Municipal Securities: The Crises of State and Local Government Indebtedness, Systemic Costs of Low Default Rates, and Opportunities for Reform

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Length: 27,981 words (including footnotes)
ABSTRACT

Municipal Securities: The Crises of State and Local Government
Indebtedness, Systemic Costs of Low Default Rates, and Opportunities for Reform

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Municipal securities are securities that state and local governments issue to pay for large infrastructure projects like roads and power plants, to fund economic development and public welfare initiatives like sports stadiums and hospitals, and to meet day-to-day funding needs. According to conventional wisdom, municipal securities are safe because state and local government issuers rarely default. State and local governments rarely default because they may be legally obligated to collect taxes, fees and assessments in amounts necessary to pay bondholders. In addition, legal and non-legal constraints may make it difficult or impossible for state and local governments to obtain discharge. The municipal securities regulatory regime reflects this view. Under the current regime, so long as facts relating to default risk are disclosed to investors, and the offering process is not corrupt, stakeholders essentially have complied with their regulatory obligations respecting systemic risk.

For investors, the conventional wisdom makes sense. After all, if issuers are unwilling or unable to default or obtain discharge, investor risk of loss is low. For taxpayers and others who are ultimately responsible for paying back municipal debt, however, low default rates are a more complicated issue. This is because the very steps that issuers take to pay back bondholders and retain access to public markets may increase systemic risks and costs for taxpayers and others who are ultimately responsible for repaying municipal bond debt. For example, cash-strapped issuers may implement austerity plans to avoid default and retain access to public markets, including tax increases and budget cuts. Since taxpayers must pay government levies, and depend upon on public services, austerity plans can have a devastating effect upon personal economic situations and public life. Likewise, for public workers, austerity programs may result in layoffs or reductions in compensation or post-employment benefits. Lest one think that the tension between paying for public works and paying back bondholders is theoretical, consider what has happened in places like Jefferson County, Alabama (which declared bankruptcy in 2011 in the wake of a corruption scandal including $3 billion of municipal bond debt and related interest rate swaps transactions), Vallejo, California (which declared bankruptcy in 2008 after struggling with declining revenues, soaring costs and municipal bond obligations), Harrisburg, Pennsylvania (which was placed into receivership last year and recently announced that it would skip $5.27 million in payments due on general obligation bonds). In these and other similarly-situated communities, taxpayers and other community stakeholders are getting squeezed between declining tax revenues, soaring costs, and the price of municipal bond debt.

In an ideal world, taxpayers and workers would be able to reduce risks and costs associated with municipal securities and low default rates through the political system (e.g., voting against bond issuances and/or the public officials who champion them),
private ordering (e.g., negotiating more favorable terms with investors, underwriters, credit enhancement providers, and other involved in structuring offerings and related transactions), or by exiting their investment in the municipal enterprise (e.g., selling real estate and moving out). Unfortunately, taxpayers are not well-positioned to take advantage of these risk-reducing tools. Individual offerings may not be subject to a taxpayer vote, and taxpayers are not always well-informed about risk, nor are they empowered by current systems to monitor or discipline those who structure offerings or implement tax increases and spending cuts. Moreover, once a taxpayer makes the initial decision to live or work in a community or use its services, her choices are limited. She must pay government levies whether or not she approves of particular expenditures, and exit is not a readily available option, since it is neither cheap nor easy to sell real estate and move out of town, especially when real estate markets are in turmoil.

In this paper, I argue that our system of municipal securities regulation is inadequate because it externalizes and fails fully to address systemic risks and costs that taxpayers and other community stakeholders face precisely because default rates are low. I would bring these risks and costs into the securities regulation regime. For example, I would hold government officials and underwriters who structure municipal funding plans to fiduciary standards of care and loyalty and require them to consider whether the plans are in the best interest of the issuer (and its stakeholders), considering both short and long-term objectives. I also would expand and formalize risk identification and tracking systems so that stakeholders would have a better chance of identifying issues before a crisis erupts. Finally, I would implement systems to assess, track and monitor the effectiveness of regulatory reforms, so that we can leverage successful strategies and avoid (or at least mitigate the impact of) mistakes.

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Part I: Introduction

Until the mid-1970s, the municipal securities market was a small and relatively sleepy corner of the nation’s capital markets. As late as 1975, there were less than $50 million of municipal bonds estimated to be outstanding, and only about $58 million in new issuances per year. Most offerings took the form of general obligation bonds with standard terms. Investors were predominantly institutions like banks and insurance companies. Interest rates were steady, and defaults were rare. And, because the

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2 Section 3(a)(29) of the Exchange Act defines “municipal securities” to include direct obligations of a state, any political subdivision, agency or instrumentality of a state, any municipal corporate entity of a state, and tax-exempt industrial revenue bonds. See 15 U.S.C. § 77(c). As discussed below, municipal securities are securities issued by states and their political subdivisions and instrumentalities to fund infrastructure projects like roads, schools and water/sewer plants, and to meet day-to-day funding needs.


4 Ann Judith Gellis, Municipal Securities Market: Same Problems—No Solutions, 21 DEL. J. CORP. L. 427, 428 (1996). As discussed below, general obligation bonds are backed by the taxing power of the issuer. See pp. 6-10 for a discussion of the most common types of municipal securities.


Securities and Exchange Commission (hereinafter, the Commission) brought only a handful of enforcement actions prior to 1975, there was little publicly-available evidence of misconduct.\(^7\)

Since that time (and without the benefit of sustained public scrutiny),\(^8\) the municipal securities market has become exponentially larger, more complex and more important to American life. Of the approximately 90,000 state and local governments in the United States today, there are approximately 60,000 different issuers of municipal securities.\(^9\) As of December 31, 2011, approximately $3,795.6 trillion of municipal bonds were estimated to be outstanding.\(^10\) Instead of “plain vanilla” general obligation bonds, revenue bonds comprise a majority of new issuances.\(^11\) In addition, even smaller issuers

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\(^9\) For the number of state and local governments (including authorities) see, e.g., United States Census Bureau, State and Local Government Finances Summary: 2009, at 1 (Issued October 2011) (stating there are approximately 90,000 issuers), available at [http://www2.census.gov/govs/estimate/09_summary_report.pdf](http://www2.census.gov/govs/estimate/09_summary_report.pdf); Mead, Dean Michael, What You Should Know About Your Local Government’s Finances: A Guide To Financial Statements, at 1 (2011) (stating there are approximately 90,000 state and local governments in the United States, including tens of thousands of local governments (counties, cities, towns, villages), school districts, water districts, parks districts, fire districts, and special districts for myriad other purposes). For an estimate of the number of issuers, see MSRB, How the Market Works, available at [http://www.msrb.org/Municipal-Bond-Market/How-the-Market-Works.aspx](http://www.msrb.org/Municipal-Bond-Market/How-the-Market-Works.aspx) (“There are approximately 60,000 different issuers of municipal securities, and many of these issuers may issue different types of securities. This wide array of choices in the municipal market contrasts sharply with the corporate market, where the number of issuers and issues is much smaller.”).


now regularly use complex municipal financing structures, including interest rate swaps. Individual investors (not institutions) now hold a majority of outstanding municipal securities issuances. Rates have become more volatile, and the default rate is up (though defaults remain relatively rare). And, while the municipal securities of the issuing public body. Instead, revenue bonds generally are payable from defined sources such as revenues or receipts from funded projects. See General Accounting Office, Report to the Chairman, Subcommittee on Economic Stabilization, Committee on Banking, Finance and Urban Affairs House of Representatives: Trends and Changes In the Municipal Bond Market As They Relate to Financing State and Local Public Infrastructure, GAO/PAD-83-46 (September 12, 1983), at p. 13 for a discuss of issuers’ growing use of bonds for “non-traditional” purposes including housing, private economic development, hospitals, pollution control and student loans.

Commenting on these trends, Commission Elisse Walter recently noted that, “this market is enormous and operates with increasing participation by retail investors. Municipal securities are securitized and both large and small municipalities use complex structured products and financial derivatives whose risks even sophisticated investors sometimes have trouble understanding.” Walter, supra note 5. See also, Lawrence E. Harris & Michael S. Piwowar, Municipal Bond Liquidity, 61 J. Fin. 1361, 1364 (2005) (“The municipal securities market includes both primary and secondary market derivative products. Primary derivatives are based on bonds issued by municipal issuers. Examples include inverse floater bonds, bonds with embedded swaps and caps, and bonds with coupon payments based on interest rate indices such as the Bond Market Association’s swap index. Secondary derivatives are based on securities that are not directly issued by a state or local government. Examples include stripped interest rate bonds and trust certificates with interest rate swaps. Both types of derivatives tend to be highly customized.”).

According to statistics compiled by the Federal Reserve System and Published by SIFMA (and updated as of 3/12/12), of the $3,743.3 trillion in municipal bond issuances held by investors, $1,879.3 are held by individual investors, $930.3 billion by mutual funds; $332 billion by banking institutions; 466 by insurance companies, and $135.6 by a variety of other individual, governmental and non-governmental holders. See Holders of Municipal Securities, excel spreadsheet published by SIFMA, available at http://www.sifma.org/research/statistics.aspx and accessed on March 17, 2012. See also Mary Shapiro, 2010 Speech before the Investment Company Institute (May 7, 2010) (noting that of $2.8 trillion in municipal bond estimated to be outstanding, about 35% held by individuals, with another 34% indirectly held by retail investors through the money market funds and mutual funds), available at http://www.sec.gov/news/speech/2010/spch050710mls.htm.

See, e.g., Moody’s Investor Services, SPECIAL COMMENT: U.S. Municipal Bonds and Recoveries, 1970-2011 (March 7, 2012) (reporting that there have been 11 defaults on long-term bonds rated by Moody’s in 2010 and 2011, averaging 5.5 defaults per year as compared with an average of 2.7 annual defaults over the period 1970-2009). See also Russell Pearlman, Municipal Bonds: Derailed, SMARTMONEY (May 17, 2010) available at http://www.smartmoney.com/investing/bonds/muni-bonds-derailed/ (“But investors are starting to see signs of deeper problems – hairline fractures in the muni market’s foundation. With the real estate crash and high unemployment robbing cities and town of tax revenue, more municipalities are being forced to renge on their debts. Since last July, 201 municipal bond issuers have missed interest payments on some $6 billion worth of bonds, or an average of about one every other day. That’s up from 162 in 2008, and a hefty increase from the 31 that did in all of 2007.”)
market is not a hotbed of securities law violations, there have been several high-profile cases in recent years involving bid rigging, price fixing, political influence peddling, abusive sales practices, materially misleading statements and omissions in offering documents, and other alleged securities law violations.

Despite these developments, conventional wisdom respecting risk and municipal securities has not changed much over the years. Municipal securities are thought to be a “widow and orphan” asset class – i.e., safe for vulnerable and risk-averse investors – because state and local government issuers rarely default or seek discharge. State and


17 For a discussion of yield-burning, or the practice by which securities dealers sell treasury securities to municipal bond issuers at inflated and arguably illegal prices in connection with advance refunding transactions, see Jeffrey J. Wick, Yield Burning and Municipal Finance: A Primer, 18 Ann. Rev. Banking L. 533 (1999).

18 For examples of cases in which the Commission alleged that units of government violated the anti-fraud provisions of the ’33 and ’34 Acts with respect to the financial information in disclosure documents, see, e.g., In re State of New Jersey, Release No. 9135 (Aug. 18, 2010), available at http://www.sec.gov/litigation/admin/2010/33-9135.pdf; In the Matter of the City of San Diego, SEC Release No. 34-54745, 89 S.E.C. Docket 807 (Nov. 14, 2006) (alleging City of San Diego failed to disclose the gravity of its pension and retiree health liabilities or that those liabilities had placed city in financial jeopardy); Opinion of the Commission, In the Matter of the City of Miami, Florida, SEC Release No. 34-47552 (March 21, 2003) (holding City of Miami failed to disclose cash flow shortage which it had eased, in part, by spending the proceeds of bonds issued for other purposes for operating costs); In re Maricopa County, SEC Release No. 33-7354, 34-37779, 62 S.E.C. Docket 2574 (Oct. 3, 1996) (alleging Maricopa County, AZ failed to disclose material decline in financial condition and operating cash flow, substantial deficit in general fund and increased deficit in another fund in connection with municipal bond offering); In re City of Syracuse, SEC Release No. 34-39149, 65 S.E.C. Docket 1199 (Sept. 30, 1997) (alleging city of Syracuse falsely claimed surplus for its general and debt service funds, materially overstated its fund balance in those funds, and misled investors by describing certain financial information as audited.).

local government issuers rarely default or seek discharge for at least two reasons. First, because of the way municipal bonds are structured, issuers may be legally obligated to increase taxes, fees and assessments if necessary to satisfy bondholders. Second, legal and non-legal constraints may make municipal securities issuers unable or unwilling to seek discharge. Put simply, unless a municipal securities issuer literally disappears from the face of the map, or loses most of its taxable real property or revenue-generating infrastructure, bondholders are likely to get paid. The regulatory regime applicable to municipal securities reflects this investor-centric view of risk: traditionally, so long as facts relevant to default risk are disclosed to investors, and the offering process is not corrupt, stakeholders’ are likely to have satisfied their regulatory obligations respecting systemic risk.

Focusing on investor risk of loss, the low default rate in the municipal securities market is good news. After all, if issuers are unable or unwilling to default or seek discharge, investor risk of loss is low. For stakeholders like taxpayers, however, the low default rate is a more complex issue. This is because the very steps that reduce investors’ risk of loss may simultaneously increase risks and costs for taxpayers and others whose credit backs up municipal bond issuances, and who are ultimately responsible for paying back municipal bond debt. For example, when budgets are tight, issuers may increase taxes and cut spending to avoid default and retain access to public markets. Since taxpayers must pay government levies, and depend upon on public services, austerity measures can have a devastating effect upon personal economic situations and public life. Austerity plans also may mean that public workers are terminated or subject to cuts in compensation or benefits. Lest one think these risks and costs are merely theoretical, consider what has happened in places like Jefferson County, Alabama (which declared bankruptcy in 2011 in the wake of a corruption scandal tied to millions of dollars in municipal bond offerings and related interest rate swap transactions), Vallejo, California (which declared bankruptcy in 2008 after struggling with declining revenues, soaring costs and municipal bond obligations), Harrisburg, Pennsylvania (which was placed into receivership last year and recently announced that it would skip $5.27 million in payments due on general obligation bonds). In communities across the country, issuers, taxpayers and other community stakeholders are getting squeezed by declining revenues, increasing costs and the price of municipal bond debt.

In an ideal world, taxpayers and others responsible for repaying issuer debt would be able to reduce risks and costs associated with low default rates through the political system (e.g., by voting against bond issuances and/or the public officials who champion them), private ordering (e.g., by negotiating more favorable terms with investors, underwriters, credit enhancement providers, and other involved in structuring offerings and related transactions), or by exiting their investment in the municipal enterprise (e.g., selling real estate and moving out). Unfortunately, taxpayers are not well-positioned to take advantage of these risk-reducing tools. Individual offerings may not be subject to a

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20 See pp. ___ - ___.

21 See pp. ____.
taxpayer vote, and taxpayers are not always well-informed about risk, nor are they empowered by current systems to monitor or discipline those who structure offerings or implement tax increases and spending cuts.\(^\text{22}\) Moreover, once a taxpayer makes the initial decision to purchase real estate or consume services, her choices are limited. She must pay government levies whether or not she approves of particular expenditures, and exit is not a readily available option, since it is neither cheap nor easy to sell commercial or residential real estate and move out of town as a means of disposing of one’s investment in the municipal enterprise, especially when real estate markets are in turmoil.

In this paper, I argue that our existing system of municipal securities regulation is inadequate because it fails fully to address systemic risks and costs that taxpayers and other stakeholders face precisely because default rates are low, costs and up, and revenues are down. Instead of focusing solely on investor risk, I would amend the municipal securities regulation regime to require stakeholders to consider systemic risks and costs that taxpayers, public workers and others incur when issuers access public markets to pay for infrastructure and public services. Such risks may include painful tax increases and spending/budget cuts implemented to avoid default. I would pay particular attention to volatile products like interest rate swaps when amending the current regime, as municipal securities issuers tend not to have easy access to new or expanded sources of revenue to meet unexpected demands associated with interest rate volatility or swap termination fees.

With these goals in mind, Part II of this paper provides a brief overview of the municipal securities and the municipal securities market. This section identifies the conventional wisdom that municipal securities are low-risk, and argues that this view of risk systematically minimizes and externalizes risks and costs that taxpayers and other stakeholders experience because default rates are low. In Part III, I explain how and why the low default rate in the municipal securities market and the focus on investor loss might increase risks and costs for other stakeholders. This section identifies risks that non-investor stakeholder’s experience, and discusses why non-investor stakeholders are not well-positioned to reduce risks and costs through political systems, private ordering and/or exit. In Part IV, I discuss the regulatory regime applicable to the municipal securities market. This section argues that the existing regime is inadequate because it focuses on investor risk of loss and does not adequately consider risks and costs experienced by other stakeholders. Finally, in Part V, I explore possible regulatory reforms targeting systemic risk. Among other reforms, I propose to extend the reach of the fiduciary standard in this market to require stakeholders like underwriters to place the interests of the municipal entity before their own when developing funding plans. I also propose expanding and formalizing risk identification and tracking systems so that stakeholders have a better chance of identifying issues before a crisis erupts; and

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\(^{22}\) According to Amurdsky & Gillette, “[i]n recent years, courts and legislatures have restricted the ability of taxpayers to contest the issuance of municipal bonds.” Robert S. Amurdsky & Clayton P. Gillette, *Municipal Debt Finance Law: Theory and Practice*, 2011 Cumulative Supplement (Wolters Kluwer), at 25. As Amurdsky and Gillette explain, judicial review may be limited to specific issues, such as “(1) the regulatory of the proceedings at which the bonds are issued; (2) the validity of the bonds; and (3) the legality of the purpose for which the bonds are issued.” *Id.* at 25-32 and cases cited therein.
implementing systems to track and monitor the effectiveness of regulatory reforms, so that we can leverage successful strategies and avoid (or at least mitigate the impact of) mistakes.

Part II. Municipal Securities and Risk

A. What Are Municipal Securities?

Municipal securities are securities issued by states and their political subdivisions and instrumentalities in order to pay for public projects like the construction of water, sewer

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23 Section 3(a)(29) of the Exchange Act defines “municipal securities” to mean securities which are “direct obligations of, or obligations guaranteed as to principal or interest by, a State or any political subdivision thereof, or any agency or instrumentality of a State or any political subdivision thereof, or any municipal corporate instrumentality of one or more States, or any security which is an industrial development bond (as defined in section 103(c)(2) of Title 26) the interest on which is excludable from gross income under section 103(a)(1) of Title 26 if, by reason of the application of paragraph (4) or (6) of section 103(c) of Title 26 (determined as if paragraphs (4)(A), (5), and (7) were not included in such section 103(c)), paragraph (1) of such section 103(c) does not apply to such security.” See 15 U.S.C. § 77(c). Section 3(a)(12)(A)(iii) defines municipal securities as “exempted securities,” or securities which are exempt from registration and reporting requirements applicable to most publicly-traded securities.

24 State and local governments began to create public authorities and special districts in the early 1900s to build housing, coordinate economic development incentives, provide low-cost loans, treat wastewater, operate electric utilities, and construct hospitals, among other rationales. One notable early example of this trend was the Port of New York Authority, which was founded in 1921 and renamed the Port Authority of New York and New Jersey in 1972. SIFMA, Fundamentals of Municipal Bonds, at p. 56. Over the past one hundred years, the number of authorities and special districts has grown significantly. See, e.g., United States Census Bureau, 2002 Census of Governments, Vol. 1, Number 1, Government Organizations, at vii (“Special district governments rose in number to a total of 35,052, an increase of 369, or 1.1 percent, since the 1997 Census of Governments. This small growth over the past 5 years on top of a 9.9 percent rise between 1992 and 1997, and a 10.4 percent rise between 1982 and 1992 reflects the continuing public demand for the provision of specialized services either not offered or not performed by existing governments. Since most special districts perform only one function, or a very limited number of functions, their establishment allows a greater degree of concentrated effort in providing services. As shown in Table 5, the number of special district governments reported in 2002 is almost three times the number of special district governments reported in 1952.”). Commentators have opined that this growth reflects increasing demand for services provided by authorities and special districts, as well as the desire to circumvent restrictions on issuances of debt by state and local governments. SIFMA, Fundamentals of Municipal Bonds, at 57. While a detailed examination of special districts and authorities is beyond the scope of this article, it is worth noting that states have sought to improve transparency and disclosure relating to the role and impact of special districts and authorities on state and local economies. See Lynn Wilson and Clayton Eichelberger, New York State Public Authority Reform: Where We Have Come From and Where We Need to Go, Vol. 11, No. 2 Law and Policy Journal, 15- 22 (Fall 2009). For an earlier discussion of the history of the growth of public authorities, see generally William J. Quirk and Leon E. Wein, A Short Constitutional History of Entities Commonly Known as Authorities 56 Cornell Law Review 521 (April 1971). It also is worth noting that due
and power plants, highways, bridges, hospitals and schools, and to meet day-to-day funding needs. The municipal securities market is sometimes referred to as the tax exempt market because interest paid on eligible municipal bonds may be exempt from federal income tax, state and/or local taxes, depending on the characteristics of the instrument and the residence of the bondholder.25

Traditionally, issuers used two types of municipal securities to meet funding needs -- general obligation bonds and revenue bonds.26 General obligation bonds are secured by

to state constitutional limits on incurring debt, a huge volume of capital spending may be funneled through public authorities and related instrumentalities. In New York for example, the Comptroller reported the following facts respecting debt incurred by authorities: (i) between 200 and 2005, 41.4% of state capital project spending was debt authorized and issued by “state authorities,” versus 4.3% for constitutional debt; (ii) between 2006 and 2010, 48.9% of such spending of capital project spending was state authority debt, versus only 3/6% of such spending for state constitutional debt. See N.Y. State Comptroller, Planning for the Long Term: Capital Spending Reform in New York State 8-12 (2010), available at http://www.osc.state.ny.us/press/releases/nov10/capital_spending_report_nov2010.pdf. Note that the law respecting whether and under what circumstances authority debt may be paid with general fund appropriations is complicated. In New York, for example, the Court of Appeals has upheld appropriations-backed debt as not prohibited under the New York State Constitution. See e.g., Local Gov’t Assistance Corp. v. Sales Tax Asset Receivables Corp., 813 N.E.2d 587 (N.Y. 2004); Wein v. City of New York, 331 N.E.2d 514 (N.Y. 1975).

25 See U.S.C. § 103 (2006). There are also taxable municipal bonds, and this segment of the market includes both fully taxable municipal bonds and municipal bonds subject to the Alternative Minimum Tax under the IRC. The taxable segment of the market exists because certain activities do not provide a significant benefit to the public at large and are not federally subsidized. Investor-led housing, sporting facilities and borrowing to replenish a municipality’s under-funded pension plans are examples of bond issuers for which the interest earned is subject to federal income tax. In general, taxable municipal bonds offer yields more comparable to those of other taxable sectors than to those of tax-exempt municipal bonds. 2008 Report at 119. I do not address this segment of the market in specific detail in this paper, nor do I examine issues unique to the Build America Bond program as authorized by the American Recovery and Reinvestment Act of 2009.

26 In addition to the types of securities listed above, issuers may also use so-called moral obligation bonds. According to the Municipal Securities Rulemaking Board (“MSRB”), “[t]he term “moral obligation bond” refers to a bond, usually issued by a state or agency, that is secured by a non-binding covenant that any amount necessary to make up any deficiency in pledged revenues available for debt service will be included in the budget recommendation made to the state legislature or other legislative body, which may appropriate moneys to make up the shortfall. The legislature or other legislative body, however, is not legally obligated to make such an appropriation. Unlike a general obligation pledge, the moral obligation bond does not require voter approval and does not have the state’s official pledge of its full faith and credit.” See MSRB, Certain Types of Municipal Securities, Moral Obligation Bonds, available at http://www.msrb.org/Municipal-Bond-Market/About-Municipal-Securities/Types-of-Municipal-Securities.aspx. There are also so-called “double-barreled” bond, which are secured by both a defined revenue source as well as the faith and credit of an issuer with taxing power. See MSRB, Certain Types of Municipal Securities, double-barreled bonds, available at
the taxing power or “faith and credit” of the issuer, and generally are subject to laws which restrain state and local governments from incurring debt without voter approval or from exceeding debt limits based on percentages of real property values or types of government revenues. If an issuer defaults on a general obligation bond, bondholders typically have the right to compel a tax levy or a legislative appropriation. In this way, taxpayers are at risk for nonpayment.

Revenue bonds are bonds secured by revenues or receipts from the funded project or other special funds, and are not backed by the taxing power or taxable property of the borrower. Issuers generally are not required to obtain voter approval before issuing


Historically, debt limits were enacted after the failure of projects that were financed with bonds secured by the issuer’s faith and credit. Amdursky & Gillette, Municipal Debt Finance Law Theory and Practice (Little Brown 1992), at 162 (citing City of Redondo Beach v. Taxpayers, Property Owners, Citizens and Electors of the City of Redondo Beach, 54 Cal. 2d 126 (1960); Edmunds Hous. Auth. of the City of Muncie, 215 Ind. 330 (1939); Richard v. City of Muscatine, 237 N.W.2d 48 (Iowa 1975). As Amurdsky and Gillette point out, “[t]he demise of these enterprises led to increased property taxes to pay bonds, or to default and subsequent loss of access to credit markets, while constituents of the issuer received nothing of commensurate value in return.” Id. More generally, municipal entities may be subject to state statutes designed to spread the costs of public projects over time. For example, New York law prohibits municipalities, school districts or public corporations from incurring indebtedness for a period longer than the useful life of the project as set forth in the statute. See N.Y. Local Fin. Law § 11(McKinney 2011).

For example, in Flushing National Bank v. Municipal Assistance Corporation for the City of the New York, 40 N.Y.2d 731 (1976) (holding that a city may not contract indebtedness under the New York State Constitution unless it has “pledged its faith and credit for the payment of the principal thereof and the interest thereon,” and held that this obligation is both “a commitment to pay and a commitment of the city’s revenue generating powers to produce the funds to pay.” Id. at 734-35 (citing N.Y. Const. Art. VIII, §2 and holding that faith and credit pledge is a prior lien on revenues of issuer).


Revenues pledged for repayment may be derived from “operation of the financed project, grants or excise or other specified non-ad-valorum taxes. See MSRB, Certain Types of Municipal Securities, Revenue Bonds, available at http://www.msrb.org/Municipal-Bond-Market/About-Municipal-Securities/Types-of-Municipal-Securities.aspx. Some revenue bonds are issued by governmental agencies to fund facilities for essential public services like water and sewer systems. With these types of revenue bonds, the issuer typically pledges revenues obtained through assessments towards repayment. Id. Such pledges typically identify the specific assessments that the issuer can use to pay interest and repay principal, the issuer’s authority and
revenue bonds. Issuers may also use so-called conduit or industrial development bonds, which are a type of bond that governmental units issue for the benefit of conduit borrowers (typically private not-for-profit entities) in furtherance of a public purpose, such as the construction of a not-for-profit hospital, affordable housing projects student loan programs and economic development and redevelopment projects. Conduit bondholders typically must look to the credit (and resources) of the conduit borrower for the payment of interest and the repayment of principal.

ability to increase assessments to satisfy payment and repayment obligations, and any other, superior claims on the assessment. Id.

See, e.g., MSRB, What Are Bonds, How are Bonds Secured, (“Third Party Beneficiary's Pledge & Private Activity Bonds—Municipal issuers often issue bonds for the benefit of one or more private entities that will use the funds for purposes that the issuer views as furthering the public interest. These private activity bonds may be issued for projects such as not-for-profit hospitals, single and multi-family housing, airports and seaports, solid waste disposal facilities, student loan programs, redevelopment programs, and various other purposes. For these issues, the bond proceeds are used to finance loans to fund the specified purposes, and the issuer pledges payments it receives on these loans to repay the bonds. Unless otherwise provided, private activity bonds are solely payable from funds of the private beneficiary and the issuer generally will not be obligated to use any other source to repay the bonds if the payments from the private beneficiary prove to be inadequate.”), available at http://emma.msrb.org/educationcenter/WhatAreBonds.aspx. A wide range of both not-for-profit entities and for-profit entities are potentially eligible to use conduit financing, including colleges, universities, museums and hospitals. See, e.g., N.Y. Pub. Auth. Law. §§ 1675 et. seq. (2009); N.Y. Unconsol. Law §§ 6251 et seq. (2009); Priv. Hous. Fin. Law §§ 40 et seq. (2009).

In New York, for example, the New York City Industrial Development Agency issued in excess of $1.2 million of tax-exempt bonds to finance the design and construction of the new Yankee Stadium. See Official Statement, New York City Industrial Development Agency, $258,999,944.60 Pilot Revenue Bond Series 2009A (Yankee Stadium Project) (Jan. 28 2009), available at http://emma.msrb.org/MS278144-MS276487-MD560920.pdf.

Issuers may obtain third-party credit enhancement as a back-up to the primary source of revenue pledged to repay bonds. See MSRB, What Are Bonds, How Are Bonds Secured?, available at http://emma.msrb.org/educationcenter/WhatAreBonds.aspx. Bond insurance has been the most common form of credit enhancement in recent years, especially prior to the current economic crisis. See also pp. __ - __. Issuers have also obtained letters of credit, which can be drawn upon to make payments on bonds if the primary source of pledged revenues is inadequate. See MSRB, What Are Bonds, How Are Bonds Secured?, available at http://emma.msrb.org/educationcenter/WhatAreBonds.aspx. Insured bonds and bonds backed by letters of credit often carry two separate ratings -- one based on the financial strength of the insurer or bank, and the other based on the financial strength of the underlying issuer (and, in some circumstances, on the structure of the bond issue). In other cases, a guarantee may be provided by a related third-party, such as another unit of government or, in the case of conduit bonds, a parent corporation or other entity related to the private beneficiary of the bonds. Id.
In recent years, issuers seeking to access lower interest rates available at the short end of the yield curve have made greater use of complex instruments such as variable rate demand obligations (VRDO) and interest rate swaps. While markets for these types of securities have contracted during the current economic crisis, complex non-traditional securities (including derivatives) remain part of the current landscape.

B. The Conventional Wisdom: Municipal Securities Are Low-Risk

34 For a brief, “plain English” description of VRDOs, see http://emma.msrb.org/educationcenter/UnderstandingVRDOs.aspx. Generally speaking, VRDOs are municipal securities for which the interest rate resets on a periodic basis, and which permit investors to liquidate their holdings at par through a “put” or “tender” feature. Id. A dealer or remarketing agent is responsible for reselling tendered VRDOs to new investors, and, to ensure that investors are able to use the “put” or “tender” feature in the event a remarketing agent is unable to locate a new purchaser, VRDOs typically operate with a liquidity facility (typically a letter of credit or Standby Bond Purchase Agreement). Id.

35 As discussed at pp. __ below, municipal securities issuers use interest rate swaps to convert interest rate basis (e.g., from floating to fixed or fixed to floating) to manage liabilities, and (ideally) to enable issuers to lower their costs of borrowing. CITE See also 2008 report, Sirri, 203. The MSRB describes interest rate swaps (and their characteristics and uses) as follows: “[a] contract entered into by an issuer or obligor with a swap provider to exchange periodic interest payments. Typically, one party agrees to make payments to the other based upon a fixed rate of interest in exchange for payments based upon a variable rate. Interest rate swap contracts typically are used as hedges against interest rate risk or to provide fixed debt service payments to an issuer or conduit borrower dependent on a specified revenue stream for payment of such debt. For example, an issuer may issue variable rate debt and simultaneously enter into an interest rate swap contract. The swap contract may provide that the issuer will pay to the swap counter-party a fixed rate of interest in exchange for the counter-party making variable payments equal to the amount payable on the variable rate debt.” See MSRB Glossary entry for “interest rate swap” available at http://emma.msrb.org/educationcenter/Glossary.aspx. According to SEC personnel, 70% of issuers of VRDOs have entered into floating-to-fixed swap agreements. See Speech by SEC Chairman: Remarks at Investment Company Institute 2010 General Membership Meeting, available at http://www.sec.gov/news/speech/2010/spch050710mls.htm.

36 See, e.g., SIFMA, Municipal Bond Credit Report Research Report For Fourth Quarter 2011 (stating “[i]ssue of variable-rate demand obligations (VRDOs), long-term municipal bonds with a floating interest rate that resets periodically and a put feature, rose in the fourth quarter. According to Thomson Reuters, $11.4 billion were issued in 4Q’11, more than double the amount from 3Q’11 ($3.5 billion), but a 6.5 percent decline year-over-year ($11.4 billion). While the fourth quarter spike in issuance quarter-over-quarter is typically seasonal (in the last 10 years, fourth-quarter issuance composed on average 30.7 percent of annual issuance, compared to third quarter’s 21.5 percent), issuance in the fourth quarter composed nearly 60 percent of issuance in 2011. Despite the jump, only $20.1 billion was issued in aggregate for 2011, a 19.5 percent decline from 2010 and the lowest issuance in 15 years. For 2012, survey participants in the SIFMA Municipal Survey project a continued decline in VRDO issuance to $10 billion.)
Although municipal securities can and do default—sometimes in spectacular fashion—municipal bonds are thought to be a relatively safe asset class, because defaults are rare. Defaults are rare in the municipal securities market because municipal bonds tend to be backed by the taxing power of the issuer (general obligation bonds) or dedicated funding sources such as revenues generated by funded projects (revenue bonds). The notion that general obligation bonds must be paid at all costs is expressed in cases like Flushing National Bank v. Municipal Assistance Corporation for the City of the New York, 40 N.Y.2d 731 (1976). In Flushing, the New York Court of Appeals observed that a city may not contract indebtedness under the New York State Constitution unless it has “pledged its faith and credit for the payment of the principal thereof and the interest thereon,” and held that this obligation is both “a commitment to pay and a commitment of the city’s revenue generating powers to produce the funds to pay.”

According to the Court, the faith and credit requirement, together with a number of other statutory provisions, “express[es] a constitutional imperative: debt obligations must be paid even


38 See, e.g., Washington Public Power Supply System’s default on billions of dollars in bonds issued to build nuclear power facilities at note __ and pp. __ below, and the Jefferson County, Alabama default and bankruptcy at __ - __.

39 See note __ for characterization of default rate in municipal securities market as “very low,” see Moody’s Investor Services, SPECIAL COMMENT: U.S. Municipal Bond Defaults and Recoveries, 1970-2011 (March 7, 2012) at 1. Moody’s Special Report further notes that, “[m]unicipal issuers have historically experienced lower average cumulative default rates than global corporate issuers overall, and by like-rating category.” Id. at 2. For some recent examples of market commentary citing the low default rate in the municipal securities market as evidence of the relative safety of this asset class, see, e.g.,
General Accounting Office, Report to the Chairman, Subcommittee on Economic Stabilization, Committee on Banking, Finance and Urban Affairs House of Representatives: Trends and Changes In the Municipal Bond Market As They Relate to Financing State and Local Public Infrastructure, GAO/PAD-83-46 (September 12, 1983), at p. 1 (“Municipal securities are also characterized by a high degree of investment safety, according to credit analysts, and a wide variety of individual issuers) (citations omitted).

40 Id. at 734-35 (citing N.Y. Const. Art. VIII, §2 and holding that faith and credit pledge is a prior lien on revenues of issuer).
if tax limits be exceeded."  As a historical matter, the sources of security for both general obligation bonds and (to a lesser extent) revenue bonds have kept default rates low in the municipal securities market.

In addition to the source of security, there are legal and non-legal constraints on municipal securities issuers’ ability or willingness to default or obtain discharge. As constitutionally-recognized sovereigns, states have taxing power and are legally prohibited from declaring bankruptcy. As a result, while a state’s fiscal status may be reflected in its ability to access public debt markets, and/or in interest rates and other deal terms required to access public markets, investor risk of loss due to non-payment remains low.

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41 Id. With its holding, the Court distinguished the faith and credit obligation reflected in general obligation bonds with a revenue obligation (which is limited to a pledge of revenues from a designated source or fund” and a “moral obligation,” which is “backed not by a legally enforceable promise to pay but only by a moral commitment.” Id. at 735 (internal quotations and citations omitted). Notably, in Quirk v. MAC, 363 N.E.2d 549 (N.Y. 1977), the Court of Appeals modified its view slightly, holding that only real property taxes are subject to the prior lien of first revenue. As the MSRB points out in one of its investor guides, “[g]eneral obligation bonds issued by local governments typically include a pledge to use the issuer’s ad valorem taxing power to pay principal and interest. Ad valorem taxes necessary to pay debt service on general obligation bonds are often not subject to state constitutional property tax millage limits (an unlimited tax general obligation bond). The term limited tax is used when such limits exist.” See, Certain Types of Municipal Securities, available at http://www.msrb.org/Municipal-Bond-Market/About-Municipal-Securities/Types-of-Municipal-Securities.aspx.


43 While there are reports that policymakers are considering whether to let states declare bankruptcy as a means of dealing with crushing debt burdens, see http://www.nytimes.com/2011/01/21/business/economy/21bankruptcy.html?pagewanted=all, that has not (yet) happened.
While non-state issuers can seek bankruptcy protection under certain circumstances, involuntary bankruptcies are not permitted, liquidation is not an option, and the issuer’s powers to operate (and thus raise revenue and make payments on defaulted debt) may not be affected. Even if bankruptcy is an option, political considerations may mitigate the risk of investor loss. For example, local government issuers may not reach the point of default or bankruptcy because a higher level of government (e.g., the state) may step in to prevent defaults on outstanding obligations. As Massachusetts Representative Barney Frank explained in 2008 during Congressional Hearings on turmoil in the municipal bond market:

No State, no State legislators, no governor, can allow any one of its municipalities to default because then every other municipality would pay through the nose. So


45 For example, despite the automatic stay, chapter 9 permits a municipality to continue revenue bonds under Section 922(d). See 11 U.S.C. § 922(c)(2003).
that is why this is not just some charity here; this is self-defense. The particular municipality, you might pity the municipal workers there. Services may get cut back. Maybe the trash won't get picked up. But we can guarantee you, we have all been there, you can't do that [default]. Because if any one municipality falters, every municipality in that State would pay, and there isn't a State governor and legislature in the country who doesn't understand that, and that's why the State guarantee is such a good one. 46

Finally, even if an issuer files for (and is permitted to seek) bankruptcy protection, it may continue to pay its bondholders, and thus avoid default, even as it seeks to raise taxes and reduce obligations owed to public workers and other community stakeholders, further limiting investors’ risk of loss. 47

The tendency to view municipal bonds (especially state-issued bonds and general obligation bonds) as low-risk due to the low default rate has persisted even in the face of the recent recession, and despite budget crises and federal, state and local levels. State and local governments have been hit hard by the financial crisis, with revenues down and costs and expenditures and indebtedness up across the country. 48 Nevertheless, analyst Meredith Whitney ignited a firestorm – and was the target of intense criticism -- when she predicted that state and local government’s financial difficulties would result in a “spate of municipal bond defaults,” including at least “50 to 100 sizeable defaults” involving “hundreds of billions of dollars” in principal during a December 2010 appearance on the television news program 60 Minutes. 49 Whitney reportedly based her


47 As discussed below, this is what happened in Vallejo, California after the city declared bankruptcy.

48 For example, the United States Census Bureau determined that state and local government revenues declined 22.1% from 2008 to 2009. See, United State and Local Government Finances Summary: 2009, Governments Division Brief (Issued October 2011), at 2 (available at http://www2.census.gov/govs/estimate/09_summary_report.pdf). By contrast, expenditures increased 4.6% for state and local governments over the same period, with education and public welfare accounting for 43.2% of total state and local government spending during 2009. Id. Also during the same period, state and local indebtedness increased 5.1%, with local governments accounting for 61% of the total amount of state and local debt outstanding and state indebtedness accounting for 39% of total state and local indebtedness. Id. The Census Bureau also found that security holdings of state and local governments fell 15% during 2009, with state governments accounting for 67.9% of the total and local governments accounting for the remainder. Id. Employee retirement funds comprised the largest source of cash and security holdings at $2.4 trillion during 2009. Id.

prediction on an analysis of the financial condition of the fifteen largest states – including states like California and Illinois, which have experienced significant financial and budgetary problems in recent years. Whitney predicted that while states would ultimately find ways to honor their debts, local governments which depend on states for revenues might be unable meet their obligations.

When defaults failed to materialize as swiftly or to the extent that Whitney had predicted, stakeholders questioned Whitney’s understanding of the municipal securities market. Whitney’s critics argued that because issuers generally make the hard choices necessary to avoid default (i.e., tax increases and/or budget cuts), municipal bonds remain a relatively low-risk asset class.

**Questioning the Conventional Wisdom**

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52 See, e.g., http://online.wsj.com/article/SB10001424053111903927204576574583469232522.html.

Focusing solely on investor risk of loss as a measure of risk, there is some force to the conventional wisdom. Default rates historically have been low in the market, and even in cases of default, ultimate recovery rates on defaulted municipal bonds reportedly are higher, on average, than those on senior unsecured bonds of corporate issuers.\textsuperscript{54}

Moreover, because defaults are relatively rare in this market, those that do occur can seem like outliers, particularly when they involve political corruption. The parallel civil and criminal cases involving Jefferson County, Alabama offer one such example. On April 30, 2008, the Commission charged Larry Langford (the then-mayor of Birmingham, Alabama and former president of the Jefferson County commission) with securities fraud, and brought related cases J.P. Morgan Securities Inc., two of its former managing directors and other securities industry professionals and political officials, in connection with an alleged kick-back scheme involving the water and sewer project.\textsuperscript{55} Langford was also charged in a parallel criminal case for sending more than $7 million in county bond business to an investment banker in return for bribes worth $241,843.\textsuperscript{56} According to the Commission, JP Morgan made more than $8 million in undisclosed payments to local broker-dealers with ties to the local officials in connection with $5 billion in county sewer bond offerings and interest rate swap agreement. The alleged purpose of these payments was to obtain bond business for J.P. Morgan’s broker-dealer and swaps business for its affiliated bank.\textsuperscript{57}

\textsuperscript{54} See U.S. Municipal Bond Defaults and Recoveries, 1970-2010, at 1 (March 7, 2012), available at

\textsuperscript{55} In particular, the Commission’s order instituting settled administrative proceedings against J.P. Morgan Securities found that the firm violated Sections 17(a)(2) and 17(a)(3) of the Securities Act of 1933, Section 15B(c)(1) of the Securities Exchange Act of 1934 and Municipal Securities Rulemaking Board (MSRB) Rule G-17. In addition to the monetary relief described above, the SEC’s order censures J.P. Morgan Securities and directs it to cease-and-desist from committing or causing any further violations of the provisions charged. According to the Commission, LeCroy and MacFaddin allegedly referred to the payments as “payoffs,” “giving away free money,” and “the price of doing business.” LeCroy also allegedly boasted to MacFaddin in a taped telephone conversation about his efforts to persuade the two commissioners to select J.P. Morgan Securities for the deal, beating out a rival firm. LeCroy allegedly told MacFaddin that he said to the commissioners, “Whatever you want — if that’s what you need, that’s what you get — just tell us how much.”


\textsuperscript{57} The Commission charged LeCroy and MacFaddin with violations of Section 17(a) of the Securities Act, Sections 10(b) and 15B(c)(1) of the Exchange Act, and Rule 10b-5 thereunder, and violations of MSRB Rules G-17 and G-20. The Commission’s complaint seeks judgments against LeCroy and MacFaddin providing for permanent injunctions and disgorgement with prejudgment interest.
The Commission claimed that as a result of these payments, county commissioners voted to select J.P. Morgan Securities as managing underwriter of the county’s bond offerings and the firm’s commercial bank affiliate as swap provider – a deal that was, according to the Commission, the largest municipal auction rate securities and swap agreement in JP Morgan’s history. The Commission alleged that J.P. Morgan did not disclose any of the payments or conflicts of interest in the swap confirmation agreements or bond offerings, and yet passed on the cost of the unlawful payments on to the county (and its citizens) by charging higher interest rates on the swap transactions. In the Commission’s view, "[t]his self-serving strategy of paying hefty secret fees to local firms with ties to county commissioners assured J.P. Morgan Securities the largest municipal auction rate securities and swap agreement transactions in its history."

Eventually, Langford was sentenced to fifteen years in prison, and JP Morgan agreed to settle the Commission’s charges without admitting or denying the allegations by (i) paying $50 million to Jefferson County for the purpose of assisting displaced county employees, residents and sewer rate payers, (ii) forfeiting more than $647 million in termination fees allegedly owed under the swap transactions (an amount that is almost three times the budgeted revenues for Jefferson County in the 2008-2009 budget year, and (iii) paying a $25 million penalty.

Certainly, one reading of the Jefferson County case is that venal bankers bribed corrupt officials, to the detriment of investors. This reading is legitimate, and as discussed below, the existing regime of securities regulation rightfully empowers the Commission to target corruption and disclosure failures of this sort. As important as investor loss is,


59 J.P. Morgan Securities agreed to settle the SEC's charges without admitting or denying the allegations by paying $50 million to the county for the purpose of assisting displaced county employees, residents and sewer rate payers; forfeiting more than $647 million in termination fees it claims the county owes under the swap transactions; and paying a $25 million penalty that will be placed in a Fair Fund to compensate harmed investors and the county in the municipal bond offerings and the swap transactions. See http://www.sec.gov/news/press/2009/2009-232.htm. On October 28, 2009, Langford was found guilty in a parallel criminal case on sixty counts of bribery, mail fraud, wire fraud and tax evasion. See U.S. v. Langford, 647 F.3d 1309 (11th Cir. 2011), cert. denied, 132 S.Ct. 1121 (U.S. Jan. 17, 2012) (No. 11-7762). See http://www.justice.gov/usao/aln/News/August%202011/August%205,%202011%20County%20Commission.htm

60 http://www.bizjournals.com/birmingham/stories/2010/03/01/daily38.html

61 On March 3, 2009, certain of county’s interest rate swap agreements were terminated. On March 6, 2009, J.P. Morgan Securities’ affiliated commercial bank notified the County that it owed $647,804,118.00 as the result of the termination of the Swap Agreements. According to Jefferson County’s official budget for 2008-2009, budgeted revenues were $289 million. See http://jeffconline.jccal.org/home/jcinfo/Ajc_budget0809.pdf, at p. 15.

62 See pp. __ - __.
however, investors were not the only ones hurt when things went off-track in Jefferson County. Due to the way the offerings and swaps transactions were structured, the annual payment on Jefferson County’s debt jumped from $53 million to $636 million between 2008 and 2009. As debt obligations grew, and the county’s finances worsened, sewer taxes skyrocketed and public services were stripped to the bone. Although the governor of Alabama reportedly tried to negotiate a deal which would have replaced the county’s existing debt with new securities with a lower face value and more favorable terms in exchange for a commitment by the state to step in if the county failed to stay current, negotiations ultimately broke down. Participants in the municipal bond market reportedly concluded that the new bonds would not be secure enough to attract buyers at an affordable rate of interest because potential buyers remained concerned that the plan did not give the county enough power to raise sewer rates if revenues were not sufficient to repay bondholders. On November 8, 2011, after teetering on the edge for years, Jefferson County’s commissioners voted 4 to 1 to declare bankruptcy on approximately $4 billion of sewer debt. While there was some effort to obtain relief for county residents through the settlement with J.P. Morgan, county residents continue to suffer lasting harm. As it stands today, the County’s sewers still do not function properly, county services are operating at skeleton crew levels, and the debt has not gone away. As one county resident reportedly said, “[e]veryone wonders how the county will ever get out of this financial mess.”

Lest one think that such harms befall victims of public corruption, consider what happened to the small upstate New York village of Canajoharie when it tried to deal with its own water and sewer problems. A community of approximately 3,700 residents

63 In January 2008, ratings agencies downgraded the County’s sewer bond insurers, and shortly thereafter, also downgraded the County’s approximately $3.2 billion of sewer bonds. In February 2008, the auction market for the County’s auction-rate sewer bonds failed.


68 Walsh, Mary Williams, When a County Runs Off the Cliff, and Into Bankruptcy, New York Times (Feb. 19, 2012), p. 1 business section. New Jersey also has faced considerable turmoil in its efforts to deal with the fiscal problems exposed by the case against it. See, e.g., http://www.cbsnews.com/2100-18560_162-7166220.html?pageNum=4&tag=contentMain;contentBody.

(and approximately 2,200 water/sewer ratepayers) located hard alongside the New York State Thruway, Canajoharie has spent the past several years trying to repay more than $5 million in principal plus interest that it borrowed to renovate its water and sewer treatment systems. Canajoharie borrowed the money for two reasons. First, village officials sought to meet the anticipated future needs of a baby food factory operated by Beech-Nut Nutrition Corp. For almost one hundred years, the factory had been the village’s largest employer and its largest consumer of water and sewer services, and payments for these services accounted for a substantial portion of the village’s revenues for its water and sewer funds. Second, the village needed to improve its water treatment plant in order to meet state water quality standards. In this regard, the village followed the recommendation of state officials, who counseled in favor of building an entirely new water treatment plant over less expensive upgrades to the village’s existing facility. In both of these matters, village officials acted in good faith. Certainly, there was no evidence of political corruption or disclosure failure.

Because the cost of the water and sewer projects exceeded what the village could pay from its own coffers, the village borrowed money from a number of sources, including Environmental Facilities Corporation (“EFC”), a public benefit corporation established to provide low-cost capital and technical assistance for environmental projects in New York State through the Clean Water State Revolving Fund (“CWSRF”). The CWSRF, which is jointly administered by EFC and the New York State Department of Environmental Conservation, provides low-interest rate financing to municipalities to construct water quality protection projects such as sewers and wastewater treatment facilities. To raise money for CWSRF projects, EFC issues municipal securities to the public. EFC then loans the proceeds of its securities offerings to municipalities like Canajoharie. Canajoharie planned to repay its debt to EFC and its other lenders over

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70 See Conversations with Village Officials.
72 In fact, the renovations and improvements were designed with Beech-Nut’s needs in mind, with the result that the village’s water and sewer systems were built with a capacity that far exceeded the needs of the village’s non-Beech-Nut rate-payers. DiNapoli Report at 5.
73 Under New York law, public benefit corporations (“PBC”) are "...organized to construct or operate a public improvement wholly or partly within the state, the profits from which inure to the benefit of this or other states or the people thereof." PBCs must be created by a special act of the New York State legislature, and they usually have one function (typically service delivery or oversight).
75 Id.
various periods of time through 2019 using amounts charged to water and sewer customers, including Beech-Nut. With respect to the EFC loans, the village also was required to pledge its taxing power to repay interest and principal.

For about ten years, Canajoharie paid down its loan obligations without incident. Beginning in 2006, however, the village encountered a series of challenges to its financial condition. First, in June of 2006, flood waters inundated the village, causing millions of dollars in property damage to the Beech-Nut factory and other village buildings. Second, on May 15, 2007, Beech-Nut announced that it had decided to build a new, state-of-the-art production facility in the nearby town of Florida, New York, and to relocate operations from Canajoharie to Florida as of 2010. Third, Beech-Nut’s corporate owners were unable to find a new use or new tenant for the Canajoharie factory prior to its closure on March 28, 2011.

From the perspective of the state and the county, Beech-Nut’s decision to site its new factory in Florida was a win, as the factory was set to employ hundreds of people in an economically depressed part of the state. In fact, both the state and the county provided economic development incentives in order to persuade Beech-Nut’s corporate owners to select Florida for the site of its new plant. For Canajoharie, however, Beech-Nut’s

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77 1999 project financing and loan agreement at p. 10.

78 For example, according to certain funding documents, Canajoharie’s obligation to pay was secured by a pledge of the “faith and credit,” such that all real property within the village’s boarders was subject to the levy of ad valorem taxes (without limitation as to rate or amount) to pay the principal of interest on the bonds that were to be issued to fund the project.” See, e.g., Official Statement, New York State Environmental Facilities Corporation, $81,760,000 State Clean Water and Drinking Water Revolving Funds Revenue Bonds (Jan. 30, 1998), 4, available at http://emma.msrb.org/MS145894-MS121202-MD234901.pdf


81 E.g., http://www.beechnut.com/About%20Us/itn_pr3.asp


84 Id.
decision to close its factory was devastating. Because Canajoharie and Florida do not share water or sewer systems, Beech-Nut’s departure from Canajoharie meant that the village lost its major water and sewer rate-payer. Although the village instituted steep rate increases for water and sewer services before the final closure date, cut costs and eventually received some relief through debt restructuring, it still owed money on its debts when the factory closed. Today, Canajoharie owes millions of dollars on loans -- loans which the village must repay without the benefit of revenues from Beech-Nut (or a new tenant) -- for systems which have far greater capacity (and thus higher fixed costs) than the village’s remaining residents currently need.

On one hand, Canajoharie’s decision to raise taxes, cut costs and restructure its debt validates the conventional wisdom that municipal securities are low risk because issuers generally take steps necessary to avoid default, and bondholders generally get paid. If we examine events from the perspective of Canajoharie’s taxpayers and ratepayers, however, the picture is significantly different. When Canajoharie pledged its taxing power as security for its repayment obligation, it risked having to increase taxes and/or cut budgets in order to meet repayment obligations. This is what happened, and press accounts suggest that the tax increases were difficult for the village’s residents to bear. Had its residents balked at tax increases, the village might have found it difficult to refinance existing obligations, to obtain financing for future infrastructure needs and/or to maintain control over its own finances. This has happened in other communities having financial difficulties, including Harrisburg, Pennsylvania. If things had gotten bad

85 Former New York Governor David Patterson, while supportive of the Florida construction initiative, was critical of failure to plan for Canajoharie. http://www.leaderherald.com/page/content.detail/id/525750/Visits-Rock-Canajoharie.html

86 In an August 2010 report, the New York State Comptroller’s Office estimated that the village’s residents would face “unsustainable” water and sewer usage rate increases of approximately $2,700 per household to pay for operating costs and debt service.

87 Because Canajoharie borrowed money through Environmental Facilities Corporation (“EFC”), its loan cannot be forgiven under state law. http://www.leaderherald.com/page/content.detail/id/525750/Visits-Rock-Canajoharie.html

88 Because the factory paid for water and sewer services based on its usage, its obligation to pay disappeared once the factory was closed.

89 Because Canajoharie raised taxes, implemented cost savings measures, and restructured its obligations, it was able to avoid defaulting on its debt to EFC, thereby mitigating the risk EFC might default on its obligations to bondholder. EFC further mitigated its bondholder’s risk of loss by funding a number of different projects with the proceeds of the offerings at issue, making bondholders less dependent upon the success (or failure) of any single project.

90 Respecting Harrisburg, see notes __- __. In Jefferson County, Alabama, although the governor of the Alabama sought to prevent the bankruptcy filing by proposing a plan to restructure the county’s outstanding water and sewer obligations, market insiders reportedly concluded that new bonds proposed as part of a restructuring plan would not be secure enough to attract buyers at affordable interest rates.http://www.nytimes.com/2011/11/10/us/alabama-governor-fails-to-
enough, the village might have been forced to consider bankruptcy.\(^91\) As noted, this happened in Jefferson County, Alabama late last year.

Finally, lest one think that the tension between paying for public infrastructure and public services on one hand, and paying back bondholders on the other, is not a real and present danger, consider what has happened in Harrisburg, Pennsylvania. On March 9, 2012, Harrisburg announced that it would skip $5.27 million in payments due March 15 on two series of general obligation bonds.\(^92\) Harrisburg’s fiscal crisis reportedly has been driven by more than $300 million in debt – reportedly more than five times the city’s annual budget\(^93\) – that the city incurred in order to renovate and expand trash facilities. In December 2011, after a federal judge rejected Harrisburg’s bankruptcy petition on the grounds that the filing was illegal, Pennsylvania’s governor declared a fiscal emergency\(^94\) and the court appointed a receiver.\(^95\) In announcing the city’s intention to miss payments due on March 15, Harrisburg’s receiver explained that his “first priority as receiver is to ensure that vital and necessary services such as police and fire are maintained within Harrisburg during the state of fiscal emergency.”\(^96\) The receiver further explained that Harrisburg would not be making payments due on the 15\(^{th}\) “to ensure sufficient cash flow so the citizens of Harrisburg continue to receive essential services.”\(^97\)

**Part III: Systemic Risks and Costs for Other Stakeholders.**

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\(^97\) Id.
To understand how and why the conventional wisdom respecting municipal securities and risk might minimize systemic risks and costs that non-investor stakeholders face, it is helps to remember that that municipal securities (and their issuers and markets) differ from corporate debt securities (and their issuers and markets).

For my purposes, some of the most important differences relate to the issuer’s purpose in accessing the capital markets, funds available for repayment, options available if repayment becomes difficult, political restraints on taxation and borrowing, and transaction costs associated with disciplining those who make decisions about money of the issuer’s behalf.

A. Corporate Issuers and Corporate Debt

Because corporations are profit-driven enterprises, they issue debt to support profit-seeking activities (e.g., to build a new plant to enter or grow a business, invest in research and development) and to improve returns on equity for shareholders. To repay bondholders, corporations use revenues from business activities and/or money generated through investment activity. When necessary, corporations also may sell assets (e.g., sell facilities, lines of business) and/or cut costs (e.g., through layoffs) to generate funds. When corporations encounter difficulty repaying their debts, they may investigate restructuring existing obligations, raising additional capital through securities offerings, and/or entering into a corporate combination or other transaction with a fiscally stronger counter-party. If these efforts prove unsuccessful, a debtor corporation may consider (or be forced into) bankruptcy as a means of obtaining discharge. Since shareholders generally cannot be held personally liable for corporate obligations, corporations cannot demand money from shareholders to pay bondholders, nor can they require employees or customers to “kick in” to fund debt service.

B. Municipal Securities Issuers and Municipal Bonds

The funding activities of state and local governments and their associated instrumentalities are completely different. State and local governments generally do not have a profit motive when they issue debt. Instead, they borrow for public purposes — e.g., to ensure that public services and infrastructure systems meet community needs, to

98 Some of the differences are fairly technical, and are associated with legal obligations applicable to municipal issuances. For example, unlike corporate bonds, which tend to have a single interest rate and maturity date, municipal bonds often are sold as serial bonds with each series bearing its own interest rate and date of maturity. Municipal issuances therefore tend to contain a “bundle” of different issues, each carrying its own coupon amount (amount of interest paid per year expressed as a percentage of the face value of the bond) and maturity date. Municipal securities issuers use serial bond structures so that they can repay principal over time and match repayment obligations to expected revenues. This structure also helps issuers stay within legal limits in states where bond issuances must contain substantially equal annual debt service payments or maturities. SIFMA, The Fundamentals of Municipal Bonds, at 47.

99 For a discussion of the rational and origins of the so-called public purpose doctrine, see Amdursky & Gillette, Municipal Debt Finance Law Theory and Practice, (Little Brown 1992), at 84-105.
comply with substantive law requirements (e.g., environmental regulations respecting sewer and water systems), and to contribute to local economic development. Because the size, scope and timing of governmental projects may be dictated by pressing community needs or legal requirements, municipal securities issuers may not have as much flexibility as corporate issuers respecting the timing or size of securities offerings.

Municipal securities issuers also depend upon different, and less elastic, sources of funds for debt repayment. Unlike corporations, municipal securities issuers cannot simply enter or exit businesses to generate revenues or cut costs, nor can they easily leverage or sell-off public infrastructure or services to raise funds for debt service obligations. Instead, municipal securities issuers rely upon taxes, assessments and use fees to repay their debts. While issuers may be required raise taxes and/or cut budgets to satisfy bondholders, such steps may be politically difficult and painful for issuers and their taxpayers and ratepayers, or even impossible if there are tax caps or other such limits in place under state law. Municipal issuers experiencing financial difficulties also may find it difficult or impossible to borrow funds to satisfy repayment obligations and/or day-to-day funding needs, either because private credit markets deem the issuer too great a credit risk, or because state law prohibits additional indebtedness.

There also are differences in the governance tools available to shareholders and municipal bondholders, and in the transaction costs associated with disposing of one’s investment. In the private sector, shareholders can decide what to invest in, and when to invest. If they become unhappy with decisions made by the corporation’s agents (i.e., the board of directors and management), they may express their disapproval in a variety ways, including (i) voting against incumbent board members during annual director elections, and proposing replacement slates of directors; (ii) making proposals during meetings and/or through the proxy system; (iii) voting against proposals and/or transactions proposed by incumbent boards and management; and (iv). Shareholders also may use exit discipline – i.e., selling ones shares – to express disapproval. Certainly, there are variations in shareholders voting rights across corporations. Moreover, not every corporate security (debt or equity) is liquid or freely transferrable. That said, since shareholder liability is generally limited to the amount of the shareholder’s investment, a

100 If a default on a general obligation occurs, bondholders generally can seek a writ of mandamus whereby a court will direct the appropriate governmental entity to levy and collect taxes to pay debt service or to make required debt service payments using other available funds of the issuer.

101 See, e.g., In re McCurtain Municipal Authority, 2007 Bankr. LEXIS 4010, at *5 (E.D. Ok. 2007); In re City of Vallejo, Memorandum of Fact and Law In Support of Qualifications under Section 109(c), Case No. 2008-26813 (E.D. CA. Bankr. 2008), at p. 18.

102 E.g., Article XVI, Section 18 of the California Constitution (prohibits cities from incurring a debt in any year that exceeds the available revenues of the City for that year, without the approval of two-thirds of the qualified voters);

shareholder’s potential loss is capped, and transaction costs associated with expressing disapproval or using exit as a means of discipline are likely to be relatively low.

With municipal securities, voter/taxpayers take the place of shareholders, and municipal officers take the place corporate officers and directors. Once a taxpayer or ratepayer makes the initial decision to purchase real estate or consume services, her choices should she become unhappy are far more limited than her corporate shareholder counterparts. Once a taxpayer “buys in” to the municipal enterprise, such as through the purchase of residential real estate or the use of municipal services, she must pay government levies. While she may vote against bond offerings that are subject to a voting requirement, not all offerings or transactions are subject to a vote. If she decides to try to unseat government officials responsible for particular offerings, she may have to wait until the next election (assuming the official serves as an elected official) or pressure government officials to terminate appointed personnel. If the taxpayer is not happy with the results of these efforts, she must sell her real estate holdings and move to different city/town, county and/ or state to exit her investment. Those who stay and rely on the political process to advocate for change face any number of risks and costs, including the risk that the value of their investment will decline (e.g., declining real estate prices) and/or costs will increase (e.g., higher taxes, fees and assessments) before change occurs. Those who leave face significant transaction costs, since selling one’s real estate and moving to a new city or state is neither cheap nor easy, especially when real estate markets are in turmoil.

C. Comparing Markets

Differences between the structure and operation of the municipal securities and corporate debt securities markets also impact systemic risks. For example, the municipal securities market tends to be less liquid, and more opaque than its corporate securities counterpart. There are several reasons for this. First, unlike the market for publicly-traded corporate securities, there is no centralized, organized exchange where municipal securities are listed or traded, nor is there a two-sided quotation or formal market maker system. Instead, trading in the municipal securities market occurs on an over-the-counter basis. Investors who wish to buy or sell municipal securities generally must work through a municipal securities dealer via a broker-assisted transaction, or through the purchase or sale of a municipal bond fund. For this reason, and because the vast majority of municipal bonds and notes do not trade regularly in the secondary market after the initial

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104 See, e.g., What You Should Know About Your Local Government’s Finances, at 2.
105 http://emma.msrb.org/educationcenter/WhatAreBonds.aspx
106 2008 report at 236.
107 For example, investors may purchase passive or active closed-end funds or open-end funds or exchange-traded funds in order to invest in municipal bonds.
offering period, “last sale” information in the municipal securities market tends not to provide the same degree of price transparency as an actively-traded corporate debt instrument. Lack of price transparency may make it harder for stakeholders (including, but not limited to investors) to detect and register systemic risks, especially when the risk of default and investor loss remains low.

The municipal securities market also is characterized by a comparatively large number of issuers and (highly disparate) offerings. As noted, approximately 60,000 state and local governments (including authorities, special districts) have issued municipal securities. At any given time, there are approximately 1.3 million different municipal securities outstanding in the market. Issuances range from multi-billion financings of large infrastructure projects involving state or local governments to offerings of less than $100,000 in securities by localities, school districts, fire districts and other local authorities. Due in part to the large number of highly disparate issues and issuers, the municipal securities market tends to be more fragmented, and traditionally has been more dependent upon the participation of regional underwriting firms than the market for corporate securities. Like the lack of price transparency, the opaque, fragmented nature of the municipal securities market also may make it difficult for stakeholders (including, but not limited to, investors) to make detailed risk assessments and to detect systemic risk.


109 This has long been the case. See General Accounting Office, Report to the Chairman, Subcommittee on Economic Stabilization, Committee on Banking, Finance and Urban Affairs House of Representatives: Trends and Changes In the Municipal Bond Market As They Relate to Financing State and Local Public Infrastructure, GAO/PAD-83-46 (September 12, 1983), at 2 (noting large number of disparate issues and decentralized nature of market, compared to corporate securities market).

110 See supra note 8.


112 2008 report at 234. GET MSRB CITE HERE.

113 The accounting regime applicable to municipal securities also is less uniform than its corporate securities counterpart. The Government Accounting Standards Board (GASB) establishes generally accepted accounting principles that are used by many state and local governments. The stated mission of the GASB is to establish and improve standards of state and local governmental accounting and auditing and financial reporting that will: (i) Result in useful information for users of financial reports, and (ii) Guide and educate the public, including issuers, auditors, and users of those financial reports. See http://www.gasb.org/sp/GASB/Page/GASBSectionPage&cid=1175804850352. Prior to Dodd-Frank, GASB was funded by voluntary payments and contributions from states and local
D. Complex, Volatile Securities May Present Particular Risks for Municipal Securities Issuers

Because municipal issuers have limited and not terribly elastic revenue sources available for interest and principal repayment (i.e., namely, taxes, fees and assessments), risks may be particularly acute when issuers use complex products that have interest rate risk. Consider, for example, municipal securities issuers’ experience with auction rate securities. First developed in 1984, auction rate securities (ARS) are municipal bonds, preferred stocks, and other securities with interest rates or dividend yields that are periodically reset through auctions, which prior to the current economic crisis typically were held every 7 to 35 days. Although ARS typically were issued and rated as long term bonds, they were priced and traded as short term instruments because of the liquidity provided through the interest rate reset mechanism. As noted, for municipal issuers, auction rate bonds provided a way to finance long term projects by using the

name=Foundation%2FDocument_C%2FFAFDocumentPage&cid=1176158366673. As discussed below, among other reforms, Section 978(a) of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (WSRA) directs the Commission to take formal action to direct the Financial Industry Regulatory Authority (FINRA) to establish rules for the assessment and collection of accounting support fees from FINRA’s members to fund the annual operating budget, including expenses, capital and accrued items of the GASB. Id. Although many states require compliance with GASB standards, compliance is voluntary in some jurisdictions. For example, the Texas legislature enacted a law which requires the state, and permits local governments, not to use GASB Statement 45, which requires the governmental entities that provide health care, life insurance and other postemployment benefits to retirees to report the estimated accrued cost of the benefits. See Tex. Gov’t. Code Ann. §§ 2266.051, 2266.052 § 2266.102 (West).

114 As Erik Sirri and others have commented, “[t]he widespread use of complex and potentially volatile products by municipal issuers raises concerns about risks to investors, markets, and taxpayers 2008 report, Sirri, 203.


“short end” of the yield curve, which normally represents lower interest rates, potentially saving taxpayers money in debt service. According to Erik Sirri, the then-director of the Commission’s Division of Trading and Markets, by early 2008, the ARS market had “grown to over $325 billion of securities, with State and local governments accounting for about $160 billion of the outstanding auction rate debt.”

From 1984 through early 2007, the auction rate market functioned relatively smoothly, allowing municipal issuers flexibility in meeting funding needs. Beginning in 2007, however, auctions began to fail. By early 2008, hundreds of auctions for ARS issued by municipal issuers had failed to obtain a sufficient number of bids to establish a clearing rate. By early 2008, an estimated $80 billion in ARS auctions had failed, according to Sirri.

When the auction rate market failed, issuers who had used this method of financing to obtain favorable short-term interest rates were forced to pay penalty interest rates, which could be as high as 20 percent, at least until the next successful auction. While some municipal issuers and conduit borrowers sought to address these failures by converting auction rate securities into variable rate bonds backed by letters of credit or other credit enhancements, or by converting auction rate securities into fixed rate bonds, issuers encountered difficulties, and funding costs spiked, due to the heavy demand for substitute instruments and/or contractions in the credit market. According to Sirri, the failure of


121 Statement of Erik R. Sirri, Director, Division of Trading, and Markets, U.S. securities and Exchange Commission, Municipal Bond Turmoil: Impact of Cities, Towns, and States, Hearing before the United States House of Representatives Committee on Financial Services (March 12,
the auction rate markets “created unanticipated hardships for municipal issuers, and in some cases, [...] dramatically increased borrowing costs.”

The Airport Commission of the City and County of San Francisco’s efforts to deal with the collapse of the ARS market show what can happen to issuers faced with interest rate risk, even when they attempt to act prudently in the face of challenges. In May of 2008, officials issued $205 million of variable rate demand obligations (VRDO) to restructure some auction rate debt, as the market for auction rate securities was collapsing. According to the airport’s assistant deputy director for capital finance, this issuance was “backed up with liquidity from Depfa [an Irish bank], insured by FSA [a monoline insurance company] and hedged with a Lehman Bros. swap.” At the time, this looked like a strong deal – Depfa was a well-respected Irish bank, FSA [Financial Securities Corp.] was one of the two remaining municipal bond insurers with a triple-A rating from all three rating services, and Lehman Bros. was venerable Wall Street firm. By the end of September 2008, however, just four months after the issuance, Depfa had serious liquidity issues, FSA was on watch for a ratings downgrade and Lehman Bros. had filed for bankruptcy protection under Chapter 11 of the federal bankruptcy code. Not surprisingly, costs at the San Francisco significantly increased.

E. Swaps and Other Derivatives

For similar reasons, interest rate swaps and other derivatives present challenges for municipal securities issuers and their taxpayers, especially in a low default rate environment. An interest rate swap is a contract between two parties to exchange a series of fixed rate and floating rate interest payments over a defined period of time, without exchanging the underlying principal amount, which is referred to as a “notional”

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123 See, e.g., Andrew Ward, S.F. Airport Restructuring No Laughing Matter, The Bond Buyer 365.32994 (October 27, 2008), p.1

124 Id.

125 Id.

126 Id.

127 Id.
Municipal securities issuers use interest rate swaps to convert interest rate basis (e.g., from floating to fixed or fixed to floating) to manage liabilities, and (ideally) to enable issuers to lower their costs of borrowing. Although once relatively rare, the swaps market grew exponentially prior to the crisis.  

While swaps may offer borrowers potential cost savings, they subject issuers to risk not present in other financing alternatives. For example, recent changes in reference interest rates have caused losses in swap positions taken by hundreds of municipalities, according to the consulting firm NERA. The Government Finance Officers Association likewise has cautioned issuers that due to recent economic turmoil and credit downgrades, issuers holding derivatives products have been subjected to collateral calls and, in some cases, involuntary terminations at severe cost to governmental entities. NERA’s research suggests that, “[i]n some cases, as interest rates have fallen during the crisis, municipalities have lost money on floating-to-fixed swap agreements that they first entered into to protect against rising interest rates. In other cases, even though interest rates have fallen, municipalities have found that floating payments have increased due to downgrades of the monoline insurers.”

Oakland, California’s difficulties with swaps demonstrate what can happen when interest rates move. In 1998, Oakland reportedly issued variable rate bonds in order to help the city finance its pension obligations. To protect against interest rate spikes, the City entered into an agreement with Goldman Sachs to swap its variable rate for a fixed rate obligation. Instead of spiking, however, interest rates dropped to about half what the city was paying to Goldman Sachs. Although the bonds were refunded for additional

128 See http://www.msrb.org/msrb1/glossary/view_def.asp?param=INTERESTRATESWAPCONTRACT.


133 See http://www.seiu1021.org/story/oaklanders-demand-end-swap-ripoff

134 Id.

135 Id.
debt in 2005, the swap agreement was structured to continue until 2021, and requires the city to pay $5 million per year until that time. According to press reports, terminating the swap would cost Oakland $19 million. High termination costs are not unique to Oakland. According to its annual financial statements, the State of New Jersey paid Goldman Sachs $122 million in one month partially to terminate certain swap arrangements. Other state and local government issuers across the country have struggled with swaps as well. Some municipal issuers reportedly face millions of dollars in termination fees and other liabilities as a result of swap agreements. In a number of cases, municipalities which have suffered losses due to swap agreements have sued their swap providers, often resulting in settlements or the restructuring of swap agreements.

C. Pensions, OPEB Liability and Tax Caps

Liabilities associated with rising pension and other post-employment costs also create systemic risks and costs for issuers and their taxpayers, especially in jurisdictions where benefits may be guaranteed by state law or contract and/or where tax caps or other


138 Id.


141 In 2009, for example, the Alabama Public School and College Authority (APSCA) sued to void a swaption that it had sold to JP Morgan and refused to make payments on the swaption until a decision was rendered. According to press reports, the APSCA agreed to pay a $19 million in settlement to JP Morgan to resolve the dispute. “Judge OKs deal in Alabama, JP Morgan Swaption Suit,” Bloomberg 27 December 2010.
legislation limits issuers’ ability to borrow or raise revenues.\textsuperscript{142} According to an analysis by the Pew Center on the States, there was a $1 trillion gap between the $2.35 trillion states and participating localities had set aside to pay pensions\textsuperscript{143} and health care and other retirement benefits (so-called “OPEB” or other post-employment benefits)\textsuperscript{144} promised to public sector employees, and the $3.5 trillion in estimated actual cost as of 2008.\textsuperscript{145} Also according to the Pew study, while the economic down-turn has undoubtedly made it harder for state and local governments to manage their financial obligations, the Pew Center identified a number of factors as contributing to problems respecting pension and OPEB liability, including: (1) the volatility of pension plan investments; (2) states falling behind in their payments; (3) ill-considered benefit increases; and (4) other structural issues.\textsuperscript{146}

Vallejo, California’s efforts to deal with declining revenues, soaring costs, tax cap legislation and municipal bond debt also reflect the challenges that municipal entities face, especially during difficult economic times. A city of 120,000 located about 30 miles northeast of San Francisco, Vallejo was hit hard by the housing market crash and California’s struggling economy.\textsuperscript{147} Between 2005 and 2008 as revenues faltered and employment costs rose, the city operated at a substantial deficit.\textsuperscript{148} As its financial condition deteriorated, Vallejo tried a number of strategies to deal with its financial


\textsuperscript{143} According to the government accountability office (GAO), “[n]early 20 million employees and over 7 million retirees and survivors are covered by state and local government pension plans.” Government Accountability office, Report to the Ranking Member, Committee on Finance, United States Senate, State and Local Government Pension Plans: Governance Practices and Long-Term Investment Strategies Have Evolved Gradually as Plans Take On Increased Risk, GAO-10-754, at 1 (August 2010).

\textsuperscript{144} Pension and OPEB liabilities have been the subject of significant debate and analysis in recent years. \textit{See}, e.g., D. Roderick Kiewat, the Day After Tomorrow: The Politics of Public Employee Retirement Benefits, Vol. 2 Issue 3 The California Journal of Politics & Policy (2010), For a summary of accounting standards relevant to OPEB liability, \textit{see} GASB, Summary of Statement No. 45 Accounting and Financial Reporting by Employers for Postemployment Benefits Other Than Pensions, available at \url{http://www.gasb.org/isp/GASB/Pronouncement_C/GASBSummaryPage&cid=1176156700943}


\textsuperscript{146} \textit{Id.}, at 23.

\textsuperscript{147} Memorandum of Fact and Law In Support of Statement of Qualifications Under Section 109(c), In re City of Vallejo, CA, Debtor, Case No. 2008-26813 (May 23, 2008), at p. 3.

\textsuperscript{148} \textit{Id.}, at 3.
difficulties. First, the city drew upon general fund reserves to fund its deficits. By mid-2008, however, the city estimated that funding its annual operating deficit for the 2008 fiscal year would entirely deplete the city’s general fund and cause the city to lack sufficient general fund revenues or cash flows to pay its bills as they came due. The city also negotiated with labor associations representing city workers in an effort to reduce labor costs (the largest expenditure the city incurred during each fiscal year), cut expenditures that did not require the mutual agreement of other parties, cut jobs, services and staff, and reduced or eliminated funding for almost all of its general fund services and programs beyond levels which the city viewed as “minimally acceptable.” These efforts also did not solve the city’s financial crisis. Finally, the city negotiated with Union Bank, the issuer of several letters of credit supporting the city’s $54 million in outstanding bonds respecting the city’s potential bankruptcy filing and other possible adjustment strategies. While the bank reportedly was willing to negotiate with the city, it deferred detailed discussions regarding adjustments to the city’s general fund bond obligations until such time as the city and labor group reached agreement respecting the city’s labor costs.

Unfortunately, Vallejo was not able to solve its financial difficulties prior to becoming insolvent. On May 23, 2008, the city filed a petition for bankruptcy under Chapter 9 of the Bankruptcy Code over the objections of city workers, who argued that the city was not insolvent, and that it had filed for bankruptcy as a stratagem to reduce or avoid obligated owed to public workers.

In petition and support documents, the city cited several reasons for its financial distress, including (i) a decrease in revenues, (ii) $3.4 million in unbudgeted pension cost and

149 Id., at 3.
150 Id., at 1.
151 Id., at 4, 8.
152 Id., at 5.
153 Id., at 7.
154 Id., at 1.
155 Id., at 11-12.
156 Id., at 13.
157 Memorandum of Fact and Law In Support of Statement of Qualifications under Section 109(c), In re City of Vallejo, CA, Debtor, Case No. 2008-26813 (May 23, 2008), at p. __
158 Memorandum of Fact and Law In Support of Statement of Qualifications under Section 109(c), In re City of Vallejo, CA, Debtor, Case No. 2008-26813 (May 23, 2008), at p. __
other expenses relating to public employee compensation or benefits; and (iii) cuts in funding from the state of California as taking away additional sources of revenue that would have been used to pay for bond servicing.\textsuperscript{159} City officials also cited Proposition 13 and related tax-cap legislation as contributing to Vallejo’s financial difficulties.\textsuperscript{160} Enacted three decades ago, Proposition 13 both rolled back and froze assessments for residential and commercial real estate property at 1976 levels.\textsuperscript{161} It then set the tax rate at 1% of that valuation,\textsuperscript{162} and limited annual increases of the value to 2%.\textsuperscript{163} Because values are reassessed only when properties are sold, people who have owned their homes for years may pay substantially less in taxes than neighbors who recently purchased a comparable home.\textsuperscript{164} While the law has reduced property taxes -- according to the Board of Equalization, the average real estate tax in California is 60 percent lower than when the law was passed – some have argued that it is in part responsible for California’s perennial budget crisis, and declines in per-student spending.\textsuperscript{165}

Vallejo’s bankruptcy documents also cited California Proposition 218 as a further constraint on the city’s ability to raise sales taxes. Proposition 218 requires that a majority of voters approve any new or increased general tax, and that a two-thirds majority approve any new or increased special tax.\textsuperscript{166} City officials also claimed that Article XVI, Section 18 of the California Constitution prohibited the city from borrowing money to deal with its revenue or cash-flow shortfall. This provision of the California

\textsuperscript{159} Memorandum of Fact and Law In Support of Statement of Qualifications under Section 109(c), In re City of Vallejo, CA, Debtor, Case No. 2008-26813 (May 23, 2008), at p. __

\textsuperscript{160} Memorandum of Fact and Law In Support of Statement of Qualifications under Section 109(c), In re City of Vallejo, CA, Debtor, Case No. 2008-26813 (May 23, 2008), at p.4

\textsuperscript{161} CAL. CONST. art. XIIIA §§ 1(a), 2(a); see also Julie K. Koyama, Financing Local Government in the Post-Proposition 12 Era: The Use and Effectiveness of Nontaxing Revenue Sources, 22 PAC. L.J. 1333, 1334 (1991) (noting that Proposition 13 limited jurisdictions which taxed in California to the 1975-76 assessed value of the real property).

\textsuperscript{162} CAL. CONST. art. XIIIA § 1(a).

\textsuperscript{163} Id. § 2(b).

\textsuperscript{164} Id. § 2(a); see also Jonathan Schwartz, Prisoners of Proposition 13: Sales Taxes, Property Taxes, and the Fiscalization of Municipal and Land Use Decisions, 71 S. CAL. L. REV. 183, 193 (1997).


\textsuperscript{166} Cal. Con., art. XIIIC, §2. See Memorandum of Fact and Law In Support of Statement of Qualifications Under Section 109(c), at p. 4.
Constitution prohibits cities such as Vallejo from incurring in any year a debt which it could not pay from revenues attributable to that same year.167

Although Vallejo’s bankruptcy filing gave the city “breathing room” to adjust debts owed to various creditor constituencies, respite came at a cost to the city’s residents and its public workers. Through the bankruptcy process, the city adjusted compensation and benefits packages with city workers, with the result that, “[c]ity staffers now contribute more to their health insurance, new firefighters have lower pension plans and the fire department no longer has minimum staffing requirements.”168 Even though the city emerged from bankruptcy last year, sales taxes remain high, public services remained “hollowed-out” and there are neighborhoods with dilapidated homes.169 City workers and taxpayers have also had to deal with approximately $8 million in legal fees that the city incurred in connection with the bankruptcy.170

Notably, Vallejo’s bondholders appear to have survived the city’s bankruptcy relatively unscathed. According to press reports, Vallejo reportedly paid bondholders in full and on time.171

D. Other Market Disruptions Impact Taxpayers’ Risks and Costs

The Collapse of the Monoline Insurance Companies

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168 http://www.sfgate.com/cgi-bin/article.cgi?f=/c/a/2011/11/01/BARI1LPAHN.DTL. Fire and police unions had opposed Vallejo’s bankruptcy filing on the grounds that the city used bankruptcy strategically as a means of avoiding contractual obligations respecting benefits. Id.


170 Id. Among other reasons for the legal fees, the city and certain of its public workers engaged in extensive litigation over whether the bankruptcy filing was necessary, or whether it was means of avoiding collective bargaining obligations. See, e.g., http://www.ci.vallejo.ca.us/uploads/712/062708%20-%20Dkt.%20No.%2097%20-%20Union%20Objections%20to%20Petition.pdf.

171 Patrick McGee, Vallejo Shows the Way, The Bond Buyer (March 1, 2001), available at http://www.bondbuyer.com/issues/120_40/vallejo_muni_bankruptcy-1023803-1.html. Some state and local governments reportedly have attempted to deal with soaring pension liabilities by issuing so-called pension obligation bonds. Pew Center Report, at 34. As the Pew Report reflects, pension obligation bonds entail a number of risks for issuers and those responsible for repayment. For example, because pension obligation bonds are sensitive to market conditions, returns can vary from year to year. Id. When returns are robust, they may be sufficient to fund pension plans. If returns falter, however, they may not be sufficient to meet funding obligations, or even to meet borrowing costs. As the Pew study states, if that happens, issuers have the potential to lose billions of dollars on these deals. Id.
Finally, developments and disruptions occurring outside the municipal securities markets also can have a significant impact on taxpayers’ risks and costs, particularly in a low default environment. The collapse of the monoline bond insurance business offers one such example. The monoline insurance business started in 1971, when American Municipal Bond Insurance Corp. (AMBAC) was formed as a subsidiary of a mortgage insurer. For many years, bond insurance was attractive to investors because insured bonds were assigned the rating of the insurer. Since monoline bond insurers tended to carry the highest possible ratings from the rating agencies, insured bonds likewise tended to carry the highest possible rating. As investors sought highly-rated insured bonds, issuers benefitted by paying lower interest rates. From 1971 through 2007, the number of insured issues grew significantly.

In 2007/2008, however, a number of the monoline insurers began to experience severe financial distress, resulting in ratings downgrades. Like other market participants, some of the monolines got caught up in the subprime mortgage crisis. To enhance earnings, and in an effort to diversify, certain monolines had insured collateralized debt obligations (CDOs) that were based on mortgages. As the value of the CDOs began to fall, the rating agencies began to review the monoline insurers’ exposure to the subprime market. On December 14, 2007, Moody’s issued a press release noting that two monoline bond insurers had been placed on a watch list for possible downgrade. By November 2008, none of the major monoline insurers had a triple-A rating from Moody’s.

Although the ratings downgrades had nothing to do with the credit quality of the underlying municipal securities issuers or their issuances, the lowered ratings for insurers had a number of collateral consequences for issuers and taxpayers. In a market that was already feeling the effects of the subprime mortgage crisis, downgrades and the threat of downgrades reportedly put pressure on municipal bond prices, and investors demanded higher yields to compensate for added uncertainty regarding credit risk. In addition, according to some commentators, the downgrades and concerns about the ability of insurers to satisfy their insurance obligations contributed to a lack of liquidity in the municipal bond market during 2008, and explained (at least in part) why municipal bonds delivered “anemic” returns during this period.

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172 [http://www.munibondadvisor.com/BondInsurance.htm](http://www.munibondadvisor.com/BondInsurance.htm) CITE


174 Id. See also [http://www.sec.gov/news/testimony/2008/ts031208ers.htm](http://www.sec.gov/news/testimony/2008/ts031208ers.htm) ("Estimates of the value of the recent failures of auctions for municipal auction-rate securities exceed $80 billion. Prior to the current disruption in the municipal auction-rate market, participating dealers retained to solicit bids for the auctions generally supported the liquidity of the municipal auction-rate securities market by placing proprietary bids, as necessary in order that auctions not "fail," and disclosed the fact that they might do so. However, in recent weeks, for a variety of reasons, including liquidity concerns and uncertainty surrounding the monoline insurers, participating dealers have ceased to intervene proprietarily in auctions, with the result that hundreds of auctions have failed.")
The collapse on the monoline industry and associated downgrades reportedly also had a significant impact on the ability of municipal securities issuers to obtain Triple-AAA rating, leading to a significant downgrade across the municipal securities market as a whole.\footnote{See, e.g., http://www.lazardnet.com/confcalls/pdfs/2011/AdjustingToTheNewLandscapeOfTheMunicipal_LazardInsightsCallSummary_2011-04.pdf.} Lower ratings tend to be associated with investor demands for higher yields as compensation for allegedly increased credit risk, or in some cases, to issuers’ decreased ability to access products and/or the capital markets generally.\footnote{E.g., Jeffrey A. Parker & Associates, Inc., Impacts of the Financial Crisis on the Transit Industry: Challenges and Opportunities, Prepared for the American Public Transportation Associations, at p. 8 (April 2009), available at http://www.apta.com/gap/policyresearch/Documents/APTA_Credit_Crisis_Report_062209_FINAL.pdf} In any event, post-crash, bond insurers’ role in the municipal securities market has significantly diminished. According to The Bond Buyer, whereas insurance issuance approached 60% of the total market prior to the recession, only approximately 10% of issuances were being insured by 2010.\footnote{The Bond Buyer, 31 December 2010. There is a complicated and important story to be written about efforts to save the monoline insurance industry, and to develop new sources of insurance for the municipal bond market. In early 2008, at the urging of New York State Comptroller Eric DiNapoli, Berkshire Hathaway activated Berkshire Hathaway Assurance Company (“BHAC”) as an insurer of tax-exempt bonds issued by states, cities and other local entities. See Warren Buffet 2008 Letter to Berkshire Hathaway shareholders, at p. 3, available at http://www.berkshirehathaway.com/letters/2008ltr.pdf. Because of Berkshire’s deep pockets, it quickly became an insurer of preference – and in some cases, the only insurance acceptable to bondholders – even though it wrote “second-to-pay” insurance, or insurance that could only be drawn upon of the first-line insurer failed to pay. Id. Despite the appeal of Berkshire’s product, however, Buffet told investors that he as “very cautious” about the business. Id. Buffet noted that prior to the crisis, insurers had charged very low premium rates for insuring tax-exempts because defaults historically were rare. Id. at 14. Buffet noted, however, that the historically low default rate developed at a time when the bonds were much more likely to be uninsured. Id. Citing the example of the example of the New York City bond crisis of the mid-1970s, Buffet questioned whether the loss experience on bonds -- especially those insured by Berkshire Hathaway’s deep pockets - -would follow historical patterns. Buffet opined that in New York in the mid-1970s, bonds were heavily held by wealthier residents of New York City, New York Banks and other institutions. Id. According to Buffet, when the crisis erupted, these bondholders had a vested interest (as both bondholders and given ties to New York City) in solving the city’s financial crisis. Id. In Buffett’s estimation, this helped to produce the compromises, concessions and cooperation necessary to avoid losses. In his investor letter, Buffett wondered whether “similar belt-tightening, tax increases, labor concessions, etc.” would have been forthcoming if the city’s bonds had been insured by Berkshire. Id. Buffett speculated that communities facing revenue shortfalls would be more prone to implement “solutions” less favorable to bondholders if bonds are insured by entities like Berkshire. Id.}
Like the conventional market wisdom for municipal securities and risk, the conventional regulatory wisdom for the municipal securities market also focuses on investor risk of loss as a key regulatory concern, along with conflict of interest violations. In a nutshell, under the current regime, so long as (i) facts relating to risk of loss are disclosed to investors on an adequate and timely basis, and (ii) the offering process is not corrupt due to “pay to play” or other conflict of interest violations, stakeholders’ securities law-

178 See, e.g., 17 C.F.R. § 240.15c2-12(b) (2012) (disclosure rule for municipal securities). See also MSRB Notice 2009-42, Guidance on Disclosure and Other Sales Practice Obligations to Individual and Other Retail Investors in Municipal Securities (Noting that “[s]ignificant participation by individual investors has long been a hallmark of the municipal securities market and, consequently, a focus of the core investor protection efforts of the Municipal Securities Rulemaking Board) (July 14, 2009), available at http://www.msrb.org/Rules-and-Interpretations/Regulatory-Notices/2009/2009-42.aspx?n=1; FINRA, Municipal Bonds—Staying on the Safe Side of the Street in Rough Times, available at http://www.finra.org/investors/protectyourself/investoralerts/bonds/p118923 (last accessed on March 13, 2012) (Stating that“ FINRA and the Municipal Securities Rulemaking Board (MSRB) are issuing this Alert to remind investors that while munis have historically been considered relatively conservative investments, they do, like all bond investments, carry risk” and noting that, “[w]hen it comes to evaluating a municipal bond, a major focus should be on the issuer’s ability to meet its financial obligations. A key question to ask is: How likely is the bond’s issuer to default? This is referred to as “default risk.”); United States Securities and Exchange Commission Office of Investor Education, Investor Bulletin: Focus on Municipal Bonds (discussing risks from perspective of investor), available at http://www.sec.gov/investor/alerts/municipal.htm. For examples of disclosure-focused enforcement actions, see infra note ___ ( citing http://www.sec.gov/litigation/admin/2010/33-9135.pdf; In the Matter of the City of San Diego, SEC Release No. 34-54745, 89 S.E.C. Docket 807 (Nov. 14, 2006) (alleging City of San Diego failed to disclose the gravity of its pension and retiree health liabilities or that those liabilities had placed city in financial jeopardy); Opinion of the Commission, In the Matter of the City of Miami, Florida, SEC Release No. 34-47552 (March 21, 2003) (holding City of Miami failed to disclose cash flow shortage which it had eased, in part, by spending the proceeds of bonds issued for other purposes for operating costs); In re Maricopa County, SEC Release No. 33-7354, 34-37779, 62 S.E.C. Docket 2574 (Oct. 3, 1996) (alleging Maricopa County, AZ failed to disclose material decline in financial condition and operating cash flow, substantial deficit in general fund and increased deficit in another fund in connection with municipal bond offering); In re City of Syracuse, SEC Release No. 34-39149, 65 S.E.C. Docket 1199 (Sept. 30, 1997) (alleging city of Syracuse falsely claimed surplus for its general and debt service funds, materially overstated its fund balance in those funds, and misled investors by describing certain financial information as audited.)


180 See generally 17 C.F.R. § 240.15c2-12(b) (2012) (outlining the required disclosures for municipal securities).
related obligations respecting risk are satisfied. While brokers, dealers, and municipal securities dealers must deal fairly with municipal securities issuers, and may not use any deceptive, dishonest or unfair practices under MSRB Rule G-17,\(^1\) neither that rule nor interpretive releases issued prior to Dodd-Frank specifically addressed whether and to what extent these stakeholders owed obligations to taxpayers, public pensions and others whose credit supports municipal securities offerings.\(^2\) Consequently, while there have always been important non-investor stakeholders in the municipal securities market (i.e., taxpayers, public pension plans and others who produce, consume and must pay for infrastructure and municipal services) and risks other than investor risk of loss (e.g., risks associated that taxpayers and others may incur when an issuer seeks to avoid default, such as tax increases and spending or budget cuts), they have not traditionally been the focus of robust scrutiny under the federal securities law regulatory regime, except as an issue of investor disclosure.

There are at least two reasons why municipal securities regulation has focused on the issuer-investor relationship and investor risk of loss as key regulatory concerns. First, as is the case with securities regulation generally, municipal securities regulation has an investor protection mandate, which it has addressed by focusing on the timeliness and adequacy of investor disclosure, and by policing conflicts of interest which might cause stakeholders to put their own interests before those of issuers or investors. Second, for a

\(^1\) See MSRB Rule G-17 (“In the conduct of its municipal securities or municipal advisory activities, each broker, dealer, municipal securities dealer, and municipal advisor shall deal fairly with all persons and shall not engage in any deceptive, dishonest, or unfair practice.”), available at http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G-17.aspx?tab=1. See MSRB, Reminder Notice on Fair Practice Duties to Issuers of Municipal Securities (“The MSRB is publishing this notice to remind dealers that the fair practice requirements of Rule G-17 . . . apply to their municipal securities activities with issuers of municipal securities. Thus, the rule requires dealers to deal fairly with issuers in connection with all aspects of the underwriting of their municipal securities, including representations regarding investors made by the dealer. . . . Whether or not an underwriter had dealt fairly with an issuer is dependent upon the facts and circumstances of an underwriting . . .”) (September 29, 2009), available at http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G-17.aspx?tab=2#.D30F9C81-9802-432A-8C30-743C355D613D; Rules and Interpretations, Rule G-17, Purchase of a new issue from issuer (G-17 “requires dealers to deal fairly with issuers in connection with the underwriting of their municipal securities”) (December 1, 1997), available at http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G-17.aspx?tab=3#.73476ED0-CCA6-4A9B-88F0-6278466BB60D; MSRB, Rule G-20, Gifts, Gratuities and Non-Cash Compensation, Dealer Payments In Connection With the Municipal Securities Issuance Process (Reminding brokers, dealers and municipal securities dealers of the application of Rule G-20 (on gifts, gratuities and non-cash compensation) and Rule G-17 (fair dealing) in connection with payments made and expenses reimbursed during the municipal bond issuance process) (January 29, 2007), available at (http://www.msrb.org/Rules-and-Interpretations/MSRB-Rules/General/Rule-G-20.aspx?tab=2#.25ADDCBA-D952-4FD1-856F-349324EE3CE6

variety of reasons, the regulatory regime applicable to municipal securities is less robust than its corporate securities counterparty, at least with respect to registration and disclosure. Concerned about the investor-protection implications of the less-robust regulatory regime in the municipal securities market, and mindful of the strictures imposed by federal law (which are described below), the Commission understandably has focused its attention on improving the quality and timeliness of investor disclosure as a key regulatory goal.

A. The Development of the Current Regime

Almost one hundred years ago, when Congress enacted Section 3(a)(2) of the Securities Act of 1933, it exempted municipal securities from the registration, disclosure and periodic reporting requirements applicable to publicly-traded corporate securities. As a historical matter, this exemption has been attributed to principles of comity, the power of the local government and Wall Street lobbies, concerns about cost, the financial expertise of the institutional investors who then dominated the ranks of purchasers, and the lack of perceived abuses as compared to the market for corporate securities. As a

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183 See U.S.C. §77c(a)(2)(2000). The statute provides, in relevant part, that. “[e]xcept as hereinafter expressly provided, the provisions of this title [15 U.S.C. §§17a et seq.] shall not apply to . . . [a]ny security issued or guaranteed by the United States or any territory thereof, or by the District of Columbia, or by any State of the United States, or by any political subdivision of a State or Territory, or by any public instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States.” For a discussion of the As noted, this exemption has been attributed to principles of comity, the power of the local government and municipal securities industry lobbies, and a belief that requiring municipal securities issuers to comply with the registration and disclosure requirements applicable to publicly-traded corporate securities would be expensive and unduly burdensome.

184 15 U.S.C. §77c(a)(2)(2000). The statute provides, in relevant part, that. “[e]xcept as hereinafter expressly provided, the provisions of this title [15 U.S.C. §§17a et seq.] shall not apply to . . . [a]ny security issued or guaranteed by the United States or any territory thereof, or by the District of Columbia, or by any State of the United States, or by any political subdivision of a State or Territory, or by any public instrumentality of the Government of the United States pursuant to authority granted by the Congress of the United States.” For a discussion of the As noted, this exemption has been attributed to principles of comity, the power of the local government and municipal securities industry lobbies, and a belief that requiring municipal securities issuers to comply with the registration and disclosure requirements applicable to publicly-traded corporate securities would be expensive and unduly burdensome. See, e.g., Joel Seligman, The Transformation of Wall Street 187 (1982) (“During the Roosevelt administration, no business lobby proved nearly as effective against the SEC as the nation’s municipal securities issuers and municipal securities dealers. Strengthened by the appearance of defending local government, not big business, with political allies in both parties and almost every state, the municipal securities lobby was able to wrest exemption from the 1933 Securities Act and the 1934 Securities Act. . . .”) According to Seligman, James Landis noted in a letter written several years later that “the mayors of our various cities rose up en masse when we tried to bring the issuance of municipal securities under the 1933 Act.” Id. at 65. See also Hearings on S. Res. 84,
practical matter, the exemption meant that the distribution of municipal securities was essentially unregulated for almost fifty years, save for the antifraud provisions of the federal securities laws.

B. *Crises-Driven Regulatory Reform Target Investor Disclosure and Registration and Regulation of Industry Professionals*

It was not until 1975, after New York City nearly defaulted on $600 billion of outstanding bonds, that Congress took its first steps towards federal regulation of the municipal securities market.\(^{185}\) At that time, through a series of reforms to the federal securities laws, Congress created the Municipal Securities Rating Board ("MSRB"), a new self-regulatory organization charged with establishing fair practices and conduct rules for firms and individuals involved in the underwriting, trading and selling of municipal securities.\(^{186}\) Congress also required the Commission to provide for the registration of a municipal securities brokers and dealers. In deference to the exempt status of municipal securities (and to protect issuers from direct regulation under

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principles of comity), 187 Congress also enacted the so-called Tower Amendment at this time. 188 The Tower Amendment, which still exists today, prohibits the Commission and the MSRB from requiring any municipal securities issuer to make any disclosure filings with the Commission or the MSRB prior to the sale of securities, and also prohibits the MSRB from requiring any municipal issuer to provide pre-issuance disclosure documents to purchasers and prospective purchasers. 189

With the Tower Amendment in place, the issue of investor disclosure did not come up again until 1989, after the Washington Public Power Supply System (“WPPSS”) defaulted on $2.25 billion of bonds issued to fund the construction of nuclear power plants. 190 Mindful of Section 3(a)(2) and the Tower Amendment’s proscriptions, neither Congress nor the Commission imposed disclosure obligations directly upon municipal securities issuers in the wake of the WPPSS default. 191 Instead, the Commission adopted Rule 15c2-12 pursuant to its authority to adopt rules to deter fraud and manipulation in

187 During the New York City bond crisis, two bills were introduced in Congress which would have imposed disclosure requirements directly upon issuers. S. 2574, 94th Cong., (1975); S. 2969, 94th Cong., 1976). For a discussion of these bills, see Ann Judith Gellis, supra note 18, at 65, 75—77. Neither passed.


191 Together with the Section 3(a)(2) exemption, the Tower Amendment forms the basis of the regulatory regime applicable to municipal securities. Based upon these provisions, the Commission has imposed disclosure obligations (and other obligations concerning market practices and procedures) upon municipal securities dealers rather than directly upon issuers. To the extent municipal securities issuers have any disclosure obligations, such obligations are indirect and derive from the Commission’s authority under the antifraud provisions of the federal securities laws. See, e.g., Municipal Securities Disclosure, Exchange Act Rel. No. 26,985 (July 10, 1989); Municipal Securities Disclosure, Exchange Act Rel. No. 33,742 (March 17, 1994); Municipal Securities Disclosure, Exchange Act Rel. No. 34,961 (Nov. 10, 1994). These releases, which were issued simultaneously with the adoption and (later) reform of Rule 15c2-12, reflect the Commission’s views with respect to the disclosure obligations of participants in the municipal securities market. As these releases reflect, the Commission has expressed the view that issuers are subject to the antifraud provisions of the federal securities laws, including Sections 10(b) and 15(c) of the Securities Exchange Act of 1934. See 15 U.S.C. §§ 78(b), 78(c).
the municipal securities market.\footnote{Specifically, the Commission adopted Rule 15c2-12 pursuant to its authority under Section 15(c)(2) of the ’34 Act to enact rules designed to deter fraud and manipulation in the municipal securities market. Exchange Act Release No. 26985, 54 Fed. Reg. 28799 (June 28, 1989).} As originally adopted, Rule 15c2-12 required underwriters participating in primary offerings of municipal securities to obtain, review and distribute to investors copies of issuers’ official statement (a type of disclosure document).\footnote{Specifically, Rule 15c2-12 required underwriters in a primary offering of municipal securities to: (i) obtain and review a copy of an official statement deemed final by an issuer of securities, except for the omission of specified information; (ii) in non-competitively bid offerings, to make available, upon request, the most recent preliminary official statement, if any; (iii) to contract with the issuer, or its agent, to receive within specified time periods sufficient copies of the issuer’s final official statement, both to comply with Rule 15c2-12 and any rules of the MSRB; and (iv) to provide, for a specified period of time, copies final official statements to any potential customer upon request. See generally id.} In a companion statement issued with Rule 15c2-12, the Commission discussed the due diligence obligations of municipal underwriters, including the obligation to review the issuer’s official statement.\footnote{See generally id.}

information repositories. The 1994 amendments also prohibit a broker, dealer or municipal securities dealer from recommending the purchase or sale of a municipal security unless it has procedures in place that provide reasonable assurance that it will receive promptly any event notices with respect to that security.

In May 2010, in response to continuing concerns about the quality and timeliness of disclosure, the Commission adopted amendments to Rule 15c-12 to require broker-dealers and municipal securities dealers to provide additional disclosure with respect to certain issuer events. The amendments also revised (and largely eliminated) an exemption to Rule 15c2-12 for municipal securities with put features, such as variable rate demand obligations. In conjunction with these amendments, the Commission issued additional interpretive guidance reminding underwriters of their obligations under the antifraud provisions, particularly in cases where a municipal issuer fails to comply with agreements to provide continuing disclosure documents.

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197 17 C.F.R. §§ 240.15c2-12(b)(5)(i)(A), 240.15c2-12(b)(5)(i)(C). See also Exchange Act Rel. No. 34961, 57 S.E.C. Docket 2641 (Nov. 10, 1999). Under the 1994 amendments, disclosure was required in eleven situations, if material: (1) principal and interest payment delinquencies; (2) non-payment related defaults; (3) unscheduled draws on debt service reserves reflecting financial difficulties; (4) unscheduled draws on credit enhancements reflecting financial difficulties; (5) Substitution of credit or liquidity providers, or their failure to perform; (6) adverse tax opinions or events affecting the tax-exempt status of security; (7) modifications to rights of security holders; (8) bond calls; (9) defeasances; (10) release, substitution, or sale of property securing repayment of securities; and (11) ratings change. See 17 C.F.R. §240.15c2-12 (2001). That same year, the Commission also issued interpretive guidance concerning the disclosure obligations of municipal bond market participants under the antifraud provisions of the ’33 and ’34 Act.

198 17 C.F.R. § 240.15c2-12(c). In 2009, the Commission further amended Rule 15c2-12 to provide for a single centralized repository— the MSRB, through a system now known as EMMA, or Electronic Municipal Market Access – for information about municipal securities trading in secondary markets. 17 C.F.R. § 240.15c2-12(b)(5)(i)

199 Specifically, the 2010 amendments require a broker, dealer, or municipal securities dealer to reasonably determine that an issuer or obligated person has agreed to provide notice of specified events in a timely manner not in excess of ten business days after the event’s occurrence. See 17 C.F.R. § 240.15c2-12(c). See generally Exchange Act Rel. No. 62184A, 2010 WL 2149496 (May 26, 2010).

200 See 17 C.F.R. § 240.15c2-12(d)(5).

201 The interpretive guidance provides, in relevant part, that, “[t]he Commission believes that if the underwriter finds that the issuer or obligated person has on multiple occasions during the previous five years failed to provide on a timely basis continuing disclosure documents, including event notices and failure to file notices, as required in continuing disclosure agreements for prior offerings, it would be very difficult for the underwriter to make a reasonable determination that the issuer or obligated person would provide such information under a continuing disclosure agreement in connection with a subsequent offering. In the Commission’s view, it is also doubtful that an underwriter could meet the reasonable belief standard without the underwriter
and other reforms over the years, Commission Staff have expressed the view that the Commission has reached at the outer reaches of its rule-making authority under 15c2-12.\(^\text{202}\)

C. **Dodd-Frank**

Although most of the ink spilled over the Dodd-Frank Wall Street Reform and Consumer Protection Act (“the Act”) has related to high-profile topics such as derivatives and hedge fund regulation, and the establishment of the new Consumer Financial Protection Bureau, the Act includes some potentially important reforms for the municipal securities market. For my purposes, some of the most important of these reforms relate to the scope and mission of the MSRB, and regulation of municipal advisors.

With respect to the MSRB, Section 975 of Dodd-Frank broadened the MSRB’s mission specifically to include the protection of state and local issuers and public pension plans and others whose credit stands behind municipal bonds.\(^\text{203}\) While the MSRB had previously issued interpretive releases stating that brokers, dealers and municipal securities dealers are bound by MSRB G-17’s good faith and fair dealing requirements in their dealings with municipal securities issuers, pre-Dodd Frank guidance had not specifically addressed whether and how these obligations might related to taxpayers and other similarly situated stakeholders. Post Dodd-Frank, the MSRB cited its expanded mission in a number of proposed rules and interpretative notices that speak directly to the protection of issuers and other non-investor constituencies who back-stop issuers’ credit.\(^\text{204}\)

For example, in August 2011, the MSRB filed a proposed rule change consisting of a proposed interpretive notice with the Commission concerning the application of G-17 to underwriting activities.\(^\text{205}\) That proposal, as amended, would require certain underwriters

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\(^\text{203}\) See, e.g., Section 15B of the Securities Exchange Act, as revised by Dodd-Frank (“(2) The Board shall propose and adopt rules to effect the purposes of this title with respect to transactions in municipal securities effected by brokers, dealers, and municipal securities dealers and advice provided to or on behalf of municipal entities or obligated persons by brokers, dealers, municipal securities dealers, and municipal advisors with respect to municipal financial products, the issuance of municipal securities, and solicitations of municipal entities or obligated persons undertaken by brokers, dealers, municipal securities dealers, and municipal advisors.”) See also http://msrb.org/Rules-and-Interpretations/Regulatory-Notices/2010/2010-42.aspx.

\(^\text{204}\) See notes 200-201 and pp. 45 below.

\(^\text{205}\) See MSRB Notice 2011-36 (August 2, 2011).
recommending complex municipal securities financing (e.g., VRDOs with a swap) to disclose all material risks, characteristics, incentives and conflicts of interest to the issuer in a manner sufficient to allow the issuer to assess risks and potential costs ex ante.  

Earlier this year, the Commission instituted proceedings to determine whether to disapprove this proposed rule change. These proceedings remain pending at this time.

With respect to municipal advisors, Dodd-Frank contains important new registration and fiduciary duty requirements. Municipal advisors are a type of financial intermediary that issuers retain for advice regarding the timing and terms of securities offerings and/or purchases. While many municipal advisors are skilled, competent professionals, Commission Staff have long expressed concerns about unethical and/or incompetent unregistered municipal financial advisors. With these concerns in mind, Dodd-Frank makes three important changes to the regulatory regime.

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Securities and Exchange Commission, Order Instituting Proceedings to Determine Whether to Disapprove Proposed Rule Change, as Modified by Amendment No. 2, Consisting of Interpretive Notice Concerning the Application of MSRB G-17 to Underwriters of Municipal Securities (December 8, 2011).

Although the precise reach and scope of Dodd-Frank’s definition of and registration requirement for municipal advisors is the subject of ongoing rule-making, the MSRB has stated that the term municipal advisor, “includes include a variety of different types of firms and individuals that provide advice to state and local governments and other municipal entities, as well as to certain private beneficiaries of municipal bond issues (such as hospitals, colleges and other obligated persons), on a range of municipal securities or investment-related matters.” See MSRB, How the Market Works, Regulation of Municipal Advisors, available at http://www.msrb.org/Municipal-Bond-Market/How-the-Market-Works.aspx. Also according to the MSRB, “[m]unicipal advisors include financial advisors that provide advice to issuers and obligated persons regarding municipal bond offerings, swap advisors that provide municipal entities with advice in connection with derivatives transactions, and brokers and other advisors that provide advice or assistance to issuers regarding guaranteed investment contracts or the investment of municipal bond proceeds.”

Municipal advisors also include firms and individuals that solicit business from municipal entities on behalf of broker-dealers, banks, other municipal advisors or investment advisers to secure certain types of investment banking, financial advisory or investment advisory work with municipal entities, such as public pension funds, 529 plans, local government investment pools and other state and local governmental entities or funds. These municipal advisors are sometimes referred as consultants, third-party marketers, placement agents, solicitors or finders.

First, Dodd-Frank provides for the first time that anyone who acts as a municipal advisor must register. The Act defines municipal advisor broadly to include any person who “provides advice to or on behalf of a municipal entity . . . with respect to municipal financial products or the issuance of municipal securities, including advice with respect to the structure, timing, terms and other similar matters concerning such financial products or issues, or undertakes solicitation of a municipal entity.” The Commission has a temporary rule in place concerning the registration requirement for municipal securities, and has proposed a permanent rule.

Second, Dodd-Frank provides for the first time that municipal advisors and their associated persons “shall be deemed to have a fiduciary duty” to any advised municipal client. To implement this standard, the Act states that municipal advisors may not engage “in any act, practice, or course of business which is not consistent with the municipal advisors fiduciary duty or that is in contravention of any rule of the Board [MSRB].” Although the MSRB proposed a rule respecting the fiduciary obligations of municipal advisors, it has withdrawn its proposal until such time as the Commission adopts a permanent definition of the term municipal advisor.

Third, the Act directs the MSRB to promulgate rules governing advice provided to or on behalf of municipal entities relating to municipal financial products, and to set

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210 See Pub. L. No. 111-203, § 975(a)(1)(B), 124 Stat. 1916 (to be codified at 15 U.S.C. § 78o-4). Prior to Dodd-Frank, municipal advisors were not required to register with the Commission so long as they limited their activities “to providing advice as to whether and how a municipality should issue debt securities, including advice with respect to the structure, timing and terms concerning such issue or issues.” See SEC Staff Legal Bulletin No. 11 (2000), available at http://www.sec.gov/interps/legal/slbim11.htm.


professional standards for municipal advisors and test individuals associated with municipal advisors on their proficiency and competency.\textsuperscript{216}

With respect to the Tower Amendment and other controversial issues, Dodd-Frank calls for study rather than immediate reform. For example, Dodd-Frank requires the Government Accountability Office to study the value of enhanced investor disclosure and the repeal of the Tower Amendment’s prohibition of rules which would require issuers to make disclosure. Dodd-Frank also calls for a wide-ranging study of the structure and operation of the municipal securities market, including issues such as price transparency, liquidity and the use of derivatives. Finally, Dodd-Frank requires the GAO to study the role and importance of, and funding sources for, the Government Accounting Standards Board.\textsuperscript{217}

D. Enforcement Programs Target Traditional Vices

Mindful of the limits imposed by the Section 2(a) exemption and the Tower Amendment, both the Securities and Exchange Commission and the Department of Justice have focused on the quality and timeliness of investor disclosure and conflict of interest violations in enforcement actions involving the municipal securities market. The Commission’s 2010 action against the State of New Jersey – the first such action against a state – reflects this focus. On August 18, 2010, the Commission charged the State of New Jersey with securities fraud for allegedly misrepresenting and failing to disclose to investors in billions of dollars worth of municipal bond offerings that it was underfunding the state’s two largest pensions.\textsuperscript{218} According to the Commission, the state of New Jersey offered and sold more than $26 billion of municipal bonds between August 2001 and April 2007 via offering documents which created the false impression that the Teachers’ Pension and Annuity Fund (TPAF) and the Public Employees’ Retirement System (PERS) were being adequately funded, masking the fact that New Jersey was unable to make contributions to either TPAF or PERS without raising taxes, cutting other services or otherwise affecting its budget.\textsuperscript{219}


\textsuperscript{217} Dodd-Frank also reconstituted the MSRB with a majority of independent board-members, expanded the rule-making and information-gathering authority of the MSRB, and requires the MSRB to meet with the SEC and FINRA at least twice a year to share information about rule-making, rule-interpretation, examination and enforcement issues.


\textsuperscript{219} In particular, the Commission found that New Jersey made material misrepresentations and omissions about the underfunding of TPAF and PERS in such bond disclosure documents as preliminary official statements, official statements, and continuing disclosures. Among New
to provide certain present and historical financial information regarding its pension funding in pertinent bond disclosure documents.\textsuperscript{220} New Jersey agreed to settle the case without admitting or denying the Commission’s findings.

The Commission’s 2010 case against Banc of America Securities for alleged bid-rigging likewise focuses on conflict of interest policing and concerns about market integrity.\textsuperscript{221} In its Order, the Commission found that the bidding process used to establish the fair market value for the proceeds of tax-exempt municipal securities offerings was tainted by various undisclosed consultations, agreements, and/or payments.\textsuperscript{222} To settle the Commission’s charges, Bank of America Securities agreed to pay more than $36 million in disgorgement and interest.\textsuperscript{223} In addition, Banc of America Securities and its affiliates agreed to pay another $101 million to other federal and state authorities.\textsuperscript{224}

For example, the Commission found that the state was aware of the underfunding of TPAF and PERS and the potential effects of the underfunding, but did not disclose this information to investors. The Commission also found that the state had no written policies or procedures about the review or update of the bond offering documents and the state did not provide training to its employees about the state's disclosure obligations under accounting standards or the federal securities laws. The Commission found that due to this lack of disclosure training and inadequate procedures for the drafting and review of bond disclosure documents, the state made material misrepresentations to investors and failed to disclose material information regarding TPAF and PERS in bond offering documents. According to the Commission, as a result of these misrepresentations and omissions, New Jersey did not provide investors with information adequate to evaluate the state’s ability to fund the pensions or to assess the impact of the pension funds on the state’s financial condition. \textit{Id.}, at ¶¶ 2, 17-24, 39-43.

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\textsuperscript{222} See \textit{id.}, at ¶¶ 7-11.

\textsuperscript{223} \textit{Id.}\textsuperscript{224} See, e.g., \url{http://www.sec.gov/news/press/2010/2010-239.htm}.\textsuperscript{224}
Part V: Identifying and Addressing Systemic Risk Through a Regime of Securities Regulation

A. The Limits of Private Ordering and General Conduct Standards

Given that taxpayers and other stakeholders appear to face risks and costs precisely because they are likely to be left holding the bag if an issuer is unable or unwilling to default or obtain discharge, one might question whether these risks and costs ought to be addressed through a regime of securities regulation. In other contexts, when investors take on risk, they reduce or mitigate exposure by using other systems (e.g., political systems), private ordering (e.g., contract) or through exit or the threat of exit (e.g., selling, or threatening to sell, one’s investment). Unfortunately, as noted above, taxpayers are poorly positioned to monitor or reduce risks and costs in this fashion.\textsuperscript{225}

With these limitations in mind, I would amend our system of municipal securities regulation to make systemic risks and costs that taxpayers experience subjects of regulatory scrutiny as a matter of the securities laws. Specifically, I would amend the existing regime with the following goals in mind: (i) bring systemic risks and costs associated with low default rates into the regime of securities regulation, including risks and costs associated with tax increases and spending cuts; (ii) incent and/or require stakeholders to implement systems to identify, measure, monitor and address a wider range of systemic risks and costs, including those born by taxpayers and other stakeholders who backstop the credit of municipal securities issuers; (iii) incent and/or require stakeholders to use a wider variety of regulatory tools and techniques to identify, measure, monitor and address a wide range of systemic and risks and costs; and (iv) implement systems to identify, measure, monitor and address the effectiveness of regulatory reforms in the municipal securities market reforms occurring at federal, state and local levels of government, with an eye towards identifying and leveraging lessons learned.

B. Use The Fiduciary Standard To Bring A Wider Range of Risks and Costs Inside The Securities Regulation Regime

As a first step towards these goals, I would amend the regulatory regime to make systemic risks and costs associated with the low default rate in the municipal securities market explicit subjects of regulatory scrutiny. While there are a number of ways this could be accomplished, I would start by expanding the reach of fiduciary standards (and the risk of fiduciary liability) beyond municipal advisors to include (i) underwriters; (ii) state and local government officials involved in municipal securities offerings and related transactions; and (iii) board members of public authorities, special districts and other issuing instrumentalities. Through both regulation (i.e., imposing a fiduciary obligation as a matter of federal law) and best practices guidance, I would require these

constituencies to comply with duties of care and loyalty when considering the benefits, risks and costs of municipal bond offerings and related transactions, considering the interest of taxpayers, public pension plans and others who use and pay for municipal services, and whose credit ultimately backs up the issuer and any issuance.

In adopting and implementing a fiduciary standard, I would pay particular attention to derivatives, especially those (like interest rate swaps) which can subject issuers, taxpayers and other stakeholders to interest rate volatility.\(^{226}\) Even under the best of circumstances, derivatives transactions involve costs and risks that may not be immediately apparent to all stakeholders. And, as discussed above, because municipal securities issuers cannot easily generate additional revenue should payment obligations spike, municipal issuers and their taxpayers and other stakeholders may be particularly vulnerable to risks and costs associated with derivatives, especially those with interest rate risk. While I would not, without additional evidence, recommend an outright ban on derivatives in the municipal securities market, I would require stakeholders subject to fiduciary obligations to take a hard look at derivatives transactions before they take place, to ensure that such transactions really are in the best interest of the issuer and its taxpayers, both short and long term.

Among other topics, a hard look ought to involve (i) careful consideration of material financial characteristics and material risks of the proposed financing, including any market, credit operational and/or liquidity risks; (ii) careful consideration of fees charged by the swaps provider as well any incentive fees paid to the provider in exchange for recommending the financing; (iii) careful consideration of the impact of termination, including any termination fees; (iii) careful consideration of the potential impact of the transaction on the municipal issuer’s overall economic condition, defined broadly to include an analysis of the likelihood that the issuer will meet its financial obligations to creditors, consumers, employees, taxpayers, suppliers, constituents and others as they become due and its service obligations to constituents both currently and in the future.\(^{227}\)

Underwriters might object to a fiduciary standard on the grounds that they are already subject to good faith and fair dealing rules under MSRB Rule G-17, and because they already owe duties to both issuers and investors under federal securities laws and

\(^{226}\) The notion that derivatives (including interest rate swaps) involve risks for municipal issuers may underlie a recent resolution adopted by the National Association of State Treasurers. See National Association of State Treasurers, Resolution Offering the Positions of the National Association of State Treasurers with Respect to the Transparency of Interest Rate Swap Transactions, Registration and Regulation of Financial Advisors and Swap Advisors, Regulation and Transparency of Credit Default Swaps and Related Issues http://www.nast.net/resolutions/10/Interest_rate_swaps.pdf (August 24, 2010).

\(^{227}\) In recently-issued proposed interpretive guidance, the MSRB suggested that questions such as these may be relevant to disclosure obligations. See, e.g., Securities and Exchange Commission, Order Instituting Proceedings to Determine Whether to Disapprove Proposed Rule Change, as Modified by Amendment No. 2, Consisting of Interpretive Notice Concerning the Application of MSRB G-17 to Underwriters of Municipal Securities (December 8, 2001).
regulation. In this regard, underwriters are likely to point that they were specifically exempted from the definition of municipal advisors (and thus the fiduciary standard applicable to municipal advisors) under Dodd-Frank.\textsuperscript{228} Post Dodd-Frank, the MSRB has reaffirmed the application of good faith and fair dealing rules, and proposed that underwriters be required to disclose their non-fiduciary status to issuers.\textsuperscript{229}

While I have no quarrel with the MSRB’s efforts, I am not convinced that disclosing non-fiduciary status will have a meaningful effect on issuer decision-making, largely because a growing body of research has questioned the effectiveness of the “empower and educate” approach to regulation.\textsuperscript{230} Instead of relying solely upon disclosure, I would enhance underwriter’s obligations using the fiduciary standard so that underwriters would be required to put municipal entities’ interests before their own and to comply with duties of care and loyalty when dealing with a municipal entity. In this regard, I would specifically require brokers, dealers and municipal securities dealers acting as derivatives provider (e.g., swaps provider) to comply with fiduciary obligations with respect to those transactions. In addition, drawing upon Delaware corporate law jurisprudence, I would subject transactions involving interest rate swaps and other potentially volatile derivatives review and scrutiny under an “entire fairness” standard.\textsuperscript{231} In particular, I would require

\textsuperscript{228} Underwriters are excluded from the definition of municipal advisors set forth in Dodd-Frank. (Specifically, the term municipal advisor excludes any individual who is a municipal entity or an employee of a municipal entity, a broker, dealer, or municipal securities dealer serving as an underwriter (as defined in section 2(a)(11) of the Securities Act of 1933) (15 U.S.C. 77b(a)(11)). Post Dodd-Frank, the MSRB has proposed rule changes which would emphasize, and require underwriters specifically to disclose, that they are not subject to fiduciary duties in their dealings with issuers. Specifically, the MSRB issued proposed guidance which would require underwriters to make certain disclosures concerning the underwriter’s role of issuers, including disclosures which make it clear that underwriters do not owe fiduciary duties to issuers and are thus not required by federal law to act in the issuer’s best interest without regard to the underwriter’s own financial or other interests. See Securities Exchange Act Release No. 65263 (September 6, 2011), 76 FR 55989.


\textsuperscript{230} See, e.g., http://www.econ2.jhu.edu/seminars/elyLectures/2006/empowerment_and_education.pdf

\textsuperscript{231} Under Delaware law, when a controlling shareholder stands on both sides of a transaction, the shareholder must “demonstrate their utmost good faith and the most scrupulous inherent fairness of the bargain.” See Weinberger v. UOP, Inc., 457 A.2d 701, 710 (Del. 1983) (citation omitted). As explained by the Delaware Supreme Court, this standard embraces both fair dealing and fair price. Id. at 710-11. Fair dealing in this “embraces questions of when the transaction was timed, how it was initiated, structured, negotiated, disclosed to the directors, and how the approvals of the directors and the stockholders were obtained,” and fair price “relates to the economic and financial considerations of the proposed merger, including all relevant factors: assets, market
provider to demonstrate that proposed derivatives transactions were entirely fair to the municipal entity, thus requiring the provider to demonstrate that the transaction was the product of fair dealing, that the price is fair, and that doing the transaction it is in the best interest of the issuer, considering benefits, risks and costs.\(^{232}\)

Critics of a fiduciary standard for derivatives providers, and an “entire fairness” standard for derivatives provider/issuer transactions, might argue that it is not tenable – or fair – to require providers to put issuers’ interests before their own in the context of what is otherwise an arm’s length transaction. While this argument has force, it is important to remember that derivatives transactions in the municipal securities market implicate public money – and issuers who cannot easily raise revenues, cut costs and/or go out of business to generate money to pay fees. Moreover, providers are more likely than issuers to be sophisticated and experienced players in the derivatives market, and to have the resources to devote to education and an entire fairness review. Given the amount of money involved, and the risks and costs that communities face as a result of these products, requiring derivatives providers to satisfy fiduciary obligations and an entire fairness standard may not be an undue burden.

With respect to public officials and authority board members, critics of my proposal might argue that a fiduciary standard is unnecessary because these constituencies may already be subject to conduct standards and liability rules under other substantive law.\(^{233}\) While it is true that other bodies of substantive law may be implicated, there are benefits to standardizing and formalizing the application of a fiduciary standard, and to requiring those in charge of securities offerings to consider impacts upon communities. Impact on community would have to be part of the conversation. More broadly, public officials would be required to comply with duties of care and loyalty – something that does not always happen now, despite best intentions.\(^{234}\) Both regulator and non-regulator

value, earnings, future prospects, and any other elements that affect the intrinsic or inherent value of a company’s stock.” Id.

\(^{232}\) In Lynch v. Kahn, the Delaware Supreme Court held that while controlling stockholders can never escape entire fairness review, they may shift the burden of persuasion by showing that the transaction was approved either by an independent board majority (or in the alternative, a special committee of independent directors) or, if certain conditions are met, by an informed vote of the majority of the minority shareholders. See Kahn v. Lynch Commc’n Sys., Inc., 638 A.2d 1110, 1117 (Del. 1994).


\(^{234}\) For example, Commission Staff have observed that public officials have on occasion failed to act with a high degree of diligence with respect to disclosure of issuer financial information. See Report of Investigation in the Matter of Orange, California as it Relates to the Conduct of the Members of the Board of Supervisors, Exchange Act Release No. 36761 (January 24, 1996) (“The Supervisors . . . had a duty of take steps appropriate under the circumstances to ensure
resources could be tapped to develop requirements and best practices guidance. In this regard, organizations like the Governmental Accounting Standards Board\textsuperscript{235} and the Government Finance Officers Association\textsuperscript{236} have already developed best practices respecting many “hot button” issues relating to the municipal securities market. Reforms respecting the fiduciary standard already in place at the state level could be mined, and if useful, applied in other jurisdictions. Finally, imposing a fiduciary standard might trigger discussion over whether public officials are entitled to presumptions similar to those available under the business judgment rule, whether and to what extent taxpayers or others ought to be able to sue officials or board members (given potential issues associated with immunity, for example) and over whether there ought to be a more robust insurance market for those serving in roles with fiduciary duty liability risk. These discussions might trigger a more thoughtful review of risks and costs associated with municipal funding plans.

\textbf{C. Require Risk Tracking and Monitoring Systems}

As a second step, I would amend the existing regime to require stakeholders to identify and track a wider range of risks and costs, including risks and costs experienced by taxpayers, pension plans and other stakeholders whose credit backs municipal bond offerings, and risks and costs associated with the use of derivative products in the municipal securities market. Outside the municipal securities market, regulators are using a variety of tools and techniques to address systemic risk, including enhanced oversight over certain products (e.g., OTC derivatives) and actors (e.g., hedge funds), and stress testing and methods of assessing the adequacy of capital reserves.\textsuperscript{237} I would import techniques or systemic risk management into the municipal securities market so that risks and costs associated with low default rates can be measured and tracked.

\begin{footnotesize}
\begin{enumerate}
\item See http://www.gasb.org/
\item See http://www.gfoa.org/index.php?option=com_content\&task=view\&id=118\&Itemid=130
\item E.g., For results of the latest round of stress tests, see, e.g., http://www.reuters.com/article/2012/03/13/usa-banks-stresstests-idUSL2E8EDK4820120313
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For example, I would require issuers and regulators to develop standardized means of assessing municipal issuers financial condition and “stress testing” at least some municipal issuers. While the data, means and methods for stress testing municipal issuers would differ from those applied to large banks, it would be useful to identify a cross-section of systemically important and/or representative municipal securities issuers, and assess whether those issuers are well-positioned to survive a financial storm. Such data might help regulators and issuers develop best practices respecting levels of indebtedness and the use of derivative products, and might help regulators and issuers identify “red flags” before default occurs.

D. Implement Systems To Test the Efficacy of Reforms.

Finally, I would amend the regime to require reporting and testing of reforms. For example, focusing on the new fiduciary standard for municipal advisors and state experience with the fiduciary standard, I would test whether fiduciary-obligated intermediaries are more less like to recommend (i) financial derivatives or other complex structured products (versus simpler products) or (ii) negotiated or competitively bid underwriting relationships. We also may be able to study whether using a fiduciary-obligated financial advisor impacts the size and/or cost of the offering for the issuer, the use and/or terms of credit enhancement, and the likelihood that an issuer uses

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238 It is worth noting that under Section § 975(b)(5) of Dodd-Frank, the MSRB is directed to meet with the SEC and FINRA at least twice a year to share information about the interpretation of MSRB rules and examination and enforcement of compliance with such rules. Pub. L. No. 111-203, § 975(b)(5), 124 Stat. 1920 (to be codified at 15 U.S.C. § 78o-4)

239 One 2004 study found that high-quality bonds with simple terms are the cheapest bonds to trade, and opined that investors, and perhaps ultimately issuers, could benefit if issuers issued simpler bonds. Lawrence Harris, Michael S. Piwowar, Municipal Bond Liquidity, CITE (February 9, 2004).


241 In this regard, we may wish to study whether a fiduciary-obligated intermediary helps issuers (and/or investors) reduce information asymmetries, and/or provides a certification effect. In this regard, one study found that issuers who used more prestigious underwriters incurred significantly lower borrowing costs. See Kenneth N. Daniels & Jayaraman Vijayakumar, Does Underwriter Reputation Matter in the Municipal Bonds Market?, 59 J. OF ECON. & BUS. 500, 507—08 (2007), (“[W]e believe that the more prestigious underwriters can help municipal issuers alleviate their information asymmetries better . . . [and] could also lead to a certification effect in the municipal market also for the issues underwritten by them.”). Other factors that we may wish to study include debt-maturity decision-making. See Kenneth Daniels, D.D. Ejara, Jayaraman Vijayakumar, Debt Maturity, Credit Risk, and Information Assymetry: The Case of Municipal Bonds, 45 FIN. REV. 603 (2010).

242 Prior to the economic downturn, credit enhancement (in the form of bond insurance and other forms of guarantee) had become commonplace in the municipal securities market. The authors
generally accepted accounting principles (or their equivalent), or less rigorous forms of financial reporting. Certainly, there will be limits to data obtained from the municipal securities markets. Differences in risk characteristics, market liquidity and information asymmetries and many other factors will need to be accounted for when trying to apply lessons learned from the municipal securities markets to other market participants and segments. Even with these limitations, however, the opportunity to see what happens when we deploy the fiduciary standard against a new class of financial intermediary is one that we should not waste. When developing testing and monitoring systems, we would do well to examine reforms that have occurred, and are now occurring at the state and local level. For example, in New York, authority board members are already subject to fiduciary obligations. Reforms such as this could be examined, and lessons learned could be implemented across the market as a whole.

At the end of the day, if stakeholders responsible for designing and implementing financing plans for municipal securities are to serve as a bulwark against bad decision-making, toxic products or any number of other potential costs or risks, we may want to give them a regulatory structure, and the regulatory tools necessary, to address systemic risks and costs present in the market – not just a subset of risks and costs experienced by investors when default rates are low. It may be that we need to implement new, highly-

of one recent study found that prior to the crash, issuers used credit enhancement to undue corruption penalties associated with issuer misconduct. See Alexander Butler, Larry Fauver, & Sandra Mortal, Corruption, Political Connections, and Municipal Finance, 22 Rev. Fin. Stud. 2873 (2009). This study found that although “corrupt” states paid significantly higher yields to maturity on their municipal securities versus less corrupt states, corrupt issuers could essentially undue the effect of any corruption penalty by purchasing credit enhancement. Id.

William Baber, & Angela Gore, Consequences of GAAP Disclosure Regulation Evidence from Municipal Debt Issues, 83 ACCT. REV. 565 (2008) (“As a whole, the results suggest that GAAP disclosure regulation imposed by state governments is associated with lower municipal debt costs.”).

By way of example only, scholars have noted that information asymmetries may be greater in the municipal securities market due to the number of issuers, the regional nature of the market, the prevalence of first time offerings and smaller issuers who are not well-known to investors, the large role played by individual investors, and the relative lack of disclosure compared to corporate securities offerings and transactions. See, e.g., Jun Peng, and Peter F. Brucato, An Empirical Analysis of Market and Institutional Mechanisms for Alleviating Information Asymmetry in the Municipal Bond Market, 28 J. ECON. & Fin. 226 (2004). For other potential differences between the municipal securities and corporate securities markets, See Patrick Hendershott, & David S. Kidwell, The Impact of Relative Security Supplies: A Test With Data From A Regional Tax-Exempt Bonds Market, 10 J. MONEY, CREDIT AND BANKING 337 (1978); Paul A. Leonard, Tax-Induced Segmentation in the Tax exempt Securities Market, 37 Q. J. BUS. & ECON. 27 (1998); Paul A. Leonard, Some Factors Determining Municipal Revenue Bond Interest Costs, 35 J. ECON. & BUS. 71 (1983); David S. Kidwell, Timothy W. Koch, & Duane R. Stock, Issue Size and Term Structure Segmentation Effects on Regional Differentials in the Municipal Bond Market, 39 J. ECON. & BUS. 339 (1987); Robert Lamb, & Stephen Rappaport, MUNICIPAL BONDS (2nd ed. 1987).
specific educational, training, testing and/or licensing requirements for certain stakeholders, particularly if they deal in complex financial instruments. Perhaps we also need to rethink due diligence standards for complex financial instruments, particularly with respect to risks and costs that may arise over the life of the instrument. More generally, we may need to consider how best to incorporate insights derived from other markets and other regimes into a risk-management regime for the municipal securities market. In any event, I think we owe it to taxpayers and other stakeholders who must pay for financing to consider their risks and costs as matter for regulatory attention under the federal securities laws.