend upon all the circumstances, underwriters in both competitively bid and negotiated municipal underwritings should, at a minimum, review the issuer's disclosure documents in a professional manner for possible inaccuracies and omissions. A number of factors are relevant in determining the reasonableness of a municipal underwriter's assessment of the truthfulness of the key representations contained in disclosure documents. These factors include the extent to which the underwriter relied upon municipal officials, employees, experts, and other persons whose duties

provide them knowledge of particular facts; the type of underwriting arrangement (e.g., firm commitment or best efforts); the role of the underwriter (manager, selling group member, or selected dealer); the type of bonds being offered (general obligation, revenue, or private activity); the past familiarity of the underwriter with the issuer; the length of time to maturity of the bonds; the presence or absence of credit enhancements; and whether the bonds are competitively bid or are distributed in a negotiated offering.

As to negotiated municipal offerings, where the underwriter is involved with the preparation of the official statement, the Commission believes that development of a reasonable basis for belief in the accuracy and completeness of the statements therein should involve an assessment of the key representations made in the official statement, drawing on the underwriter's experience with the particular issuer and other issuers, and knowledge of the municipal markets. Sole reliance on the representations of the issuer will not suffice. The role of the underwriter in assessing the accuracy of the issuer's key disclosures is of particular importance where the underwriting involves an unseasoned issuer. As to competitively bid offerings, the Commission recognizes that underwriters may have little initial access to background information concerning the securities. The fact that the offering was conducted on a competitive basis is thus a factor to be considered in determining whether the underwriter has met its obligations. However, the nominal

classification of an underwriting as competitive will not be relevant to the scope of an underwriter's review where there is little uncertainty about the choice of underwriters or where other factors are present that would demand a closer examination.

In a normal competitively bid offering, the municipal underwriter would generally meet its obligation to have a reasonable basis for belief in the accuracy of the key representations in the official statement by reviewing the official statement in a professional manner and obtaining from the issuer a detailed and credible explanation as to any aspect of the official statement that appears, on its face or on the basis of information available to the underwriter, to be inadequate. An underwriter in a competitively bid offering may not, of course, ignore other information available to it pertaining to the issuer. If factors suggesting inaccuracies in disclosure or suggesting the need for additional investigation appear, the underwriter should investigate and pursue the inquiry until satisfied that correct disclosure has been made. In assessing the adequacy of disclosure, an underwriter should use all information that it has available about the issuer, including information gained through the underwriter's own research department.

The Commission believes that the provisions in proposed Rule 15c2-12 are designed to contribute to a municipal underwriter's ability to meet its "reasonable basis" obligation.

The Commission requested comment on the interpretation, as well as on the current practices in both negotiated and competitively bid underwritings, the extent to which the underwriters meet the standards articulated in the release, problems experienced by underwriters in fulfilling their obligations that could be resolved through further Commission or MSRB rulemaking, and whether a clearer articulation of an underwriter's responsibilities is desirable through additional Commission interpretation or rulemaking, through amendment to the statutory provisions of the federal securities laws, or through MSRB adoption of general guidelines or interpretations to assist underwriters in determining the scope of their responsibilities.

The Commission is also requesting comment on a proposal by the MSRB and members of the industry to establish a central repository to collect information concerning municipal securities. The MSRB's proposal would call for the mandatory submission of official statements and certain refunding documents to a central repository, where information concerning new issues would be made available, for a fee, to interested parties. In its proposal, the MSRB expressed its belief that the repository would alleviate problems in offerings of municipal securities by allowing dealers executing transactions in new issues of securities to gain access to the information contained in official statements by way of in-house computer screens. The repository would also benefit the secondary market by allowing

broker-dealers to supply complete information to customers trading in that market.

The Commission has asked for general comment concerning the need for a repository, as well as comments pertaining to the following issues: should the repository be created by the industry or mandated by the Commission; should participation in a repository be voluntary or assisted by rulemaking efforts by the MSRB or the Commission; should the deposit requirement be placed on issuers, underwriters, or dealers; what kind of information should be submitted to the repository (i.e., official statements, escrow agreements, annual financial reports); when should the information be submitted; should there be periodic reporting requirements to keep the information current; should data be submitted in summary or complete form, in hard copy or electronically; and, how should the repository be funded?

The Commission believes that its proposed rule is designed to prevent fraud and enhance disclosure in municipal securities offerings by increasing the likelihood that investors will receive an official statement containing all material information necessary to make an investment decision. ^{71/} Thus, the rule is within the Commission's existing regulatory authority over

^{71/} A recent industry survey indicates that official statements are prepared "approximately 84% of the time." Public Securities Association, Municipal Securities Disclosure Task Force Report: Initial Analysis of Current Disclosure Practices in the Municipal Securities Market (June 1988) at 14.

municipal securities underwriters to enhance disclosure and to reduce the possibility of fraud in this market.

The proposed rule would indirectly affect municipal securities issuers because they typically rely on underwriters to sell their securities. It would have the effect of requiring an issuer that wishes to make a securities offering of over \$10 million through an underwriter to provide certain disclosures to the underwriter. Specifically, the issuer would be required to furnish the underwriter with an official statement prior to the time the underwriter bids for or purchases securities from the issuer, and to furnish a final official statement within two business days of any final agreement to purchase or sell securities.

While compliance with this rule might involve some increased costs to municipal issuers, the Commission believes that those costs may be outweighed by the benefits to individual investors accruing from the disclosure requirements contained in the proposed rule. Another, perhaps less obvious, potential benefit resulting from the adoption of the proposed rule was described in the legislative history accompanying the 1975 Amendments, where Congress noted a concern as to the impact of the envisioned regulatory structure on municipal issuers. 72/ The legislative history stated that "the regulation of the municipal securities industry will inevitably result in greater industry professionalism and greater investor confidence in the

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

operations of the industry." 73/ That legislative history goes on to point out that representatives of municipal issuers have recognized that failure to provide regulation could result in the erosion of a system which, for the most part, has functioned very efficiently, and that state and local governments have "recognized the desirability of regulation, which would maintain and enhance the strong markets which have developed, provided there is no adverse impact on their capital raising activities." 74/

In addition, because the Staff Report raises several issues concerning the regulation of UITs, the Commission's Division of Investment Management ("Division") has prepared a Memorandum, which describes the structure and operations of UITs and analyzes their current regulatory framework. The Division also has initiated a project to evaluate the UIT industry and to determine whether any regulatory changes are needed. That project involves conducting special inspections by mid-1989 of ten percent of the 240 UITs registered with the Commission under the Investment Company Act of 1940 (excluding UITs formed as separate accounts of insurance companies). 75/ Because the

73/ Id.

74/ Id.

75/ At the end of 1987, these registered UITs included approximately 9,000 individual series, which are separately registered under the Securities Act of 1933, with assets of over \$118 billion. In comparison, the 1,781 registered mutual funds (excluding money market funds) had assets of \$454 billion at the end of 1987.

Staff Report revealed potential problems in the way securities are selected by UIT sponsors, the Division's special inspection project focuses on the following areas:

1. The process followed by UIT sponsors in deciding what securities should be placed in the portfolio of a particular series of a UIT;
2. How and by whom the securities in the portfolio are valued on a periodic basis; and
3. Sales practices used by UIT underwriters in distributing units to investors.

In addition, the inspection program will focus on (1) secondary market operations by brokers in UIT units, and (2) experience of investors in the eventual liquidation of UIT portfolio securities and termination of a series. The project also involves heightened review of UIT disclosure documents by the Division's disclosure branches.

The Division also is working on revised Form N-7 for registering UITs and their securities, which would integrate the filing requirements of both the Securities Act and the Investment Company Act of 1940 ("1940 Act"). Currently, UITs must file two forms, Form S-6 under the Securities Act and Form N-8B-2 under the 1940 Act, neither of which has been substantially revised in over forty years. In addition, proposed staff guidelines to accompany the new form would represent a compilation and adaptation of Commission releases, staff positions, and interpretations with respect to UITs. Although staff guidelines for mutual funds and other investment companies

have existed for years, these guidelines would represent the first written guidelines for UITs.

The Division also is considering UIT advertising practices and other issues for possible future rulemaking action.

Disclosure issues relating to problems identified by the Supply System investigation are being considered in the context of these projects.

V. CONCLUSION

In taking the actions described in this Report, the Commission has considered its prior recommendations in the New York City Final Report and the developments in the municipal securities area since that time. There have been improvements, particularly with respect to the development of standards for financial reporting. At this time, however, the Commission believes that the regulatory actions described in this Report are practically and effectively designed to address current issues concerning disclosure in municipal securities offerings.

ATTACHMENT A

ATTACHMENT B

SECURITIES AND EXCHANGE COMMISSION

17 CFR Part 240

[Release No. 34-26100 ; File No. S7- 20 -88]

Municipal Securities Disclosure

AGENCY: Securities and Exchange Commission.

ACTION: Proposed Rulemaking.

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

any municipal securities that they underwrite. Finally, the Commission is requesting comment on a recent proposal by the Municipal Securities Rulemaking Board to establish a central repository to collect information concerning municipal securities.

DATE: Comments should be received on or before [ninety days following publication in the Federal Register].

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

FOR FURTHER INFORMATION CONTACT: Catherine McGuire, Esq., Special Assistant to the Director, (202) 272-2790; Robert L.D. Colby, Esq., Chief Counsel, (202) 272-2848; Edward L. Pittman, Esq., Special Counsel, (202) 272-2848; or Beth E. Mastro, Esq., Branch Chief (regarding Part IV), (202) 272-2857; Division of Market Regulation, Mail Stop 5-1, Securities and Exchange Commission, 450 Fifth Street, N.W., Washington, D.C. 20549.

I. INTRODUCTION

A. Background

The Securities and Exchange Commission ("Commission") is proposing for comment Rule 15c2-12 under the Securities Exchange Act of 1934 ("Exchange Act"), 1/ which is designed to

1/ 15 U.S.C. 78a-78jj.

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

The Commission recognizes that Rule 15c2-12, if adopted as proposed, would impose new requirements on underwriters and also might have an impact on issuers. In particular, although the rule would place the direct burden of obtaining final official statements on the underwriter, an obvious consequence would be that underwriters would require some issuers to make

available official statements at a time when, or in quantities in which, they currently might not be produced. The rule is intended to stimulate greater scrutiny by underwriters of the representations made by issuers and the circumstances surrounding the offering. The Commission believes that it is worthwhile to explore the possibility that the imposition of these requirements will result in benefits both to the municipal securities markets as a whole and to individual investors.

The Commission's decision to propose Rule 15c2-12 at this time reflects its concern about the current quality of disclosure in certain municipal offerings. At the time the securities laws first were enacted, the market for most municipal securities largely was confined to limited geographic regions. The localized nature of the market arguably allowed investors to be aware of factors affecting the issuer and its securities. ^{2/} Moreover, municipal securities investors were primarily institutions, which in other instances have been accorded less structured protection under the federal securities laws. Since 1933, however, the municipal markets have become nationwide in scope and now include a broader range of investors.

^{2/} See Final Report in the Matter of Transactions in the Securities of the City of New York. Submitted to the Senate Committee on Banking, Housing and Urban Affairs, 96th Cong., 1st Sess. (Comm. Print 1979), reprinted in [1979 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶81,936 ("New York City Final Report" or "Final Report").

Today, state and local government obligations are a major factor in the United States credit markets. Currently, over \$720 billion of municipal debt is held by investors. 3/ Moreover, while new offerings of municipal securities declined in 1987 compared to previous years, they nevertheless accounted for \$114 billion. 4/ Households now are significant investors in municipal securities. On average, households, including unit investment trusts, have accounted for slightly over one-third of the direct holdings of municipal securities in recent years. Up to an additional 21% of municipal holdings are owned indirectly by households, in the form of mutual fund shares. 5/

At the same time that the investor base for municipal securities has become more diverse, the structure of municipal financings has become increasingly complex. In the era preceding adoption of the Securities Act of 1933 ("Securities Act") 6/ municipal offerings consisted largely of general obligation bonds. Today, however, municipal issues include a

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

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

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

6/ 15 U.S.C. 77a-77aa.

greater proportion of revenue bonds that are not backed by the full faith and credit of a governmental entity and which, in many cases, may pose greater credit risks to investors. In addition, more innovative forms of financing have focused increased attention on call provisions and redemption rights in weighing the merits of individual municipal bond investment opportunities. Among other instruments, municipal issuers have utilized tax-exempt commercial paper, tender option bonds, and compound interest bonds in an effort to satisfy the needs of investors and assure efficient funding of municipal projects. Moreover, municipal issuers recently have begun to import financing techniques developed in the corporate debt markets to sell asset-backed securities. ^{7/}

In 1975, Congress, recognizing that changes had occurred in the municipal securities markets, enacted a self-regulatory scheme for these markets. ^{8/} The Securities Acts Amendments of 1975 ^{9/} created the MSRB and provided a system of regulation for both municipal securities professionals and the municipal securities markets. At the same time, however, a financial crisis experienced by the City of New York revealed serious disclosure problems in offerings of New York City's municipal

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

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

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

securities. In 1977, the Commission released a lengthy staff report presenting the results of an investigation of the distribution of debt securities issued by New York City. 10/

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

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

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

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

The recently released Commission staff report concerning the Washington Public Power Supply System ("Supply System") ^{13/} provides a second illustration of inadequate disclosure in an extremely large municipal debt offering. As discussed more fully therein, in 1983 the Supply System defaulted on \$2.25 billion in principal ^{14/} on tax-exempt revenue bonds sold to finance the construction of two nuclear power plants. The default on the bonds was the largest payment default in the history of the municipal bond market. The staff's investigation of the default disclosed that the underwriters of the Supply System's offerings did not conduct a close examination of the issuer's disclosure to determine the substantial accuracy of statements made to investors at the time the bonds were sold. ^{15/}

The Supply System's offerings took place over the course of four years, from 1977 to 1981. All but one of the 14 offerings by the Supply System during this period were underwritten on a competitive basis. ^{16/} Only two selling

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

^{14/} Id. at 1.

^{15/} Id. at 15, 168.

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

groups, however, successfully bid on the offerings. Despite the magnitude, frequency, and size of the offerings, and the fact that only one or two syndicates were bidding on the offerings, the underwriters did not require their public finance units to conduct an investigation, 17/ or retain underwriters' counsel to conduct an investigation, as they would have done customarily in negotiated sales. 18/

The Commission recognizes that the Washington Supreme Court's decision 19/ invalidating contractual agreements between the Supply System and a number of public utilities in the Pacific Northwest was the precipitating factor in the Supply System's default. The most critical nondisclosures relating to matters apart from legal validity occurred after the great majority of the offerings had gone forward.

The syndicate offering the best bid, usually the lowest interest cost to the issuer, wins the auction and buys the bonds for resale into the market. In a negotiated sale, the issuer selects a lead underwriter, which then usually helps prepare the official statement and investigates the adequacy of disclosure in the official statement. The lead underwriter also advises on timing, price, and structure for the sale of the bonds. When the issuer agrees to the offering terms, the lead underwriter, and the syndicate that it has formed, buy the bonds from the issuer and sell them into the market. See generally Supply System Staff Report at 166-67.

17/ Supply System Staff Report at 171.

18/ Supply System Staff Report at 191-192.

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

Nevertheless, serious questions exist concerning whether the official statements for the Supply System's bonds adequately disclosed significant facts. Among other things, facts existed that call into question the adequacy of disclosures regarding the estimated cost to complete the Supply System's projects, the ability of the Supply System to meet its growing financing needs, the projected demand for power in the Pacific Northwest, and the extent to which the participating utilities continued to support the Supply System project. The Commission is concerned that the underwriters did not investigate costs and delays in the project in a professional manner. Had they done so, it is possible that they would have uncovered disclosure deficiencies in the official statements for the later offerings, and could have brought to the attention of the public important information regarding delays in completing the power plants and cost overruns that might have affected individual investment decisions.

B. Need for Improvements

Notwithstanding the problems illustrated by the Supply System's disclosure, the Commission recognizes that significant changes have taken place in the practices associated with the distribution of municipal securities since the events that led to the release of the New York City Staff Report. Municipal issuers have increased substantially the quality of disclosure

contained in official statements. 20/ The voluntary guidelines for disclosure established in 1976 by the Government Finance Officers Association ("GFOA"), 21/ which are followed by many issuers, permit investors to compare securities more readily and greatly assist issuers in addressing their disclosure responsibilities. 22/ Moreover, when an issuer voluntarily prepares disclosure documents, the MSRB's rules now require that the documents be distributed to investors. 23/

Other means of enhancing the disclosure provided to investors in the initial distribution of municipal securities are also under consideration. Two states, for example, have recently proposed laws requiring that official statements accompany or precede delivery of a confirmation for the sale of certain municipal securities, in the same fashion as corporate securities. 24/ In addition, two other states recently have

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

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

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

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

24/ See Minn. Code Agency R. §2875.2390 and proposed §2875.0015 (except for general obligation bonds). See also A. 8100/S. 6093, amending N.Y. Gen. Bus. Law §352 and adding §§357-a and 359-ffff (except for

excluded from the definition of an exempt security, for state blue sky purposes, the securities of municipal issuers that have been in default. ^{25/} Members of the municipal securities industry and the MSRB also have recommended the establishment of a central repository for official statements that would provide municipal securities dealers and others with rapid access to information, from a single source, concerning the details of an offering and the terms of any call provisions. ^{26/}

Despite these developments, a number of commentators have recently expressed concern about a reduction of investor confidence in the municipal securities markets and have urged that mechanisms be established to improve the timeliness, dissemination, and quality of disclosure. ^{27/} Although the

general obligation bonds) (still pending in New York State Assembly). Other states already have laws that require such disclosure for certain types of offerings. See, e.g., Ariz. Rev. Stat. Ann. §§44-1843.01 and 44-1898 (certain industrial development bonds). The Commission also has learned that draft rules are being circulated by the State of Texas that would require issuers to conform to the GFOA Guidelines.

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

^{26/} See discussion infra at Part IV.

^{27/} See, e.g., Ciccarone, Municipal Bondholders Need More Information, Wall St. J., March 27, 1987, at 22, col. 3; Ciccarone, We Need Better Muni Disclosure, 13 Financial World, 156 (June 30, 1987); Ferris, Muni Market Needs Policing and Guidelines for Disclosure,

recent measures by the MSRB, state regulators, and industry groups are significant, the Commission believes that further steps designed to encourage timely dissemination of disclosure to investors in large offerings of municipal securities, and to affirm baseline standards of underwriter review of this disclosure, warrant consideration.

In the absence of specifically mandated disclosure standards to which municipal issuers can adhere, 28/ the underwriter's review of disclosure concerning the financial and operational condition of the issuer can assume added importance

The Bond Buyer, August 31, 1987, at 1; Disclosure Takes Place Among Top Municipal Market Issues This Year, The Bond Buyer, March 7, 1988, at 1.

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

as a means of guarding the integrity of new offerings. The Commission understands that many municipal underwriters currently conduct an investigation of the issuer in negotiated municipal offerings that, in many respects, might be comparable to the investigation conducted by underwriters in corporate offerings. Nevertheless, the practices revealed in the Supply System Staff Report underscore the need to explore the benefits that would result from a specific regulatory requirement that underwriters of municipal securities be uniformly subject to a requirement to obtain and review a nearly final disclosure document and make disclosure documents available to investors in both negotiated and competitive offerings. The Commission understands that no amount of increased review of offering materials by municipal underwriters will prevent municipal defaults totally, 29/ but the Commission believes that

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

Issuer defaults pose the most serious economic threat to investors. Nevertheless, investors also may suffer losses as a result of downgrades in ratings. In 1987 alone, one nationally recognized statistical rating organization, Moody's, lowered the ratings of 322 municipal bond issues. See Municipal Bond Rating Revisions - 1987, Moody's Bond Survey, January 11, 1988, at 1. Moody's report indicated that almost half of the issues downgraded were concentrated in three states closely tied to mineral

responsible review by underwriters of the information provided by municipal issuers, in both competitive and negotiated offerings, could encourage more accurate disclosure. Investors plainly depend on accurate disclosure in considering whether to buy the offered securities. Moreover, it is a common belief, which the Commission shares, that investors in the municipal markets rely on the reputation of the underwriters participating in an offering in deciding whether to invest.

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

sectors. During the same period, Standard & Poors reduced ratings of 105 issues, amounting to \$17 billion. Credit Watch (Feb. 1, 1988), at 1. Although there is not a great deal of empirical data in this area, downgradings clearly affect the value of bonds. For example, yields to maturity on 30-year AAA general obligation bonds are 7.60% as compared to 8.30% for the same bonds rated Baa. The direct impact of downgrades, however, may depend upon the amount of other information that is available in the markets. See generally, e.g., Ederington, Yawitz & Roberts, The Information Content of Bond Ratings, 10 J. Fin. Res. 211 (Fall 1987) (discussing the relationship between ratings and yields on industrial bonds).

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

investors in the secondary market on the basis of the yields to a fixed maturity, the exercise of early call provisions in the outstanding bonds would have altered significantly the actual yield received by investors. 31/

Apart from concerns about the quality of disclosure, it appears that problems also exist with regard to the timely dissemination of disclosure documents. Currently, many issuers routinely prepare official statements that conform to the GFOA Guidelines for offerings exceeding one million dollars. The preparation and timely dissemination of official statements, in conjunction with a careful review of the issuer's disclosure by the underwriters, are important disciplines that benefit the participants as well as investors. The Commission is aware, however, that in some cases underwriters do not receive sufficient quantities of official statements, or do not receive official statements within time periods that would allow the underwriter to examine the accuracy of the disclosure and to disseminate copies to investors in a timely manner. In rule filings with the Commission, for example, the MSRB has

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

indicated that the completion and delivery of official statements often is given a low priority by underwriters and financial advisors. ^{32/} In addition, it appears that many public finance personnel are unfamiliar with the requirements of the MSRB regarding the delivery of official statements. ^{33/} These information dissemination problems are evidenced by a recent report by the Public Securities Association, prepared after an extensive survey of its members, which concluded:

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

The markets for municipal securities are vital to the financial management of our nation's state and local governments, and the availability of accurate information concerning municipal offerings is integral to the efficient

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

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

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

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

For these reasons, the Commission has determined to propose a limited rule designed to prevent fraud by enhancing the timely access of underwriters, public investors, and other interested persons to municipal official statements. In the context of the assured access to offering statements provided

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

by the proposed rule, the Commission also is reemphasizing the existence and nature of an underwriter's obligation to have a reasonable basis for its implied recommendation of any municipal securities that it underwrites.

II. DISCUSSION OF PROPOSED RULE 15c2-12

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

The Commission believes that proposed Rule 15c2-12 may promote greater industry professionalism and confidence in the municipal markets. In the past, state and local governments have regarded regulation to enhance the municipal markets as beneficial, so long as there is no adverse impact on their capital-raising function. ^{36/} Rule 15c2-12 is designed to strengthen the municipal markets and to benefit all participants, including issuers. The Commission wishes to

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

emphasize, however, that the rule is not intended to inhibit the access of issuers to the municipal markets. For this reason, the Commission is particularly interested in receiving the views of municipal issuers on the provisions of proposed Rule 15c2-12.

A. Scope of Rule 15c2-12

As proposed, the provisions of Rule 15c2-12 would apply only to underwriters participating in offerings of municipal securities that exceed \$10 million in face amount. ^{37/} Data supplied by the Public Securities Association and the MSRB indicate that in 1987, 1,743 long-term municipal debt offerings, accounting for about 25% of total long-term municipal debt offerings, exceeded \$10 million. These offerings, however, raised over \$89 billion, or approximately 86% of the money borrowed annually by municipal issuers. Thus, the rule would apply only to the largest issues of municipal securities, where there is greatest reason to believe that additional costs the rule might impose by the establishment of specific standards would be justified by the potential protection provided to a large number of investors that otherwise might purchase securities on the basis of inaccurate

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

or incomplete information. 38/ By conditioning underwriters' participation in large offerings on the preparation and dissemination of official statements, the rule would provide dealers and investors with more timely access to disclosure of basic information about the issuer. 39/

The Commission requests comment on the proposed \$10 million threshold and whether alternative minimum levels would be more appropriate. Specifically, would some other minimum, such as \$1 million, \$5 million, \$20 million, or \$50 million, be

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

<u>Purpose</u>	<u>No. Iss.</u>	<u>\$ Amt.*</u>	<u>\$ Average*</u>
Elec. Utility**	20	2,412	120.6
Retirement Housing	56	725	12.9
Ind. Lease Revenue	60	520	8.6
Nursing Homes	65	411	6.3
Hospitals	12	94	7.8
Pollution Control Revenue	5	343	68.6
Housing and Apt. Development	22	209	9.5
<u>Other Types</u>	<u>59</u>	<u>523</u>	<u>8.8</u>
All Types**	299	5,240	17.5

* in millions.

** including the Supply System default.

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

warranted for the rule as a whole or for particular provisions? As noted earlier, in 1987, 25% of all new issues of long-term municipal bonds, comprising 38% of all revenue bond issues and 12% of all general obligation bond issues, exceeded the \$10 million threshold. These offerings accounted for 90% and 74% of the dollar amounts issued in revenue and general obligation bond offerings, respectively. The figures for alternative thresholds, as of 1987, were as follows: 40/

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

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

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

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

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

The primary intent of the rule is to focus on those offerings that involve the general public, and which are likely to be traded in the secondary market. While the Commission recognizes that there may be reason to create an exception from the rule for offerings that are similar to traditional private placements under Section 4(2) of the Securities Act, 42/ involving a limited number of financial institutions, the proposed rule does not contain such an exception. 43/ In part, this reflects the Commission's concern that, in the absence of trading restrictions, the bonds could be resold immediately to numerous secondary market purchasers lacking the sophistication of the initial purchasers of the bonds.

In order to consider whether any rule that is adopted should contain some type of "private placement exemption," the Commission requests comment on this aspect of the rule. In particular, the Commission would like specific comments on whether and in what manner the rule's disclosure dissemination provisions should distinguish between offerings made to a limited number of sophisticated investors and those involving broader selling efforts. Comment is requested on whether a specific exemption from the rule should be created for

42/ 15 U.S.C. 77d(2).

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

offerings to fewer than 10, 25, 35, or 50 investors and whether an exemption should look to the institutional nature or sophistication of investors. In addition, should the underwriter be required to assure that initial purchasers acquire the bonds with investment intent, rather than to resell the securities into the secondary market, or should other restrictions, such as holding periods or transfer restrictions, be imposed? Finally, the Commission solicits comment on whether exceptions for limited offerings should be applied to all provisions of the rule or only to particular parts of the rule.

B. Receipt and Review of Preliminary Official Statements

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

44/ Cf. Securities Act Rule 430A, 17 C.F.R. 230.430A (form of prospectus filed as part of registration statement declared effective may omit information with respect to public offering price, underwriting syndicates, underwriting discounts or commissions, discounts or commissions to dealers, amount of proceeds, conversion dates, call prices and other items dependent on offering price, delivery dates, and terms of securities dependent on offering price). Although paragraph (b) would require that underwriters receive official statements that are nearly

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

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

complete prior to bidding for or purchasing an offering, this would not prevent an underwriter from requesting even substantial changes to the document where necessary to assure complete and accurate disclosure.

prior to the date of sale, which, after pricing, underwriting, and other information is attached, is then regarded as the issuer's final official statement.

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

Paragraph (b) would prevent the underwriter from submitting a bid in a competitive offering, or from committing to buy securities in a negotiated offering, until it has received and reviewed an official statement that is deemed final by the issuer, except for pricing, underwriting, and certain other specified information. This paragraph is

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

designed to prevent fraud by providing the underwriter with information about the issue sufficient to determine, before becoming obligated to purchase the securities, whether changes to the disclosed information are needed and should be obtained before the bid is submitted. 46/

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

46/ See also discussion infra in Part III.

C. Public Dissemination of Preliminary Official Statements upon Request

Proposed paragraph (c) would require that preliminary official statements be sent to any person promptly upon request. 47/ The purpose of paragraph (c) is to provide potential investors 48/ with access to any preliminary official statement prepared by the issuer for dissemination to potential bidders or purchasers at a time when it may be of use to investors in their investment decision. Because preliminary official statements frequently are used as selling documents, large investors often are provided copies when they are solicited to purchase securities in a municipal offering. Indeed, the Commission understands that some institutional investors will not agree to purchase securities in an offering without receiving a preliminary official statement. Even so, there does not appear to be a uniform practice among underwriters of providing preliminary official statements to

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

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

all potential investors. Because sales efforts may be conducted in competitive offerings prior to the time that an underwriter is awarded a bid, and investors may not have access to a final disclosure document for an extended period of time following their commitment to purchase the securities, the Commission believes that confusion concerning the offering terms and the potential for misleading sales representations would be reduced if investors had the ability to obtain information contained in the preliminary official statement. 49/

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

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

D. Distribution of Official Statements

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

Rule G-17 of the MSRB's rules requires municipal securities brokers and dealers to deal fairly with customers. The MSRB interprets this rule to require that a dealer disclose, at or prior to a sale, all material facts concerning the transaction, including a complete description of the security. ^{50/} Moreover, MSRB rule G-32 requires that underwriters deliver to a customer, no later than settlement, a copy of any official statement that is prepared by or on behalf of the issuer. If no official statement is prepared by the issuer, a written notice of that fact must be provided to the

^{50/} See, e.g., MSRB Manual (CCH) ¶ 3581.30.

customer. The Tower Amendment 51/ limits the authority of the MSRB, however, directly or indirectly to require municipal issuers to furnish disclosure documents. Thus, rule G-32 applies only where an official statement is prepared and does not mandate disclosure of any particular information to the investor in the official statement.

The Commission understands that it is currently the practice for issuers to state, in notices of sale, the number of official statements that will be provided to a successful bidder or that a "reasonable" number of official statements will be provided. If any official statements are prepared by the issuer, the MSRB has taken the position that the underwriter is required to produce sufficient copies to comply with rule G-32. 52/ In most cases, issuers do prepare official statements. Both underwriters and investors have complained, however, that even when official statements are prepared by the issuer, there frequently is not an adequate supply, or sufficient time, to permit distribution to each investor at settlement.

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

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

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

The proposed rule requires that adequate copies of the official statements would need to be provided within two business days after final agreement is reached. Nevertheless, the issuer's undertaking may call for provision of the official

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

statement to be made by designated agents. Thus, an undertaking would comply with Rule 15c2-12 by indicating that sufficient quantities of official statements will be made available from a printer designated by the issuer, or will be reproduced by the syndicate manager from those official statements that it receives from the issuer. Also, the rule would allow a reasonable fee to be requested by the printer, issuer, or syndicate manager for providing copies of official statements to syndicate members or investors.

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

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

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

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

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

Rule 15c2-12; and whether, and at what price, those costs may effectively be passed on to recipients of official statements.

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

E. Public Dissemination of Official Statements upon Request

Paragraph (e) of proposed Rule 15c2-12 would require that underwriters provide a copy of the final official statement to any person on request. ^{56/} The purpose of this provision is to make the underwriter responsible for transmission of information to analysts, rating agencies, industry news services, and individuals who wish to analyze particular municipal securities offerings. In this regard, the Commission believes that increased availability of official statements, to

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

potential investors, analysts, and other persons willing to pay a reasonable fee for access to the information contained in the final official statement, will promote more accurate pricing in the secondary market and may facilitate the discovery of potentially fraudulent practices. Thus, in addition to making final official statements available to actual investors, paragraph (e) would require that other interested parties be provided with copies as well.

No specific time limitation currently is specified in proposed Rule 15c2-12. Comment is solicited on whether and under what circumstances a time period should be established, after which the obligation to provide information would no longer be applicable. 57/ For example, if a central repository is developed, should this obligation expire after the repository receives and is in a position to disseminate the final official statement? The Commission also requests comment on whether a purchaser's ability under paragraph (e) of the rule to obtain an official statement on request for an unlimited time period reduces the need for the requirement

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

imposed on the underwriters by MSRB rule G-32 to supply a final official statement to all purchasers. Finally, the Commission would like to receive comments on the potential costs to underwriters of complying with proposed paragraph (e). Specifically, what costs would be entailed in maintaining and disseminating copies of official statements required to be provided under paragraph (e)? Also, would it be possible, and at what price, for costs to be passed through effectively to recipients of the official statements?

F. Definitions

In addition to containing substantive requirements, proposed Rule 15c2-12 contains two definitions. Subparagraph (f)(1) of Rule 15c2-12 would define the term "final official statement" to mean a document prepared by the issuer or its representatives setting forth, among other matters, information concerning the issuer and the proposed issue of securities that is complete as of the final agreement to purchase or sell municipal securities for or on behalf of an issuer or underwriter. A notice of sale would not be deemed a final official statement for purposes of the rule. The definition contained in subparagraph (f)(1) is based on the definition of official statement in MSRB rule G-32. By using a similar definition, the Commission is seeking to avoid any conflicts that may occur, because paragraph (d) would require that underwriters distribute copies of final official statements in accordance with MSRB regulations. The Commission

requests comment on the proposed definition of "final official statement."

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

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

59/ 17 C.F.R. 230.405.

G. Legislative Background

In contrast to the registration and reporting requirements imposed on non-exempt corporate issuers under the federal securities laws, offerings of municipal securities are not subject to review by the Commission. When Congress adopted the federal securities laws, in addition to being influenced by the local nature of markets, the absence of demonstrated abuses, and the sophistication of investors in municipal securities, it was persuaded that direct regulation of the process by which municipal issuers and municipalities raise funds to finance governmental activities would place the Commission in the position of a gate-keeper to the financial markets, a position inconsistent with intergovernmental comity. Nevertheless, Congress clearly made sales of municipal securities subject to the antifraud provisions of the federal securities laws. ^{60/} Accordingly, broker-dealers misstating or omitting to disclose material facts about municipal securities or charging excessive mark-ups have been sanctioned for violating the antifraud provisions of the federal securities laws. ^{61/}

The U.S. Supreme Court's interpretation of the scope of the Tenth Amendment has evolved significantly since the federal

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

^{61/} See discussion infra at Part III.

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

In 1975, Congress revisited the application of the general antifraud provisions of the federal securities laws when it established the MSRB and provided for a system of regulation to prevent abuses in municipal securities. In adopting the 1975 Amendments, 64/ Congress struck a balance between the need to protect investors and concerns about intergovernmental comity. This concern was reflected in Section 15B(d)(1), which prohibits the Commission and the MSRB from requiring "any

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

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

64/ See supra note 8.

issuer of municipal securities, directly or indirectly through a purchaser or prospective purchaser of securities from the issuer, to file with the Commission or the Board prior to the sale of such securities by the issuer any application, report, or document in connection with the issuance, sale, or distribution of such securities." 65/

At the same time, however, Congress more narrowly defined the authority of the MSRB. The so-called "Tower Amendment," which added Section 15B(d)(2) to the Exchange Act, 66/ also prohibits the MSRB from requiring municipal issuers, directly or indirectly, through municipal securities broker-dealers or otherwise, to furnish the MSRB or prospective investors with any documents, including official statements. The MSRB specifically is permitted, however, to require that official statements or other documents that are available from sources other than the issuer, such as the underwriter, be provided to investors.

While Congress limited the power of the MSRB to require that disclosure documents be provided to investors, it was careful to preserve and expand the authority of the Commission under Section 15(c)(2) of the Exchange Act. 67/ Section 15B(d)(2) expressly indicates that "[n]othing in this paragraph shall be construed to impair or limit the power of the

65/ 15 U.S.C. 78o-4(d)(1).

66/ 15 U.S.C. 78o-4(d)(2).

67/ 15 U.S.C. 78g(c)(2).

Commission under any provision of this title." 68/ Thus, although Section 15B(d)(1) prevents the Commission from requiring that municipal issuers file reports or documents prior to the issuance of securities in the same fashion as corporate securities, Congress expanded the Commission's authority to adopt rules reasonably designed to prevent fraud, so long as the rules did not require documents to be filed with the Commission. 69/ The Commission believes that Rule 15c2-12 is consistent with its Congressional mandate to adopt rules

68/ 15 U.S.C. 78o-4(d)(2).

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

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

reasonably designed to prevent fraud in the federal securities markets. 70/

III. MUNICIPAL UNDERWRITER RESPONSIBILITIES

In connection with Rule 15c2-12's requirements to obtain and review a near-final official statement, the Commission wishes to emphasize the obligation of a municipal underwriter to have a reasonable basis for recommending any municipal securities and its responsibility, in fulfilling that obligation, to review in a professional manner the accuracy of the offering statements with which it is associated.

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

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

in the truthfulness and completeness of the key representations made in any disclosure documents used in the offerings.

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

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

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

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

and that his recommendation rests on the conclusions based on such investigation. 73/

This obligation to have a reasonable basis for belief in the accuracy of statements directly made concerning the offering is underscored when a broker-dealer underwrites securities. 74/ A municipal underwriter's obligation extends

73/ 415 F.2d 589, 597 (2d Cir. 1969), affirming Richard J. Buck & Co., 43 S.E.C. 998 (1968). See also, e.g., Merrill Lynch Pierce, Fenner & Smith, Securities Exchange Act Release No. 14149 (Nov. 9, 1977), 13 SEC Docket 646, 561 ("A recommendation by a broker-dealer is perceived by a customer as (and in fact it should be) the product of an objective analysis [which] can only be achieved when the scope of investigation is extended beyond the company's management"); John R. Brick, Securities Exchange Act Release No. 11763 (Oct. 24, 1975), 8 SEC Docket 240, 242 ("The professional ... is not an insurer. But he is under a duty to investigate and to see to it that his recommendations have a reasonable basis"); M.G. Davis & Co., 44 S.E.C. 153, 157-58 (1970), aff'd sub nom. Levine v. SEC, 436 F.2d 88 (2d Cir. 1971) (broker-dealer registration revoked, because "representations and predictions" made and market letter relied on by registrant "were without reasonable basis," and "registrant could not reasonably accept all of the statements in the [market letter] without further investigation").

74/ The opportunity for the underwriters to require disclosure from the issuer, as well as the special selling pressures involved in the distribution of securities, generally have given rise to a heightened obligation on the part of underwriters. In Sanders v. John Nuveen & Co., 524 F.2d 1064 (7th Cir. 1075), vacated and remanded on other grounds, 425 U.S. 929 (1976), on remand, 554 F.2d 790 (7th Cir. 1977), rehearing denied, 619 F.2d 1222 (7th Cir. 1980) cert. denied 450 U.S. 1005 (1981), for example, the Seventh Circuit considered a case involving an underwriter of commercial paper. The underwriter did not have a formal underwriting agreement with the issuer and was not subject to liability under Section 11 of the Securities Act, 15 U.S.C. 77k. Nevertheless, the court noted that:

[a]n underwriter's relationship with the issuer gives the underwriter access to facts that are not equally available to

to having a reasonable basis for belief in the truth of key representations in an official statement prepared by the issuer. An underwriter's failure to have a reasonable basis for believing key representations in offering documents has resulted in private damage actions under the general antifraud provisions and in enforcement action by the Commission under Section 17(a) of the Securities Act. For example, in Hamilton Grant & Co., the Commission found that an underwriter had violated Sections 17(a)(2) and (3) of the Securities Act where the underwriter had "failed to make any substantial effort to obtain specific verification of management's key representations" and thus had "no basis for a reasonable belief in the truthfulness of the key representations made in the registration statement and prospectus." 15/

members of the public who must rely on published information. And the relationship between the underwriter and its customers implicitly involves a favorable recommendation of the issued security. Because the public relies on the integrity, independence and expertise of the underwriter, the underwriter's participation significantly enhances the marketability of the security. And since the underwriter is unquestionably aware of the nature of the public's reliance on his participation in the sale of the issue, the mere fact that he has underwritten it is an implied representation that he has met the standards of his profession in his investigation of the issuer. 524 F.2d at 1069-70.

15/ Securities Exchange Act Release No. 24679 (July 7, 1987), 38 SEC Docket 1346, 1353. See also the following decisions concerning corporate underwriters. Leonard Lazaroff, 43 S.E.C. 43, 47 (1966) (underwriter did not

Although these cases have involved underwriters of corporate securities, which, unlike municipal securities, are subject to a comprehensive disclosure and liability scheme under the federal securities laws, the Commission has emphasized through its enforcement program that broker-dealers selling municipal securities are also subject to high standards. In particular, the Commission has stated that underwriters of municipal securities must have a reasonable basis for their recommendations concerning offerings. 75/

carry out its "duty to investigate the issuer diligently and ascertain the accuracy of the offering circular"); Amos Treat & Co., 42 S.E.C. 99, 103-4 (1964) (underwriter sanctioned for knowingly using registration statement containing stale financial statements when recommending securities); The Richmond Corporation, 41 S.E.C. 398, 406 (1963) ("It is a well established practice, and a standard of the business, for underwriters to exercise diligence and care in examining into an issuer's business and the accuracy and adequacy of the information contained in the registration statement. By associating himself with a proposed offering, an underwriter impliedly represents that he has made such an investigation in accordance with professional standards" [footnote omitted]); Brown, Barton & Engel, 41 S.E.C. 59, 64 (1962) (underwriters "had a responsibility to make a reasonable investigation to assure themselves that there was a basis for the representations they made and that a fair picture, including adverse as well as favorable factors, was presented to investors").

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

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

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

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

In recognition of their responsibilities under the general antifraud provisions of the federal securities laws and the MSRB's general fair dealing rules, 78/ for some time underwriters generally have undertaken an investigation of the issuer's disclosure in negotiated offerings of municipal securities. 79/ Among other things, depending upon the nature of the issuer, this has included meetings with municipal

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

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

While issuer officials and underwriters are . . . exempt from civil liabilities under Section 11 of the 1933 Act, both the SEC and private litigants have taken the position that a duty exists under the antifraud provisions similar to, although perhaps not so severe as, the investigating activities which form the statutory "due diligence" defense under Section 11.

American Bar Association, Section of Urban, State and Local Government Law, and National Association of Bond Lawyers, Disclosure Roles of Counsel in State and Local Government Securities Offerings (1987), at 37 ("ABA-NABL Report").

officials, visits to physical facilities, and an examination of the issuer's records and current economic trends and forecasts that bear upon the ability of the issuer to repay its debt. In addition, underwriters usually require so-called "Rule 10b-5" letters from their counsel with respect to municipal offerings. 80/

Although general practice among municipal underwriters appears to recognize a responsibility to assess the accuracy of disclosure documents used in negotiated offerings, the Commission is not convinced that this practice is recognized universally or followed in all negotiated municipal offerings. Moreover, with respect to competitively bid municipal underwritings, some underwriters mistakenly consider themselves to have virtually no responsibility regarding the accuracy of the offering disclosure document. As the Commission noted in the New York City Final Report, there appears to be no clear understanding of an underwriter's responsibility to assure the accuracy of the information disclosed. 81/ The Supply System

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

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

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

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

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

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

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

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

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

would include: the extent to which the underwriter relied upon municipal officials, employees, experts, and other persons whose duties have given them knowledge of particular facts; 86/ the type of underwriting arrangement (e.g., firm commitment or best efforts); the role of the underwriter (manager, syndicate member, or selected dealer) 87/; the type of bonds being offered (general obligation, revenue, or private activity); the past familiarity of the underwriter with the issuer; the length of time to maturity of the bonds; the presence or absence of

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

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

credit enhancements; and whether the bonds are competitively bid or are distributed in a negotiated offering.

In negotiated municipal offerings, where the underwriter is involved in the preparation of the official statement, the Commission believes that development of a reasonable basis for belief in the accuracy and completeness of the statements therein should involve an inquiry into the key representations in the official statement that is conducted in a professional manner, drawing on the underwriter's experience with the particular issuer, and other issuers, as well as its knowledge of the municipal markets. Sole reliance on the representations of the issuer would not suffice. ^{88/} The role of the underwriter in assessing the accuracy of the issuer's key disclosures is of particular importance where the underwriting involves an unseasoned issuer. ^{89/} Because of the varying types of municipal debt and extent of disclosure practices, the Commission is not attempting to delineate specific investigative requirements in this release. However, the Commission notes that commentators already have suggested a variety of investigative procedures to be followed by under-

^{88/} See, e.g., Hamilton Grant & Co., *supra* note 75.

^{89/} Charles E. Bailey & Co., 35 S.E.C. 33, 42 (1953) ("where, as here, an issuer seeks funds from the public to finance a new and speculative venture, the underwriter must be particularly careful in verifying the issuer's obviously self-serving statements as to its operations and prospects").

writers in connection with negotiated municipal securities offerings. 90/

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

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

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

underwriter's review where there is little uncertainty about the choice of underwriters or where other factors are present that would command a closer examination.

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

92/ In a competitively bid offering, the task of assuring the accuracy and completeness of disclosure is in the hands of the issuer, who usually will employ a financial adviser, which frequently is a broker-dealer. Ordinarily, financial advisers in competitively bid offerings publicly associate themselves with the offering, and perform many of the functions normally undertaken by the underwriters in corporate offerings and in municipal offerings sold on a negotiated basis. Thus, where such financial advisers have access to issuer data and participate in drafting the disclosure documents, they will have a comparable obligation under the antifraud provisions to inquire into the completeness and accuracy of disclosure presented during the bidding process. See generally Doty, supra note 90, at §8-78. Although the underwriter may choose to rely upon the fact that a broker-dealer acting as a financial adviser is assisting

investigate the questionable disclosure and, if a problem is uncovered, pursue the inquiry until satisfied that correct disclosure has been made. 93/

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

the issuer, such reliance does not relieve the underwriter of its duty to investigate questionable disclosure.

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

statement 94/ and bring to bear any additional information they have about the issuer.

With respect to both negotiated and competitively bid offerings, apart from the information contained in the issuer's disclosure documents, an underwriter may have had opportunities to develop an independent reservoir of knowledge about an issuer. As noted above and in the Supply System Staff Report, 95/ even in competitively bid offerings, underwriters may have access to information about the issuer that would allow them to reach some conclusion about the worth of its bonds and the validity of representations in the preliminary or final official statement. In addition, underwriters often engage in trading of other bonds of the issuer in the secondary market and acquire information on a continuing basis in their role as dealers of the bonds, regardless of whether they underwrite a particular offering. Moreover, many municipal issuers return to the market frequently to meet their financing needs. Underwriters that participate in multiple offerings for an issuer have a continuing opportunity to become familiar with the issuer's financial and operational condition. From each of these sources, an underwriter may develop a reservoir of

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

95/ Supply System Staff Report at 170-72.

knowledge about the issuer and its securities that should be used to assess the adequacy of disclosure.

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

The Commission believes that the provisions in Rule 15c2-12 also contribute to a municipal underwriter's ability to meet its "reasonable basis" obligation. In particular, paragraph (b) of Rule 15c2-12 would assist underwriters in complying with their reasonable basis obligation by providing that an underwriter receive a nearly final official statement prior to bidding for or purchasing an offering, which it then must review. In order to allow the underwriter to meet this obligation, issuers will have to begin drafting disclosure

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

documents earlier and perhaps with greater care than in the past. Furthermore, this requirement should enable underwriters to receive, and if necessary influence the content of, the final official statement before committing themselves to an offering.

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

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

IV. CREATION OF A CENTRAL REPOSITORY

In addition to soliciting views on proposed Rule 15c2-12, and the methods used to satisfy an underwriter's responsibility to have a reasonable basis for recommending the securities it underwrites, the Commission requests comment on a proposal advanced by the MSRB and members of the industry to create a repository of municipal securities disclosure documents. This proposal is intended to improve the flow of information to the municipal marketplace. Information concerning corporate offerings is available to the public at a single location, because most corporate issuers file registration statements with the Commission. ^{97/} In addition, many corporate issuers are subject to the annual and periodic reporting requirements

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

of the Exchange Act, 98/ which provide a continual source of disclosure about the issuer to the secondary markets. No similar registration or reporting requirements exist for municipal issuers, however.

Although some repositories do collect information concerning municipal offerings, 99/ there is no central and complete source of documentary information. Moreover, even when official statements are prepared, dealers may not retain copies following the distribution. Consequently, they may not have adequate access to complete descriptive information about an issuer's securities when trading in the secondary market. As noted earlier, lack of disclosure about important features of an issuer's securities has been a frequent complaint in MSRB arbitration proceedings and has resulted in pricing and trading inefficiencies. 100/

In an effort to improve the quality of disclosure available to both the primary and secondary market, the MSRB recently has proposed the creation of a central repository of

98/ E.g., Sections 12 and 15(d), 15 U.S.C. 781 and 78g(d).

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

100/ See supra note 35.

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

While the concept of a central repository has been endorsed by elements of the municipal securities industry, the proposal has generated a number of issues that deserve careful study. 102/ The issues range from technical and operational

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

102/ See Letter from Jeffrey L. Esser, Executive Director, GFOA, to David S. Ruder, Chairman, Securities and Exchange Commission (December 18, 1987); letter from James H. Cheek, III, Chairman, Committee on Federal Regulation of Securities, and Robert S. Amdursky, Chairman, Subcommittee on Municipal and Governmental Obligations, American Bar Association, to David S. Ruder, Chairman, Securities and

concerns to more fundamental policy considerations regarding the nature of information to be provided to the repository, and the role of the Commission, if any, in assisting in the creation of the repository.

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

Exchange Commission (March 30, 1988) (suggesting that a careful study be made of the issues raised by a central repository before any formal actions are taken).

V. EFFECTS ON COMPETITION AND REGULATORY FLEXIBILITY ACT
CONSIDERATIONS

Section 23(a)(2) of the Exchange Act 103/ requires that the Commission, in adopting rules under the Act, consider the anticompetitive effects of such rules, if any, and balance any anticompetitive impact against the regulatory benefits gained in terms of furthering the purposes of the Exchange Act. The Commission is preliminarily of the view that proposed Rule 15c2-12 will not result in any burden on competition that is not necessary or appropriate in furtherance of the purposes of the Exchange Act. The Commission requests comment, however, on any competitive burdens that might result from adoption of the rule. Although the rule applies equally to all underwriters of municipal securities, the Commission in particular is interested in receiving comments on the extent to which any of the proposed dollar thresholds would burden one segment of the industry more than another.

In addition, the Commission has prepared an Initial Regulatory Flexibility Analysis ("IRFA"), pursuant to the requirements of the Regulatory Flexibility Act, 104/ regarding the proposed rules. The IRFA indicates that Rule 15c2-12 could impose some additional costs on small broker-dealers and municipal issuers, particularly if a lower dollar threshold is adopted. Nevertheless, the Commission believes that many of

103/ 15 U.S.C. 78w(a)(2).

104/ 5 U.S.C. 603.

the substantive requirements of the rule already are observed by underwriters and issuers as a matter of business practice, or to fulfill their existing obligations under the general antifraud provisions of the federal securities laws. The Commission requests comment on the extent to which current practice deviates from the requirements of the proposed rule, and the extent to which additional costs may be imposed on small municipal issuers and broker-dealers if the rule is adopted as proposed.

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

VI. STATUTORY BASIS AND TEXT OF AMENDMENTS

The Commission proposes to adopt §240.15c2-12 in Chapter II of Title 17 of the Code of Federal Regulations as follows:
List of Subjects in 17 CFR Part 240

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

1. The authority citation for Part 240 is revised by adding the following citation:
Authority: Sec. 23, 48 Stat. 901, as amended; 15 U.S.C. 78w. * * * § 240.15c2-12

also issued under 15 U.S.C. 78b, 78c, 78j, 78o, 78o-4 and 78q.

2. By adding §240.15c2-12 as follows:

Municipal securities disclosure.

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

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

(c) The broker, dealer, or municipal securities dealer shall send promptly by first class mail or other equally prompt means to any person, on request, a single

copy of any preliminary official statement prepared by the issuer for dissemination to potential bidders or purchasers.

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

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

(f) For the purposes of this section --

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

(2) The term "underwriter" means any person who has purchased from an issuer

with a view to, or offers or sells for an issuer in connection with the distribution of, any security, or participates or has a direct or indirect participation in any such undertaking, or participates or has a participation in the direct or indirect underwriting of any such undertaking; but such term shall not include a person whose interest is limited to a commission, concession or allowance from an underwriter, broker, dealer, or municipal securities dealer not in excess of the usual and customary distributors' or sellers' commission, concession or allowance.

By the Commission.

Jonathan G. Katz
Secretary

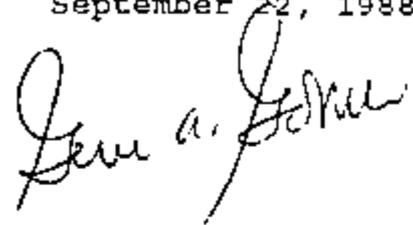
Dated: September 22, 1988

ATTACHMENT C

M E M O R A N D U M

September 22, 1988

To: The Commission
From: Division of Investment Management
Re: Memorandum on the Regulation and
Operation of Unit Investment Trusts



In letters dated February 10 and April 22, 1987, and October 19, 1984, Chairman Dingell of the House Committee on Energy and Commerce requested the Securities and Exchange Commission ("Commission") to advise his Subcommittee on Oversight and Investigation of the status of the Commission's investigation into the default on bonds of the Washington Public Power Supply System ("Supply System"). The Division of Enforcement has prepared a Staff Report to be transmitted to members of Congress who have inquired about the Supply System default that summarizes the facts relating to the default. One aspect of the Commission's investigation summarized in the Staff Report, and referred to by Chairman Dingell in his letters, concerns the purchase of Supply System bonds by unit investment trusts ("UITs") sponsored by certain underwriters of the bonds. This memorandum provides background for the UIT discussion in the Division of Enforcement's Staff Report by (1) describing the nature and structure of UITs, which differ in many significant respects from the more common types of investment companies such as mutual funds, (2) summarizing the current regulatory framework under which UITs operate, and (3) describing the Division's special inspection project.

I. Nature and Structure of UITs

A. Introduction

A UIT is an unmanaged investment vehicle that invests in a fixed portfolio of securities and sells redeemable "units" of itself. ^{1/} Each unit represents an undivided interest in the aggregate value of the underlying portfolio securities. Unlike the more prevalent type of investment company such as a mutual fund, a UIT does not have an investment adviser that manages its portfolio. The portfolio is essentially fixed. A UIT organizer ("sponsor") does nothing more than buy and assemble the portfolio of securities and deposit it with a trustee. This type of investment company allows the investor to make the basic investment decision rather than an investment adviser or manager, yet permits a small investor to obtain investment diversification without a large outlay of capital. Because a UIT is unmanaged, it also permits an investor -- unlike a mutual fund -- to obtain diversification without paying an annual management fee. Like a

^{1/} As such, a UIT meets the definition of an "investment company" found in section 3(a)(1) [15 U.S.C. 80a-3(a)(1)] of the Investment Company Act of 1940 [15 U.S.C. 80a-1 et seq.] ("1940 Act") as an issuer which is "engaged primarily . . . in the business of investing, reinvesting, or trading in securities." The term "unit investment trust" is specifically defined in section 4(2) [15 U.S.C. 80a-4(2)] of the 1940 Act as:

an investment company which (A) is organized under a trust indenture, contract of custodianship or agency, or similar instrument, (B) does not have a board of directors, and (C) issues only redeemable securities, each of which represents an undivided interest in a unit of specified securities, but does not include a voting trust.

mutual fund, a UIT issues only redeemable securities but, unlike a mutual fund, UIT shares typically trade in a secondary market.

A UIT sponsor registers the trust with the Commission as an investment company under the 1940 Act. The trust generally consists of successive "series" each of which offers securities separately registered under the Securities Act of 1933 [15 U.S.C. 77a et seq.] ("Securities Act"). 2/ While each series portfolio consists of a different mix of securities, successive series usually are structured and operate almost identically. 3/ The primary difference between a new series and a previously registered series generally is the specific composition of the portfolio. Each series is, essentially, a separate investment company, and an investor looks solely to the series in which he has invested for his investment return.

B. Background

UITs were popular in the 1930's due, in part, to a reaction against the excesses of managed investment companies discovered in the aftermath of the 1929 stock market crash. After experiencing a decline, UITs have again become a major investment vehicle for debt securities competing with debt mutual funds for many consumers' investment dollars.

2/ See infra p. 12 (discussion of UIT filing requirements under the federal securities laws).

3/ Each series often is similar to the other series (e.g., all consist of municipal bonds). On the other hand, there is no requirement that series within a trust be identical or even similar, and sometimes they are not.

By the end of 1987, there were approximately 240 UITs registered with the Commission with combined assets of over \$118 billion (compared to \$454 billion held by non-money market funds). ^{4/} The 240 registered UITs had an aggregate of over 9,000 series outstanding. ^{5/} There has been tremendous growth in the UIT industry over the last two decades. In 1970, UITs had assets of less than half a billion dollars (compared to \$52 billion for mutual funds); in 1980, UIT assets had jumped to \$41 billion (compared to \$138 billion for mutual funds). Since 1980, UIT assets have almost tripled.

Due to the similarities between trust series, and the numerous documents that must be filed in nearly identical form for each series, the Commission has developed special rules to facilitate the effectiveness of registration statements for additional series. ^{6/} Because the registration process has been streamlined for additional series of a UIT, a sponsor can assemble a new series and bring it to market very quickly.

UITs are commonly used for selling participations in fixed portfolios of tax-exempt securities such as municipal bonds. Ninety percent of the 9,000 trust series outstanding at the end of 1987 were tax-free debt trusts with assets of nearly \$98

^{4/} Investment Company Institute ("ICI"), Report on Total Outstanding Unit Investment Trusts for the Year 1987 (1988) [hereinafter "ICI Report"].

^{5/} *Id.*

^{6/} See *infra* p. 15-16 (discussion regarding rule 487 [17 CFR 230.487] under the Securities Act).

billion. ^{2/} Today, many of these trusts are insured or guaranteed by third parties as to the payment of principal and interest on the underlying bonds. Over 2,200 tax-free debt trust series representing approximately \$30 billion are insured.

C. Structure of a UIT

A UIT is organized under a trust indenture which governs many aspects of administering the UIT. Unlike mutual funds, a UIT has no board of directors overseeing its operations. The trust indenture controls the deposit of the underlying securities into the trust and the issuance of trust units to the underwriters for sale to the public. In addition, the trust indenture (1) governs the responsibilities of the trustee and other parties associated with administering the trust, (2) provides for the evaluation, redemption, purchase, and transfer of the trust units, and (3) stipulates the terms for terminating the trust and distributing its assets.

The trustee, the sponsor (who typically deposits the securities into the trust and is thus also the "depositor" of the portfolio securities), and an "evaluator" (who values the portfolio securities) all play integral roles with respect to a UIT. The trustee collects and distributes to unitholders

^{2/} See ICI Report. Sponsors also form UITs consisting of corporate bonds, mortgage-backed securities, equity securities and, recently, zero-coupon bonds. Equity UITs make up only a small percentage of the total assets invested in UITs. There were 179 equity series outstanding at the end of 1987 with assets of \$4,255,112 -- approximately 3% of total UIT assets. Id.

interest and dividends received on the underlying securities (which usually are debt obligations such as municipal bonds but may be equity instruments such as preferred or common stock). The trustee also provides an annual report to unitholders including, among other things, a portfolio schedule disclosing the current value of each bond or other security, a schedule of amounts received by the trust on the underlying securities, a list of bonds or other securities removed from the portfolio, the amounts distributed to unitholders, and a statement of operations of the series.

The trustee thus basically performs ministerial duties with few if any of the management functions normally associated with trusteeship. For these services, the trustee receives either an annual fee based on a percentage of the trust's net assets or a fixed amount (usually about \$1.00 or less) per \$1,000 principal amount of the portfolio securities. A small number of major banks serve as trustee to most UITs, 8/ but some UITs employ a subsidiary of the UIT's sponsor as trustee. 9/

8/ Section 26(a)(1) [15 U.S.C. 80a-26(a)(1)] of the 1940 Act requires a UIT trustee to be a bank with aggregate capital, surplus, and undivided profits of \$500,000. Major UIT trustees include U.S. Trust Company, Bank of New York, Bank of New England, and Security Pacific Trust Company.

9/ For example, the Kemper Tax-Exempt Insured Trust uses Investors Fiduciary Trust Company which is jointly owned by Kemper Financial Services, Inc., and DST Systems, Inc. Under section 2(a)(5) [15 U.S.C. 80a-2(a)(5)] of the 1940 Act, a "bank" can include certain trust companies.

The sponsor (or a group of sponsors) 10/ forms the trust by depositing a portfolio of securities with the trustee, and generally bears all the organizational expenses. In return, the sponsor receives a set sales charge incorporated into the offering price of each unit. The amount of the sales charge varies but generally is in the range of four to six percent of the offering price per unit. Another major source of profit for the sponsor is the difference between the aggregate price the sponsor pays for the portfolio securities and the aggregate price the sponsor receives for depositing those securities in the trust. 11/ There are about a dozen sponsors and co-sponsors who dominate the UIT industry, many of which are major securities firms. 12/

The evaluator values the securities upon deposit in the trust and determines the redemption value of the units and the prices at which the units are repurchased and resold in the secondary market maintained by the sponsor. The evaluator

10/ Sponsors usually are broker-dealers registered with the Commission.

11/ Of course, if the aggregate price decreases between the time of purchase and the time of deposit, the sponsor bears the loss.

12/ UIT sponsors include: Bear Stearns & Co. Inc., Clayton Brown & Associates, Inc., Dean Witter Reynolds Inc., Shearson Lehman Hutton Inc., John Nuveen & Company, Inc., Kemper Sales Company, Merrill Lynch, Pierce, Fenner & Smith, Mosely Securities Corporation, PaineWebber Incorporated, Prudential Bache Securities Inc., Salomon Brothers, Smith Barney, Harris Upshaw & Company, Thompson McKinnon Securities Inc., and Van Kampen Merritt Inc.

typically receives either a fixed annual fee or a fixed fee per evaluation. Nothing requires the evaluator to be independent from the sponsor and, therefore, the sponsor or an affiliate of the sponsor sometimes serves as the evaluator.

The trust indenture typically does not govern the underwriting of the trust, which usually is controlled by a separate agreement sometimes called a "selling group agreement." Unlike most mutual fund underwritings, UIT underwritings generally are not conducted on a "best efforts" basis. Instead, the underwriters (which invariably includes the sponsor or an affiliate of the sponsor, usually as the principal underwriter) become the owners of all of the units on a certain date and then resell the units to the general public. For their efforts in selling the units and for risking their capital, the underwriters receive a concession that often depends on the number of units the underwriter has agreed to sell. 13/

Units of a UIT are offered to the public at an offering price based upon the value of the underlying securities plus the sales charge added by the sponsor. Because the UIT portfolio is relatively fixed, the units of participation in the UIT are correspondingly a fixed number. Thus, a sponsor generally does not respond to an increasing demand for units by depositing more

13/ The concession is often three to four percent of the public offering price but the underwriters can receive up to the entire sales charge, which usually ranges from four to six percent of the public offering price (and is part of the public offering price).

securities in an existing series and issuing more units of that series. 14/ Instead, the sponsor usually assembles a new portfolio, constituting a new series of the trust, for which a new set of units will be registered and sold. A mutual fund, on the other hand, responds to an increased demand for its securities by merely issuing more shares in itself and purchasing portfolio securities with the proceeds.

Like mutual funds, UITs may only issue redeemable securities. A unitholder who tenders units for redemption must receive a proportionate share of the aggregate net asset value of the portfolio securities of the series. If necessary, the trust is required to meet redemptions by selling off a portion of the underlying portfolio. Although not required by law to do so, the sponsor of a UIT generally maintains a secondary market in trust units as an alternative to redemption. The trust indenture typically permits the sponsor to purchase units from investors at a price equal to or slightly higher than the redemption price and to reoffer the units to other investors. 15/ Sponsors are

14/ If a series is oversubscribed prior to the initial offering or oversold during the initial offering period, the sponsor may deposit additional securities in the portfolio subject to restrictions in the trust indenture and the 1940 Act (see Guide 10 to proposed Form N-7 on depositing additional securities) and create a corresponding number of new units.

15/ The repurchase price can be higher than the redemption price if the sponsor repurchases units from investors based on the "offering side" evaluation of the portfolio securities (based on the prices at which dealers are willing to sell the portfolio securities). The net asset value for purposes of the redemption price is based on the "bid side" evaluation (based on the prices at which dealers are willing
(continued...)

willing to make a secondary market in trust units because they charge another sales charge 16/ on the resale of the units and because they want to avoid returning investors' principal as a result of portfolio liquidation. 17/ Unitholders benefit from the secondary market because it increases liquidity and helps prevent the untimely liquidation of portfolio securities that could occur if units were redeemed. 18/

15/ (...continued)

to buy the portfolio securities), which is generally lower. Evaluations are done by the evaluator.

16/ Unlike most broker-dealer sales, the sponsor does not receive the typical dealer's "spread" for secondary market sales but is compensated solely by the sales charge.

17/ For example, if a unitholder redeemed a unit, the trust may have to liquidate a portfolio security representing far more principal than would be necessary to meet the redemption. Because there are limits on adding or substituting portfolio securities (see infra p. 20-21), the trust may have to distribute the excess to the unitholders, who would then have to recognize a capital gain or loss on the amount they receive.

18/ Substantial redemptions would make it uneconomical to continue maintenance of a trust series and could force premature termination of the series. A standard clause in most UIT trust indentures calls for the mandatory termination of a series when the corpus of the trust series has been reduced to 40% of its original value. This is not a requirement of law but represents the point at which the industry has determined it is no longer feasible to maintain the trust. In addition, in order to qualify for the exemption from section 14(a) [15 U.S.C. 80a-14(a)] of the 1940 Act (prohibiting public offerings of investment company securities unless the company has a net worth of \$100,000), the sponsor must instruct the trustee pursuant to rule 14a-3 [17 CFR 270.14a-3] to terminate the trust, distribute the trust's assets, and refund on demand all sales charges to unitholders if redemptions by the sponsor (or principal underwriter) results in the trust having a net worth of less than 40% of the principal amount of portfolio securities initially deposited in the trust.

A trust series has a fixed termination date according to the terms of the trust indenture, often twenty years during periods of stable interest rates. This date is determined by reference to the maturity date of the underlying securities in the series portfolio. Although most bonds have relatively long maturities, some have special call or redemption procedures that can result in early distributions of principal to unitholders and a corresponding shrinkage of trust assets. Upon termination of the series, any remaining portfolio securities are sold and the proceeds are distributed to unitholders.

II. Regulatory Framework of UITs

A. Introduction

Because of the way UITs are structured, they operate within a unique regulatory framework compared with other types of investment companies. UITs have no adviser or board of directors, so certain provisions of the 1940 Act are clearly irrelevant to them. A few examples are section 15, which governs an investment company's contract with its adviser, and sections 10 and 16, which govern an investment company's board of directors. 19/

Many other provisions of the 1940 Act only apply to managed investment companies such as mutual funds. Because a UIT essentially is a static entity, the 1940 Act provisions governing

19/ 15 U.S.C. 80a-15, 10, 16.

transactions with affiliates is mostly irrelevant. 20/ In addition, the provisions relating to capital structure only apply to managed companies. 21/ Finally, UITs do not issue voting stock. The 1940 Act only requires managed investment companies to issue voting stock. 22/ Thus, the proxy provisions of the 1940 Act (as well as applicable state proxy requirements) do not apply to UITs.

Due to their static nature, the Commission only requires that UITs file periodic reports annually. 23/ Mutual funds must file periodic reports semi-annually with the Commission. In addition, UITs generally are not required to provide reports to shareholders (and file them with the Commission) as other investment companies are required to do under rule 30d-1 [17 CFR 270.30d-1]. 24/ Thus, the registration process, the annual reports, and periodic inspections by the Commission staff comprise most of the Commission's regulatory contact with UITs.

B. Registration Requirements

A trust sponsor registers a trust as an investment company

20/ 15 U.S.C. 80a-17.

21/ 15 U.S.C. 80a-18.

22/ 15 U.S.C. 80a-18(i), 20.

23/ 17 CFR 270.30a-1, 30b1-1. See *infra* p. 18 (discussion of Form N-SAR).

24/ Rule 30d-2 [17 CFR 270.30d-2] only requires a UIT to comply with rule 30d-1 if all of its assets consist of securities issued by a managed investment company.

under the 1940 Act on Form N-8B-2. 25/ Form N-8B-2 requires, among other things, a general description of the trust, a description of the units and the rights of unitholders, and general information about the underlying securities composing the trust portfolio. In addition, Form N-8B-2 requires the sponsor to discuss how the trust operates, including (1) sales loads, fees, charges and expenses, (2) purchase and sale of portfolio securities, (3) redemption of securities, and (4) indenture provisions regarding the depositor (sponsor) and the trustee. Form N-8B-2 also requires a detailed discussion of the organization and operation of the depositor, persons affiliated with the depositor, and companies owning securities in the depositor (including controlling persons of the depositor).

Because each series of a trust offered for sale constitutes a new public offering of securities, the units of each series are separately registered as securities under the Securities Act on Form S-6. 26/ Thus, the trust and the trust units are registered on two separate forms. The Commission has proposed (and subsequently repropoed) a new form, Form N-7, that would consolidate the registration requirements of both the 1940 Act and the Securities Act into one form. 27/

25/ Only the trust itself, and not each individual series, need register under the 1940 Act.

26/ To alleviate the burdens associated with separately registering each series, Form S-6 permits certain items to be cross-referenced for each series from Form N-8B-2.

27/ See *infra* text accompanying notes 58-67.

The sponsor generally maintains a secondary market in which units of each series may be repurchased from unitholders and resold to other investors. Because of these secondary market activities, the registration statement of each series must be kept current. 28/ Among other things, this requires the sponsor to maintain a current prospectus with current audited financial statements for each series for which the sponsor maintains a secondary market. 29/ In addition, a prospectus must be delivered to the investor in connection with each secondary market sale.

The staff of the Commission reviews all initial registration statements filed on Forms N-8B-2 and S-6 and declares the UIT registration statement effective when it is satisfied that all of the requirements of the Securities Act and the 1940 Act have been met. The process for registering additional series of a UIT, however, often can be accomplished without affirmative action by the Commission. When a sponsor wishes to create a new series of

28/ The sponsor is an "issuer" because it typically is the depositor, and under section 2(4) of the Securities Act [15 U.S.C. 77b(4)] the term "issuer" is defined to include the depositor of a UIT. Although secondary market sales of registered securities are usually not subject to the Securities Act once the offering has "come to rest," the courts and the Commission have consistently taken the position that all securities offered or sold by an issuer (i.e., the sponsor), unless otherwise exempt, are subject to the Securities Act notwithstanding the fact that the securities may have been previously sold pursuant to a registration statement.

29/ Proposed Form N-7 would eliminate the need for audited financial statements in secondary market prospectuses under certain conditions. See infra p. 30 and note 61.

a UIT, the prospectus of a previously registered series is circulated as a "red herring." When the sponsor receives sufficient indications of interest in the new series, the sponsor assembles the series portfolio 30/ and files a registration statement which becomes automatically effective under rule 487 [17 CFR 230.487] of the Securities Act.

Rule 487 permits the registration statement of a subsequent series of a trust to become effective automatically at a date and time chosen by the sponsor, if certain conditions are met. 31/ As a result of rule 487, similar registration statements of subsequent UIT series are not usually reviewed by the Commission. Thus, the rule enables certain UIT issuers to go to market whenever they choose without being constrained by Commission review. 32/ Rule 487 was adopted, in part, because subsequent

30/ A sponsor often holds suitable securities in inventory until demand is such that it assembles a new series portfolio.

31/ Under rule 487, a registration statement relating to securities issued by a unit investment trust may become effective on a date and at a time designated by the trust without action by the Commission or its staff provided the registrant identifies at least one previous series of the trust for which the effective date was determined by the Commission or its staff, and represents, in part: (a) that the securities deposited in the series being registered do not materially differ in type or quality from those deposited in the previous series; (b) that the registration statement of the new series does not contain disclosures that differ in any material respect from those of the previously identified series, except to the extent necessary to identify the portfolio securities deposited in, and provide essential financial information for, the new series.

32/ UIT issuers thus have the same sort of control over the registration process that corporate issuers would later gain
(continued...)

series of a UIT rarely present new substantive issues. However, a subsequent series cannot be registered under rule 487 unless the sponsor represents that the new series is not materially different from a previous identified series registered with the Commission that was reviewed by the staff.

Regulatory action has also been taken by the Commission under the 1940 Act to streamline registration procedures for UITs. Because most investment companies, unlike most industrial issuers, continuously issue or sell their shares, Congress added section 24(f) [15 U.S.C. 80a-24(f)] to the 1940 Act in 1970 33/ to give the Commission rulemaking authority to permit certain investment companies including UITs to register an indefinite number of securities.

Section 24(f) is particularly important to UITs, not because UITs continuously offer new trust units, 34/ but because UIT sponsors continuously repurchase and resell trust units in the secondary market. Because the sponsor is considered an "issuer," 35/ units sold by the sponsor in the secondary market must be registered. However, the sponsor may not be able to

32/ (...continued)

when rule 415 [17 CFR 230.415], the "shelf registration" rule, was adopted.

33/ Pub. L. No. 91-547 [84 Stat. 1424 (1970)].

34/ Although open-end investment companies, such as mutual funds, continuously offer new securities of the same issuer, UITs offer securities in successive series each consisting of a relatively set number of units of different issuers.

35/ See supra note 28.

predict the activity in the secondary market. 36/ Rule 24f-2 [17 CFR 270.24f-2] allows a UIT to register an indefinite number of securities under the Securities Act and a UIT sponsor to continuously sell shares in the secondary market. The UIT completes the registration process by filing an annual notice setting forth the number of shares sold accompanied by the fee owed (on a "net" basis) on the sale of such securities. Thus, registration fees are paid on all secondary market sales at the end of the year.

A proposed new rule, rule 24f-3, 37/ would permit UITs to register an indefinite number of trust units solely for secondary market sales as long as a registration fee was paid on each unit when initially sold and the sponsor pays a set fee (at the time the initial registration statement becomes effective) to register all secondary market sales. 38/ The proposed rule also would permit a UIT to partially or totally consolidate its notice and opinion of counsel filings which are now required to be filed separately for each series. This rule would adjust the pattern of regulation to more closely reflect actual UIT operations. UITs require a rule permitting indefinite

36/ Thus, it is possible that a UIT sponsor could oversell the number of shares registered by its registration statement.

37/ Investment Company Act Rel. No. 15611 (March 9, 1987) [52 FR 8302 (March 17, 1987)].

38/ While all eligible investment companies can use rule 24f-2, rule 24f-3 would be specifically adopted for use by UITs.

registration only for its secondary market activities, not for its initial offering which typically is fixed.

As earlier noted, UITs must annually file information with the Commission on Form N-SAR, the periodic reporting form for all investment companies, regarding their current condition. The filing of Form N-SAR satisfies the periodic reporting requirements under both the 1940 Act and the Securities Exchange Act of 1934 [15 U.S.C. 78a et seq.] ("1934 Act"). Neither the 1940 Act nor the 1934 Act require a UIT sponsor to provide unitholders with an annual report to shareholders, but, as earlier noted, unitholders receive an annual report on the condition of the trust from the trustee.

C. Regulation Under the 1940 Act

Although many of the 1940 Act's provisions are irrelevant to the operation of fixed portfolio companies such as UITs, ^{39/} other provisions are particularly relevant to UITs. These provisions include: (1) section 26 [15 U.S.C. 80a-26], governing a variety of integral aspects of a UIT, including who may serve as trustee and how the assets of the trust must be kept; (2) section 17(a)(1)(C) [15 U.S.C. 80a-17(a)(1)(C)], providing an exception from the general prohibition on affiliated transactions contained in section 17 for the deposit by the sponsor of UIT portfolio securities with a trustee; (3) sections 11 [15 U.S.C. 80a-11] and 22 [15 U.S.C. 80a-22], governing the pricing of UIT

^{39/} See supra text accompanying note 19.

units; and (4) section 19 [15 U.S.C. 80a-19], governing the distribution of dividends.

1. Payments to Affiliates, Orphan Trusts,
and Substitution of Securities

Section 26 of the 1940 Act regulates certain key aspects of a UIT's operation by requiring that the trust indenture contain a number of specific provisions. 40/ Section 26(a)(2)(C) requires the trust indenture to prohibit underwriters, depositors, and their affiliates from charging the trust for administrative expenses unless such expenses are reasonable, of a character normally performed by the trustee itself, and approved by the Commission. 41/ Section 26(a)(2)(C) attempts to limit the expenses paid, over and above the sales load, to promoters of UITs.

In 1984, the Commission proposed a rule to codify certain relief it had granted to UIT promoters under section 26(a)(2)(C) and, in doing so, explained that the purpose of section 26(a)(2)(C) was to prohibit the depositor from "reaping hidden

40/ Section 26 prohibits the principal underwriter or depositor from using interstate commerce to sell trust units unless the trust indenture contains these provisions.

41/ As originally drafted by the Commission, section 26(a)(2)(C) would have prohibited the principal underwriter or sponsor from using interstate commerce to sell trust units unless the trust indenture prohibited the trustee from paying the underwriter or depositor any expense. See Hearings on S.3580 Before a Subcommittee of the Senate Committee on Banking and Currency, 76th Cong., 3d Sess. 18 (1940) [hereinafter "Hearings 3580"].

profits' through purported administrative fees." 42/ Although rule 26a-1 [17 CFR 270.26a-1] was primarily targeted at UITs organized as separate accounts of insurance companies, it allowed the Commission to codify its interpretation that section 26 permits a payment from trust assets for administrative fees provided that the fee does not exceed the estimated cost of the service provided. 43/ That is, the services must be provided at cost. 44/

A second provision, section 26(a)(3), addresses the problem of "orphan trusts" and requires the trust indenture to provide that the trustee cannot resign until either the trust has been completely liquidated and the proceeds distributed to unitholders, or a successor trustee has been designated and has accepted trusteeship. Section 26(a)(2)(D) also requires that the trustee have physical possession of the trust securities at all times.

A third provision, section 26(a)(4), contains notice provisions that must be followed when the depositor substitutes a portfolio security. The 1940 Act itself generally places no

42/ Investment Company Act Rel. No. 13705 (Jan. 6, 1984) [49 FR 1755 (Jan. 13, 1984)].

43/ Id.

44/ The Commission reiterated its insistence on the "at cost" standard when it adopted rule 26a-1, and rejected a suggestion by one commenter that the rule be modified to permit a "reasonable" profit in any administrative fee. Investment Company Act Rel. No. 14065 (July 27, 1984) [49 FR 31062 (Aug. 3, 1984)].

specific limits on substitution. However, the staff of the Commission has taken the position that, because the definition of a UIT in section 4(2) of the 1940 Act requires that units represent an undivided interest in "specified securities," substitution of portfolio securities should only occur under unusual circumstances, for example, when the creditworthiness or economic viability of the issuer of the portfolio security is seriously in doubt. The staff's position stems from a concern that a unitholder of a UIT is seldom in a position to judge the merits of a substituted security and that the only recourse a unitholder would have to accepting such substitutions would be to redeem his units. 45/

The notice requirements of section 26(a)(4) require that the depositor or its agent keep a record of the names and addresses of all unitholders of the trust. The trust indenture must provide that whenever a portfolio security is substituted the depositor must mail a notice of the substitution to unitholders within five days after the substitution. The notice must identify the eliminated security and the substituted security.

45/ In its 1966 report to Congress entitled "Public Policy Implications of Investment Company Growth" ("PPI"), the Commission voiced its concerns about portfolio substitutions and recommended that substitutions be prohibited unless approved by the Commission. H.R. Rep. No. 2337, 89th Cong., 2d Sess. 337 (1966). However, the 1970 Amendments adding section 26(b) to the 1940 Act only requires Commission approval for substitutions in those specialized trusts which invest in only one issuer, i.e., UITs that serve as a vehicle for investing in mutual funds. Pub. L. No. 91-547 [84 Stat. 1424 (1970)].

2. Affiliated Transactions

Section 17 of the 1940 Act comprehensively regulates the affiliated transactions 46/ of all investment companies including UITs, but section 17 exempts from its coverage the particular affiliated transaction most likely to arise in the case of a UIT. Specifically, although sections 17(a)(1) and (a)(2) generally prohibit affiliates and other insiders from knowingly selling any security or other property to, or buying any security or other property from, the affiliated investment company, section 17(a)(1)(C) exempts a sale to an investment company solely involving securities deposited with the trustee of a UIT by the depositor. Because a UIT's portfolio is relatively fixed following the initial deposit of the securities by the depositor, and because few other affiliated transactions subject to section 17 are likely to occur with a UIT, the prohibitions on affiliated transactions contained in section 17 only apply to an occasional elimination or substitution of a UIT portfolio security. For example, the trust might decide to eliminate a security from the portfolio and sell it to the sponsor, 47/ thus

46/ Affiliated transactions of a UIT would include transactions with the trust's depositor, promoter, or principal underwriters.

47/ The Commission has used its exemptive authority under section 17 of the 1940 Act to permit certain affiliated transactions. See Dean Witter Reynolds et al., Investment Company Act Rel. Nos. 15311 (Sept. 16, 1986) (notice), 15356 (Oct. 10, 1986) (order); PaineWebber et al., Investment Company Act Rel. Nos. 15399 (Nov. 5, 1986) (notice), 15451 (Dec. 3, 1986) (order).

creating an affiliated transaction subject to section 17.

Because of section 17(a)(1)(C), sponsors of UITs are not prohibited from purchasing portfolio securities from an affiliated underwriter and depositing them into a series of a UIT. Recently, national attention has been focused on this issue due to the massive default on bonds issued by the Washington Public Power Supply System. 48/ Lead underwriters of the Supply System bonds also sponsored UITs and deposited large quantities of Supply System bonds into those UITs. However, section 17(a)(1)(C) does not prohibit such transactions.

There is very little in the way of legislative history to explain why the affiliated transaction involving the deposit of UIT securities was exempted from the purview of section 17. 49/ This exemption may have resulted from a recognition that because a UIT is created by an affiliated transaction, requiring depositors to obtain exemptive relief at this inceptive stage might irreparably detain them from reaching the market. 50/

48/ The Supply System default was the largest nonpayment default in the history of the municipal bond market, representing more than \$7 billion in principal and interest.

49/ The exemption was contained in the original Commission draft of the 1940 Act and it was not substantially modified as the law was enacted. Hearings 3580 at 12. Pub. L. No. 76-768 [54 Stat. 789 (1940)].

50/ Another possibility is that disclosure of various fees paid to the depositor upon deposit of the underlying securities into the trust was considered an effective solution to the problem.

3. Disqualification

In addition, the principal underwriter and depositor of a UIT are subject to the disqualification provisions of section 9 [15 U.S.C. 80a-9] of the 1940 Act. Section 9 specifies certain conduct and past events which automatically bar a person or company from acting as a depositor or underwriter of a UIT. Generally, any conviction for a felony or misdemeanor involving the purchase or sale of a security within the past ten years, or any other judgment or decree for misconduct in the securities, commodities, or financial services industry will bar a person from being affiliated with a UIT.

Any person ineligible to serve as a principal underwriter or depositor of a UIT due to past conduct may file an application for an exemptive order with the Commission requesting an exemption from the disqualification provisions. After a review of all the facts and circumstances, the Commission may deny or grant in full or part the requested relief under section 9(c) from the automatic bar of section 9(a).

4. Fiduciary Standard

A UIT's depositor and principal underwriter are also subject to the fiduciary standards of section 36 [15 U.S.C. 80a-36] of the 1940 Act. Section 36 establishes a fiduciary duty for the depositor and principal underwriter with respect to the receipt of compensation for services or of payments of a material nature. An action may be brought either by the Commission or a unitholder on behalf of the UIT. If a breach of fiduciary duty is

established by the plaintiff, a court may temporarily or permanently enjoin the person from acting in its affiliated capacity or provide other appropriate relief.

5. Pricing and Exchange of Securities

Because UITs issue redeemable securities, the pricing provisions of the 1940 Act are applicable. 51/ UIT securities can thus only be sold to investors at net asset value plus any sales load. When investors liquidate or redeem their units, they must receive the current net asset value for them. 52/ UITs must disclose in their prospectuses the net asset value of their units, how net asset value is calculated, and the sales load as a percentage of the offering price. Trust units may only be sold at the price described in the prospectus. 53/ Rule 22c-1 permits UITs to value their portfolio securities once a week if the sponsor is maintaining a secondary market in the series based on the "offer side" evaluation of the underlying securities and if

51/ Section 22 of the 1940 Act, and rule 22c-1 [17 CFR 270.22c-1] thereunder, regulate the distribution, redemption, and repurchase of redeemable securities which include both the shares of open-end management companies and the units of UITs.

52/ Section 2(a)(32) [15 U.S.C. 80a-2(a)(32)] of the 1940 Act defines "redeemable security" as "any security, other than short-term paper, under the terms of which the holder, upon its presentation to the issuer or to a person designated by the issuer, is entitled (whether absolutely or only out of surplus) to receive approximately his proportionate share of the issuer's current net assets, or the cash equivalent thereof."

53/ See section 22(d) of the 1940 Act and rule 22d-1 [17 CFR 270.22d-1] thereunder.

certain other conditions are met. 54/ In contrast, mutual funds must value their securities on the basis of the current net asset value which is next computed after receipt of a tender of such security for redemption or of an order to purchase or sell such security (usually the next business day following a redemption request). Because most sponsors now base their secondary market evaluations on the "bid side," few UITs are able to use this special provision.

UITs are prohibited under section 11(c) of the 1940 Act from offering to exchange the units of a unitholder for the securities of any other investment company without prior Commission approval. This provision was designed to eliminate the practice preceding the 1940 Act of switching investors from UIT to UIT and imposing a sales charge on each transaction. The Commission is considering a new rule, proposed rule 11c-1, 55/ which would permit UIT investors to exchange units without prior

54/ The "offer side" evaluation of the underlying securities is based on the prices at which dealers are willing to sell the underlying securities. The "bid side" evaluation of the underlying securities is based on the prices at which dealers are willing to buy the underlying securities, which is generally lower. If the sponsor is not maintaining a secondary market in the units or if the secondary market is based on the "bid side" evaluation of the UIT securities, portfolio securities must be valued as frequently as mutual fund shares, *i.e.*, on the next business day following a redemption request.

55/ Investment Company Act Rel. No. 15494 (Dec. 23, 1986) [51 FR 47260 (Dec. 31, 1986)]. In repropoing a rule that would permit mutual funds to make certain exchange offers, the Commission sought additional comment on proposed rule 11c-1. Investment Company Act Rel. No. 16504 (July 29, 1988) [53 FR 30299 (August 11, 1988)].

Commission approval under certain conditions. One of those conditions would prevent the layering of sales charges.

6. Distribution of Dividends

Section 19(b) of the 1940 Act provides, in part, that a registered investment company may not make distributions of long-term capital gains more often than once every twelve months. This provision was intended to prevent investment companies from creating an impression of investment success by making frequent distributions of capital. Although section 19(b) applies to UITs, exceptions to this provision have been provided in rule 19b-1 [17 CFR 270.19b-1] under the 1940 Act to permit UITs to make more frequent capital gains distributions provided such distributions result from (1) an issuer's calling or redeeming an "eligible trust security," ^{56/} (2) the sale of an eligible trust security in order to maintain the UIT's investment stability, or (3) from regular distributions of principal and prepayment of principal on eligible trust securities. The Commission recently amended rule 19b-1 to permit regulated investment companies, including UITs, to make an additional distribution of capital gains where the failure to make the distribution would result in

^{56/} Rule 14a-3 [17 CFR 270.14a-3] under the 1940 Act defines "eligible trust securities" as (1) securities issued by a corporation which have a fixed dividend or interest rate, (2) interest bearing obligations issued by a state, or by any agency, instrumentality, authority or subdivision, (3) government securities, and (4) units of previously issued series.

a special excise tax under the Tax Reform Act of 1986. 57/

III. Recent Commission Action Regarding UITs

As earlier noted, the registration obligations of a UIT have not been integrated. In other words, a single form cannot be used to register a trust under the 1940 Act and its securities under the Securities Act, although Form S-6 incorporates as a substantial part of its requirements many of the items required by Form N-8B-2. These two forms were adopted in 1942 and have not been substantively revised since then. While these forms do require disclosure of useful information, they nonetheless are significantly out of date in that many matters that are material to prospective investors are not required to be disclosed.

A. Proposed Form N-7

The Commission proposed, in May of 1985, a new registration form and staff guidelines for UITs. 58/ Proposed Form N-7 would integrate the filing requirements of both the Securities Act and the 1940 Act. The staff guidelines would represent the first written guidelines for unit investment trusts. 59/ Like the revised registration form for mutual funds, Form N-7 as originally proposed would have had a three-part format: a

57/ Investment Company Act Rel. No. 16094 (Oct. 29, 1987) [52 FR 42426 (Nov. 5, 1987)].

58/ Rel. Nos. 33-6580, IC-14513 (May 14, 1985) [50 FR 21282 (May 23, 1985)].

59/ Staff guidelines are a compilation and adaptation of applicable Commission releases and staff positions and interpretations. Staff guidelines for mutual funds and other investment companies have existed for years.

prospectus, a statement of additional information ("SAI"), and exhibits. The prospectus would have presented material information about the UIT and its securities. The SAI would have been available to investors upon request and would have discussed in more detail matters required to be in the prospectus as well as matters not required in the prospectus which might have been of interest to some investors.

Form N-7 was widely criticized by the industry for a variety of reasons. The form would have required a brief explanation of some topics in the prospectus and greater elaboration of the same topics in the SAI. Commenters believed that because sponsors tend to explain everything thoroughly to avoid explanations that are misleading by omission, this format would have created two lengthy documents instead of the concise two-part document which was the Commission's stated goal. Because of the many changes suggested by commenters and because the Investment Company Institute, a trade association for investment companies, subsequently requested that the Commission grant UITs relief from the annual audited financial statements requirement of Form N-7, the Division decided to revise Form N-7 substantially and repropose it and the guidelines for additional comment.

B. Reproposed Form N-7

On March 9, 1987, the Commission repropose Form N-7 for public comment. 60/ The form as repropose would have a

60/ Rel. Nos. 33-6693, IC-15612 (March 9, 1987) [52 FR 8268 (March 17, 1987)].

prospectus but would have no statement of additional information. The prospectus could be prepared into two parts. One part would contain information that is specific to each series of a trust, for example, the portfolio schedule and the other financial statements. The other part would contain generic information applicable to the trust and all of its series and could be the same document for each series, although both parts would have to be delivered to meet the prospectus delivery requirements of section 5 of the Securities Act. This specific/generic format would conform to the practice currently used by some UIT sponsors and could save significant printing costs.

1. Audited Financial Statements

In the reproposal of Form N-7 the Commission proposed relieving UITs, under certain circumstances, from the requirements of annual audited financial statements in secondary market prospectuses. Under the new form a UIT would be required to have an initial audit of its portfolio schedule and a one-time follow-up audit with full financial statements, twelve to eighteen months after the initial offering. Thereafter, the UIT could substitute the unaudited trustee's report for the audited financial statements, if certain conditions are met, 61/ for

61/ Form N-7 has been revised so that a UIT maintaining a current prospectus could provide unaudited financial statements after its twelve to eighteen month follow-up audit if (1) there have been no substitutions or additions of securities to the portfolio during the previous fiscal year; (2) information generally contained in the trustee's report is annually filed as part of the registration statement and made part of the
(continued...)

prospectuses used in the secondary market. The staff believes that eliminating the audit requirement for secondary market prospectuses under these circumstances will provide substantial cost savings to the industry without reducing investor protection.

2. Third-Party Financial Statements

Since the early 1980s, UIT sponsors have created trusts containing bonds that are wholly or significantly guaranteed or insured by various third parties. ^{62/} Of the over 9,000 trust series registered with the Commission, 24.5% contain portfolio securities that are insured or guaranteed.

Under informal practices developed by the Division in 1980, registrants have not been required to include financial statements of guarantors or insurers of portfolio securities in their registration statements. However, the staff has required sponsors of "guaranteed" (but not insured) trusts to make guarantor financial statements available on request so that prospective unitholders can assess the quality and value of the guarantees. The Commission's accounting regulations (Regulation S-X) [17 CFR 210.3-10] require the financial statements of each

61/(...continued)

prospectus; (3) the trustee is audited annually by an independent public accountant; and (4) the trustee receives an unqualified report on the internal accounting controls of its trust operations.

62/ Several sponsors of insured UITs have obtained exemptive relief from the provisions of section 17 of the 1940 Act which prohibit affiliated transactions because the insurers are affiliated with the UITs whose portfolios they insure.

guarantor of any class of securities of a registrant to be included in the registration statement. Because the securities of a UIT, i.e., the units, are not themselves guaranteed but can represent an undivided interest in a portfolio that is wholly or partially guaranteed, this provision of Regulation S-X does not technically apply to UITs with guaranteed portfolio securities. However, the effect of the guarantee is functionally similar.

Form N-7 as originally proposed would have required guarantor financial statements to be part of the registration statement but would have excepted insured trusts from this requirement. When Form N-7 was repropoed, the requirement was extended to insurers as well as guarantors because, in the view of the Commission, they are functionally equivalent. This aspect of Form N-7 generated significant controversy. Industry commenters opposed inclusion of any third-party financial statements in the registration statement, citing civil liability under the Securities Act 63/ of sponsors for a third party's financial statements over which they have no control and cannot verify. The commenters also argued that investors would have great difficulty understanding insurance company financial statements. In addition, commenters said that state regulation of insurance companies and publicly available ratings from national rating organizations would provide sufficient investor

63/ Section 11 [15 U.S.C. 77k] sets forth the civil liabilities for which any person acquiring a security registered under the Securities Act may recover with respect to material misstatements or omissions in the registration statement.

safeguards.

The staff of the Commission has not resolved whether these "safeguards" are acceptable substitutes for disclosure and liability under the federal securities laws. In the Commission's recently-issued report to Congress regarding the financial guarantee market, it was estimated that municipal bond insurers had a current exposure to losses of approximately \$300 billion. 64/ One large insurer, AMBAC, Inc., ("AMBAC") has paid at least twenty claims, the largest of which relates to the Supply System default, for which its aggregate exposure is \$75.5 million. 65/ AMBAC has also paid claims resulting from four industrial revenue bond issue defaults with an aggregate par value of \$79 million. 66/ Through this financial adversity AMBAC's high credit rating has remained intact. The Commission's Financial Guarantee Market Report concluded (1) that the existence of a guarantor should not be determinative of whether a security should be exempt from registration; (2) that ratings issued by rating agencies are not adequate substitutes for the registration and reporting requirements under the securities laws; and (3) that the current level of state regulation does

64/ Report by the United States Securities and Exchange Commission on the Financial Guarantee Market: The Use of the Exemption in Section 3(a)(2) of the Securities Act for Securities Guaranteed by Banks and the Use of Insurance Policies to Guarantee Debt Securities (Aug. 28, 1987) ("Financial Guarantee Market Report") at 48.

65/ Id. See supra text accompanying notes 48-50.

66/ Financial Guarantee Market Report at 48.

not provide for the safe and sound operation of financial guarantee insurers. 67/

C. The Special Inspection Project

As a result of, among other things, the rapid growth in the UIT industry, the Division has initiated a project to evaluate the UIT industry and to determine whether any regulatory changes are needed. Part of the Division's project is to conduct special inspections of ten percent (10%) of the 240 unit investment trusts registered with the Commission under the Investment Company Act of 1940 (excluding UITs formed as separate accounts of insurance companies). Because of the Division's concerns about potential problems in the way securities are chosen by a UIT sponsor for inclusion in a UIT, the Division's special inspection project is focussing on the following areas:

1. The process followed by UIT sponsors in deciding what securities should be placed in the portfolio of a particular series of a UIT;
2. How and by whom the securities in the portfolio are valued on a periodic basis; and
3. Sales practices used by UIT underwriters in distributing units to investors.

In addition, the special inspection project is focussing on (1) secondary market operations by brokers in UIT units, and (2) experience of investors in the eventual liquidation of UIT

67/ Id. at 81-85.

portfolio securities and termination of a series. The project also involves heightened review of UIT disclosure documents by the Division's disclosure branches. The Division expects to complete its special inspection project by September 30, 1989, and at that time will transmit to the Commission its evaluations and recommendations for action.

IV. Conclusion

UITs have emerged as a popular consumer investment in the last twenty years. Like a mutual fund, a UIT offers liquidity and diversity at an affordable price. Unlike a mutual fund, however, a UIT incurs no annual advisory fee, few if any brokerage commissions, and offers the certainty of knowing exactly what securities the UIT owns (and except in the rare circumstances of eliminations or substitutions, will always own). As long as debt securities are attractive investments, UITs should remain popular.