THE MUNICIPAL DISCLOSURE DEBATE

JOEL SELIGMAN*

The default by the Washington Public Power Supply System (WPPSS), after expending $2.25 billion to construct two nuclear power plants, has reinvigorated the debate whether issuers of municipal securities should be subject to a mandatory disclosure system comparable to that which the Securities and Exchange Commission (SEC) administers for corporate issuers.2

The term "municipal securities" is a misnomer. In 1982, only approximately 32% of "municipal" securities were issued by municipalities, townships, counties, or school districts. The other 68% of "municipal securities" were issued by states or special districts and statutory authorities.3 Precisely defined, municipal securities are securities issued by a state, county, or local government or by an authority or district established by a state, county, or local government. The overall municipal market is huge. It has been estimated that 52,000 separate political entities had approximately $450 billion in debt outstanding at the end of 1982. In 1982, there were 9,340 publicly reported new offerings. New offerings of long-term municipal

* Professor of Law at George Washington University, National Law Center. A version of this article was published in J. SELIGMAN, THE SEC AND THE FUTURE OF FINANCE ch. 5 (1985). The research in this article is current through early 1984, with the exception of the material in infra note 75.

1. The WPPSS default currently is under investigation by the SEC, 1933 Securities Act Release No. 6503 (1984), and is the subject of private litigation. See Heil, Another Day Older and Deeper in Debt: Debt Limitation, The Broad Special Fund Doctrine, and WPPSS 4 and 5, 7 U. PUGET SOUND L. REV. 81 (1983). One immediate implication of the default was an increase of 50 to 100 basis points (one-half of one to one percent) in the interest that the state of Washington had to pay in an unrelated $149.9 million general obligation bond sale on August 9, 1983. MBIA letter 2 (Sept. 1983).


3. Specifically, 11% of all municipal securities were issued for states and 57% for special districts and statutory authorities. General Accounting Office, "Trends and Changes in the Municipal Bond Market as They Relate to Financing State and Local Public Infrastructure," Report to the Chairman, Subcomm. on Economic

(647)
securities in that year equalled $77.3 billion. Somewhat in distinction from the overall pattern of ownership of corporate securities, in recent years the percentage of municipal securities owned by households (or individuals) has grown (in 1982, to 35.9%); the overall percentage of institutional ownership has slightly declined.

Municipal securities usually are categorized into two general types. First, there are general obligation securities which are backed by the taxing power, or "full faith and credit" of the issuing governmental unit. Second, there are revenue securities which are backed solely by the revenues from a specific project such as a port authority, airport, bridge, or tunnel authority. In recent years, only 25 to 30% of all municipal securities have been "general obligations"; approximately

Stabilization, Comm. on Banking, Housing and Urban Affairs, GAO-PAD 83-46 (Sept. 12, 1983) [hereinafter cited as The GAO]. Special districts and statutory authorities are created by state, county, or local governments to handle specific responsibilities such as water, sanitation, transportation, transit, or housing. Id. at 15.

4. Id. at 2-3. In contrast, in 1982, there were 4,744 securities registered with the SEC which raised a total of $158.328 billion. 48 SEC Ann. Rep. 108 (1982).

5. The GAO, supra note 3, at 20, includes the following table:

<table>
<thead>
<tr>
<th>Year</th>
<th>Commercial</th>
<th>Non-Life</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Banks</td>
<td>Households</td>
</tr>
<tr>
<td>1970</td>
<td>48.6%</td>
<td>31.9%</td>
</tr>
<tr>
<td>1971</td>
<td>51.2</td>
<td>28.5</td>
</tr>
<tr>
<td>1972</td>
<td>51.1</td>
<td>27.4</td>
</tr>
<tr>
<td>1973</td>
<td>50.0</td>
<td>28.0</td>
</tr>
<tr>
<td>1974</td>
<td>48.7</td>
<td>29.8</td>
</tr>
<tr>
<td>1975</td>
<td>46.0</td>
<td>30.4</td>
</tr>
<tr>
<td>1976</td>
<td>44.3</td>
<td>29.3</td>
</tr>
<tr>
<td>1977</td>
<td>43.8</td>
<td>26.7</td>
</tr>
<tr>
<td>1978</td>
<td>43.3</td>
<td>25.0</td>
</tr>
<tr>
<td>1979</td>
<td>42.2</td>
<td>25.8</td>
</tr>
<tr>
<td>1980</td>
<td>41.8</td>
<td>26.5</td>
</tr>
<tr>
<td>1981</td>
<td>39.6</td>
<td>29.5</td>
</tr>
<tr>
<td>1982</td>
<td>34.2</td>
<td>35.9</td>
</tr>
</tbody>
</table>


NOTE: The temporary increase in the "Other" category beginning in 1976 is due to the increase in purchases of bonds by State and local employee retirement systems in the wake of New York City's fiscal crisis. See appendix X for dollar volume figures of outstanding holdings by these investor groups.

Not too much weight should be accorded the slight increase in household ownership in the 1970-81 period. In the 1960-69 decade, household ownership varied from 30 to 44%. S. Rep. No. 94-75, 94th Cong., 1st Sess. 219 (1975).

70 to 75 have been revenue bonds.  

For the purposes of analyzing the need for disclosure legislation, a third type of municipal security, industrial development bonds, should be separately categorized. Industrial Development Bonds (IDBs) are issued by a local government agency to buy or build a facility or to purchase equipment that a private business firm will then buy on installment or lease over periods that typically run from five to thirty years. The business firm will pay a rent that usually is equal to the amount necessary to pay principal and interest on the bonds. Because the only security for the bonds is the revenue from the lease payments paid by the business firm (or the facility leased by the firm), the SEC in 1978 took the position "that industrial development bonds . . . in substance are obligations of a business enterprise" and therefore "are sufficiently distinct from other municipal securities to warrant

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7. The GAO, supra note 3, at 50, included the following table:

<table>
<thead>
<tr>
<th>Year</th>
<th>General Obligation</th>
<th>Revenue Bonds, 1970-82</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Volume</td>
<td>Percent of Total Volume</td>
</tr>
<tr>
<td>1970</td>
<td>$18,082,509</td>
<td>$11,851,771 65.5%</td>
</tr>
<tr>
<td>1971</td>
<td>24,929,963</td>
<td>15,218,492 61.1%</td>
</tr>
<tr>
<td>1972</td>
<td>23,692,402</td>
<td>13,329,018 56.3%</td>
</tr>
<tr>
<td>1973</td>
<td>23,821,477</td>
<td>12,169,799 51.1%</td>
</tr>
<tr>
<td>1974</td>
<td>23,584,809</td>
<td>13,126,341 55.7%</td>
</tr>
<tr>
<td>1975</td>
<td>30,659,442</td>
<td>15,974,335 52.1%</td>
</tr>
<tr>
<td>1976</td>
<td>35,415,683</td>
<td>16,200,098 51.4%</td>
</tr>
<tr>
<td>1977</td>
<td>46,705,686</td>
<td>18,118,339 38.8%</td>
</tr>
<tr>
<td>1978</td>
<td>48,169,731</td>
<td>17,789,591 36.9%</td>
</tr>
<tr>
<td>1979</td>
<td>43,308,907</td>
<td>12,090,955 27.9%</td>
</tr>
<tr>
<td>1980</td>
<td>48,367,802</td>
<td>14,102,312 29.2%</td>
</tr>
<tr>
<td>1981</td>
<td>47,724,616</td>
<td>12,392,648 26.0%</td>
</tr>
<tr>
<td>1982</td>
<td>77,294,339</td>
<td>20,879,301 27.0%</td>
</tr>
</tbody>
</table>

SOURCE: Public Securities Association

For the months January-September 1983, the Public Securities Association reported $62.194 billion worth of municipal securities were sold: 26.36% of total volume was general obligation bonds, 73.64% were revenue bonds. Public Securities Association, "The Municipal Securities Market—Third Quarter 1983" (Nov. 30, 1983) [hereinafter cited as Public Securities Association].
treatment under a separate regulatory framework." IDBs issued in amounts above $10 million are limited by statute to specific purposes such as low-income housing, sports facilities, convention or trade show facilities, or airports, docks, wharves, mass commuting or parking facilities. Small issue IDBs, usually issued in amounts of $10 million or less, have few functional limitations and have been used to finance office buildings, retail stores, shopping centers, recreational, and tourist facilities. In the first six months of 1983, a total of $9.3 billion in IDBs were issued, of which $3.3 billion were small-issue IDBs. Congress currently is considering legislation to further limit the use of IDBs primarily as a means of increasing tax revenues.

Since 1975, issuers of municipal securities may be held liable for fraud in the offer or sale of the security. The 1975 Securities Acts

10. The Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. 97-248, ___ Stat. ___ (1982), eliminated the small issue exemption for bonds issued after December 31, 1982, if: (1) more than 25% of the proceeds of the issue are used to provide a facility whose primary purpose is retail food and beverages, automobile sales, or the provision of entertaining or recreation, or (2) any portion of which is used to provide a golf course, country club, massage parlor, tennis club, skating facility, hot tub or sun tan facility, or race track. See Report, supra note 9, at 369.
14. Before the 1975 Securities Acts Amendments created the current federal framework of municipal securities regulation, § 10(b) of the 1934 Securities Exchange Act was held not to apply to a municipal issuer. In re New York City Mun. Sec. Litig., 507 F. Supp. 169, 181 (S.D.N.Y. 1980). The SEC, however, could conduct an investigation of a city's method of distributing municipal securities. City of Philadelphia v. SEC, 434 F. Supp. 281 (E.D. Pa. 1977), appeal dismissed for want of jurisdiction, 434 U.S. 1003 (1978). Arguably, before the 1975 amendments, a municipal issuer could have been held liable under § 17(a) of the 1933 Securities Act, since § 17(c) provides that the municipal security exemption, § 3(a)(2) "shall not apply to the pro-
Amendments also created the Municipal Securities Rulemaking Board (MSRB), a self-regulatory organization, to adopt rules applicable to municipal securities brokers and dealers. Under the 1934 Act, as amended in 1975, neither the SEC nor the MSRB, however, may "require any issuer of municipal securities . . . to file with the Commission or the Board prior to the sale of such securities by the issuer any application, report or document in connection with the issuance, sale or distribution of such securities." The question addressed by this article is whether there is a need for a municipal securities act.

Opponents of mandatory municipal securities legislation may be expected to urge that the default rate of municipal bonds is lower than the default rate of corporate bonds. Thus, a disclosure statute, it is argued, is not as necessary to protect investors from the risk of default. So far as it goes, this argument is correct in twentieth century experience at least until the WPPSS default. Municipal security default rates


In the 1975 amendments, Congress amended the definition of "person" in § 3(a)(9) of the 1934 Act to clarify that a municipal issuer may be liable under § 10(b) of the 1934 Act. Id. at 475-76. Municipal securities underwriters, broker-dealers, and bond counsel also may be held liable. Id. at 477-81. See also, Note, Federal Regulation of Municipal Securities: Disclosure Requirements and Dual Sovereignty, 86 Yale L.J. 919, 939-46 (1977) [hereinafter cited as Note, Federal Regulation], arguing, "if there are well-defined liability standards, direct SEC regulation of disclosure is unnecessary."


17. In 1932, at the depth of the depression, approximately 1.8% of all municipal bonds were in default compared to 3.5% of railroad bonds, 7.2% of industrial bonds, and 19.4% of foreign bonds. Spiotto, Municipal and Corporate Bonds: Analysis of Defaults and Remedies in J. Spiotto, Bonds Defaults and Remedies (PLI Real Estate Law and Practice Course Handbook Series No. 206) (1982). Throughout the 1930s, some 4,770 municipal units defaulted on approximately 9% of the then outstanding $15 billion of municipal bonds. Spiotto, Municipal Bonds: Defaults and Remedies, Resources in Review (Mar. 1983). In contrast, approximately 30% of corporate bonds, or some $7 billion, defaulted during the early 1930s. Doty & Petersen, The Federal Securities Laws and Transactions in Municipal Securities, 71 NW. L. Rev. 283, 331 (1976) [hereinafter cited as Doty & Petersen]. By the end of the 1930s, past due interest and premium on municipal bonds did not much exceed $100 million; while, in 1944, it was estimated
clearly have been lower than corporate bond default rates. But this hardly obviates the need for a disclosure statute. Municipal securities investors are far more likely to be injured by material misrepresentations or material omissions concerning a municipal security than they are by default. The most common injury to a municipal security investor would occur when a municipal issuer misrepresented data to make the security appear less risky than, in fact, it was, or omitted to state material information concerning the riskiness of the security. In either case, the municipal security initially might earn a higher rating from Moody’s, Standard & Poor’s or other ratings agents18 than it would have received had all material data been published. When subsequently the rating agencies become aware of the material misrepresentation or omissions, they would reduce the municipal security’s rating and this, in all likelihood, would reduce the security’s price.19

The real issue concerning the need for a municipal security’s issuer disclosure statute is the likelihood that investors will be induced to pay too much for municipal securities because of material misrepresentations or omissions. This risk appears to be substantial. The best documented instance concerning fraud by a municipal security issuer is the SEC’s staff report on New York City’s near default in


In the post-world war period, 1945 to 1975, the total dollar volume of municipal bonds that defaulted equalled approximately $500 million, or the equivalent of 0.25% of all municipal bonds outstanding at the beginning of 1975. The permanent loss on municipal debt was considerably less. One study estimated a permanent loss of only $10 million for the 1945-1965 period, equal to 1/100th of 1% of the debt outstanding at the end of 1965. Doty & Petersen, supra, at 331-32; R. Forbes & J. Petersen, supra, at 114-15; and J. Petersen, supra at 110-11.

The default rate for corporate bonds equalled approximately 0.4% during the 1940s; 0.4% in the 1950s; 0.05% in the 1960s; and 0.2% in the 1970s. The default rate has been higher during the 1980s. Between 1966 and 1977, approximately $2.5 billion in principal amount of corporate bonds went into default. In 1982 alone, over $1 billion of corporate bonds went into default. J. Spiotto, Municipal Defaults and Bankruptcy: Myth and Reality, Address to the 77th Annual Municipal Finance Officers Association Conference 2-3 (June 13, 1983).

18. The rating agencies are discussed infra notes 46-56 and accompanying text.

19. For example, for the first nine months of 1983, the average yield on a one-year maturity Moody’s AAA General Obligation Bond was 4.96%; the average yield on a one-year maturity Moody’s BAA or BAA-1 General Obligation Bond was 5.66%. Public Securities Association, supra note 7. If Moody’s reduced the rating on a one-year maturity AAA General Obligation Bond to a BAA rating, this, on average, would reduce the price of the bond by approximately 12%. See also J. Petersen, supra note 17, at 43-47.
1974-1975. On March 31, 1975, New York City had outstanding debt slightly in excess of $14 billion. The SEC report focused on the sale of approximately $4 billion of this debt, sold in the form of short-term securities during the six months preceding March 31, 1975. After March 1975, New York City was unable to market additional debt securities. By December 1975, prices of some short-term debt securities had declined by 45% from their principal face amount.

It is highly unlikely that the city would have been able to sell the last $4 billion of debt securities with the same interest rate and terms had it not materially distorted its financial position. Systematically, the city overstated its revenue. For example, in October 1976, it was estimated that $963 million of the city's $5.078 billion deficit was attributable to accrued federal and state aid that was not collectible. Another $358 million in city taxes not received in cash was recognized as income but was subsequently written off as uncollectible. Similarly, it was estimated that over 80% of $502 million in real estate taxes listed by the city as receivable was not collectible. At the same time, New York City systematically understated its expenses and liabilities. One major misrepresentation involved the failure to recognize the municipal employee pension expense for a period of two years after the expense was incurred. This two-year lag was solely responsible for the understatement of the city's 1975 cumulative deficit by some $2.167 billion. The city also delayed recognizing expenses which by June 30, 1975 totaled $365 million, employing, among other contrivances, the charging of June

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21. Id. at Introduction and Summary 1-2.
22. Id. at ch. 3, 112-38 (including SEC conclusion that New York City did not make material disclosures equal to those required by the federal securities laws); id. at ch. 4, 36-39 & 74 (At 74, the SEC staff report states, "[I]n deed, as one of the underwriters' attorneys stated in April 1975 to the City's principal underwriter, 'the adverse information which would be required in [a disclosure statement] would in all likehood render the City securities unsaleable.'"); id. at Introduction and Summary 4 and ch. 2 & 3 (recognition by City Comptroller Goldin that the city employed unsound accounting practices); and id. at ch. 7 at 2-6 (survey measuring the extent to which investors in the city's securities were misled).
23. Id. at ch. 2, 18-26.
24. Id. at 9-17.
25. Id. at 27-34.
26. Id. at 37 & 49-61. The city also employed mortality assumptions that in some instances overstated the mortality rate by as much as 800%. This was not entirely a surprising result since the mortality assumptions were derived from records of the city experience from 1908-1914. Id. at 53-56.
payroll expenses (the last month of the city’s fiscal year) to July (the first month of the next fiscal year) and by use of a 364 day year.27 In addition, the city charged to its capital budget (used to fund projects such as streets, parks, bridges, tunnels, and other property of a long-term nature) some $722 million in expenses in 1975, and a total of $2.434 billion for the eleven years, 1965-1975.28

Were New York City’s accounting practices exceptional? Considerable evidence suggests that they were not. In 1976, the accounting firm of Coopers & Lybrand published a report entitled “Financial Disclosure Practices of the American Cities.” Among other findings, the report found that 80% of the 46 cities it studied did not disclose the value of their unfunded vested pension liabilities in their annual reports. The Coopers & Lybrand report estimated this liability to exceed $13 billion. Moreover, actuarial studies were made on an annual basis for only 50% of the cities studied. In some cases, actuarial studies had never been made.29 Similarly, 84% of the cities studied did not indicate the accrued cost of vacation and sick leave benefits in their financial statements. The report estimated a total cost of $130 million for accrued vacation and sick leave benefits costs in 7 of the 46 cities studied, further noting, “[T]here is no indication that monies are being set aside to meet such obligations of these or other American cities. The public is not aware of the magnitude of this problem.”30 Some 93% of the cities studied did not disclose the expense or nature of

27. Id. at 37 & 40-45.
28. Id. at 66-70. The immediate impact of the New York City crisis was a general increase in interest rate costs for new municipal issues. The net interest cost increase was estimated to be 0.50% for municipalities in the Northeast and Middle Atlantic Regions and 0.15% elsewhere in the country. See Note, Reform of the Municipal Bond Market: Alternatives to Tax-Exempt Financing, 15 Colum. J.L. & Soc. Prob. 223, 242-43 (1979); Browne & Syron, The Municipal Market Since the New York City Crisis, New Eng. Econ. Rev. (July-Aug. 1979); and Forbes & Petersen, Costs of Credit Erosion in the Municipal Bond Market, MFOA Study No. 1 (Dec. 20, 1975).


30. Id. at 28.
lease commitments in conformity with then operative generally accepted accounting principles.\textsuperscript{31} Almost half of the cities, 46\%, did not explain what methods of accounting were employed in their financial statements. The report concluded, "[O]ur findings indicate a substantial lack of compliance with current generally accepted principles applicable to governmental bodies."\textsuperscript{32} One measure of this lack of compliance cited by Coopers & Lybrand was the Certificates of Conformance awarded by the Municipal Financial Officers Association for compliance with generally accepted accounting principles:

However, the organization issues fewer than 40 Certificates of Conformance each year. In fact, only about 400 such certificates have been issued over the last 30 years. Out of approximately 18,000 municipalities eligible to apply, only about 100 applications are even submitted annually for consideration. This points up the hopelessness of voluntary compliance.\textsuperscript{33}

Coopers and Lybrand's opinion notwithstanding, the primary response of municipal issuers in several congressional hearings\textsuperscript{34} to the disclosure problems illustrated by the New York City crisis was to request that Congress give voluntary disclosure an opportunity to work. With considerable fanfare, the Municipal Financial Officers

\textsuperscript{31} \textit{Id.} at 32.

\textsuperscript{32} \textit{Id.} at 33.


Association (MFOA) in 1976 published Disclosure Guidelines for Offerings of Securities by State and Local Governments. After eight years experience with the MFOA Guidelines, it now is obvious that no matter how wisely drafted the Guidelines may be, municipal issuers will not uniformly voluntarily adhere to the Guidelines or generally accept accounting principles.

The most recent evidence concerning municipal disclosure practices was the 1983 publication of a study conducted by Arthur Young & Company concerning audited financial statements of 557 cities and counties. The study, among other findings, found over one-quarter of all audited statements contained an inadequate accounting or use of an inappropriate basis of valuation of fixed assets. Only in 29% of the statements was there an analysis of debt service requirements. Some 16% of the surveyed governments did not include a statement of revenues and expenditures. Moreover, revenues and expenses were not uniformly categorized as operating or nonoperating. Some 35% of the governmental units studied did not publish a combined statement of changes in financial position. Only about 20% of the units surveyed described in footnotes long-term leases held by the govern-


36. The unlikelihood of municipal issuers voluntarily complying with the Guidelines was noted by Senator Harrison Williams. See 123 Cong. Rec. S. 19262, 19267 (Dec. 1, 1977). Technical criticism of the MFOA Guidelines was made in 1976 by the American Bar Association Committee on State and Local Government’s Subcommittee on Municipal and Governmental Obligations. See Note, Disclosure, supra note 35, at 1035-37. A Government Accounting Standards Board (GASB), similar to the Financial Accounting Standards (FASB), recently was established to promulgate generally accepted accounting principles for municipalities. See Wall Street Journal, Jan. 30, 1984, at 37; and New York Times, Jan. 28, 1984, at 32. Unlike FASB whose promulgations must be followed by corporate auditors, GASB promulgations, like the MFOA Guidelines, will be followed voluntarily.


38. Id. at 17.
39. Id. at 29.
40. Id. at 52-55.
41. Id. at 67.
42. Id. at 131.
ment unit.43 Similarly, only about half of the surveyed governments provided footnotes relating to pension and retirement plans.44 In all, 54% of the opinions rendered by financial auditors concerning these 557 cities and counties were qualified.45

These deficiencies in municipal disclosure also effectively rebut the argument that securities investors will be protected by rating agencies such as Moody's or Standard & Poor's from material misrepresentations or omissions.46 The rating agencies do impose requirements that municipal issuers provide timely financial statements. The agencies mandate that these statements be certified by independent public accountants or by an appropriate state or local auditing agencies and be prepared in accordance with generally accepted accounting principles.47 On payments from the issuer, these agencies will rate municipal debt securities according to a scale beginning with highest ratings of Aaa, Aa, A, to the lowest, more speculative levels, Bb, B, and C level bonds.48 A substantial percentage of new municipal issues are rated, assumedly because they would be more difficult to market if they were not.49 There are significant problems, however, with relying on the rating agencies to protect municipal securities investors from material misrepresentations or omissions. First, while the agencies claim to require issuers to prepare financial statements in accordance with

43. Id. at 154.
44. Id.
45. Id. at 142. The reasons for qualifications varied. See id. at 145.
47. C. Tierney & P. Calder, supra note 37, at 4-5; and R. Lamb & S. Rappaport, supra note 6, at 56-58 & 69 (noting, in 1978, Moody's withdrew ratings on almost 500 small issuers who had not provided current data).
48. R. Lamb & S. Rappaport, supra note 6, at 53-59; and J. Petersen, supra note 17.
49. The SEC Final Report on New York City's Securities stated that as of early 1979 Moody's rated between 3,000 and 3,600 municipal issues per year, representing in dollar amount, approximately 76% of new municipal issues and Standard & Poor's rated approximately 900 municipal issues per year. In re Transactions in the Sec. of the City of N.Y., Fed. Sec. L. Rep. (CCH) at ¶ 81,257. In 1974, J. Petersen, supra note 17, at 4, estimated a total of 90% of municipal bonds, in dollar amount, were rated.
generally accepted accounting principles, they obviously accept qualified financial statements and tremendous variance in what is disclosed in these statements. Unlike the SEC in its regulation of corporate financial statements, the rating agencies cannot impose a comprehensive schedule of material data that must be disclosed by each issuer. Nor can the rating agencies improve the current low quality of the generally accepted municipal accounting principles by promulgating standards similar to those of the SEC.50

Second, the rating agencies perform no auditing function. If they are supplied with materially false information that has been certified by an independent auditor, they usually will assume it is accurate. This is inevitable given the small size of the rating agencies’ staffs.51 One critic went so far as to argue that in light of the number of municipal bonds and the number of rating analysts, the average bond rating should take only twenty seconds.52 This is an exaggeration, but, it is clear, as the SEC observed in its 1977 report on New York City’s securities, that at least in that instance,

both Moody’s and S&P (Standard & Poor’s) failed, in a number of respects, to make either diligent inquiry into data which called for further investigation, or to adjust their ratings of the City’s securities based on known data in a manner consistent with standards upon which prior ratings had been based.53

Only on April 2, 1975, after New York City’s bonds effectively had become unmarketable, did Standard & Poor’s suspend its rating for New York City bonds. The initial response to Moody’s six days later was to reaffirm its ratings of New York City bonds and notes.54 Nor

50. While the payment of a fee by the issuer raises a conflict of interest problem (a point observed by J. Coffee, Market Failure and the Economic Case for a Mandatory Disclosure System, 20-21 (Feb. 16, 1984) (draft manuscript)), this does not appear to be a major concern. A substantial percentage of new municipal issues are rated, assumedly, because they would be more difficult to market if they were not.

51. In 1974, Moody’s and Standard & Poor’s combined employed 26 analysts.

J. PETERSEN, supra note 17, at 92.

52. R. LAMB & S. RAPPAORT, supra note 6, at 51. But see J. PETERSEN, supra note 17, at 85-92.


54. Id. at 28. See also In re Transactions in the Sec. of the City of N.Y., Fed. Sec. L. Rep. (CCH) at ¶ 81,258, emphasizing that even after improvements had been made by the rating agencies in response to the New York City crisis, “the adequacy of procedures employed by such agencies in connection with the assign-
have the rating agencies notably improved the accuracy of their ratings in subsequent years. More recently, the rating agencies gave the WPPSS project ratings of A or AA. In fact, Moody's granted the San Jose School district an AA rating until after it voted to declare bankruptcy in the spring of 1983.\textsuperscript{55} This imprecision of the ratings supplied by Moody's and Standard & Poor's has been widely recognized.\textsuperscript{56} While the agencies generally may be "accurate" in their ratings, the combination of their acceptance of low quality municipal accounting, their inability to audit municipal financial statements, and their inability, given their small staff size, to investigate negative information diligently, means that their ratings alone will not provide investors much greater protection from material misrepresentations or omissions than will audited municipal financial statements.

There is, however, one major change in the institutional context of municipal securities sales that has occurred in the aftermath of the New York City crisis and the WPPSS default. Both events have stimulated a dramatic growth in the sale of municipal bond insurance. While new insured municipal bonds totalled only $63 million in 1974, before the New York City crisis, they increased in 1976, to $903 million. Similarly, the dollar value of insured municipal bonds grew from $2.907 billion in 1981 before the WPPSS default, to $12.1 billion in 1983, after the default.\textsuperscript{57}

Currently over 90\% of municipal bond insurance is written by Municipal Bond Insurance Association (MBIA), a pool of five major insurance companies, and American Municipal Bond Assurance Corporation (AMBAC), whose policies are reinsured by 17 reinsurers.\textsuperscript{58}

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\textsuperscript{55} See J. Petersen, supra note 17, at 3 & 100-04.
\textsuperscript{56} Similarly, the dollar value of insured municipal bonds grew from $2.907 billion in 1981 before the WPPSS default, to $12.1 billion in 1983, after the default.
\textsuperscript{57} Currently over 90\% of municipal bond insurance is written by Municipal Bond Insurance Association (MBIA), a pool of five major insurance companies, and American Municipal Bond Assurance Corporation (AMBAC), whose policies are reinsured by 17 reinsurers.
\textsuperscript{58} In "Investor Memorandum 1983," MBIA explained:
Consequently, because of the financial strength of the pool members in MBIA and the reinsurers in AMBAC, Standard & Poor's automatically rates all municipal bonds insured by either firm AAA. MBIA and AMBAC have somewhat different eligibility criteria for

<table>
<thead>
<tr>
<th>Percent Share in MBIA Policies</th>
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<tbody>
<tr>
<td>The Aetna Casualty and Surety Company</td>
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<tr>
<td>Fireman's Fund Insurance Company</td>
</tr>
<tr>
<td>The Travelers Indemnity Company</td>
</tr>
<tr>
<td>Aetna Insurance Company</td>
</tr>
<tr>
<td>The Continental Insurance Company</td>
</tr>
<tr>
<td>Standard &amp; Poor's Creditweek, June 6, 1983, listed the following AMBAC reinsurers:</td>
</tr>
<tr>
<td>First layer stop-loss (%)</td>
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<tr>
<td>Allstate Insurance Co.</td>
</tr>
<tr>
<td>Chiyoda Fire &amp; Marine Insurance Co. Ltd.</td>
</tr>
<tr>
<td>Constellation Reinsurance Co.</td>
</tr>
<tr>
<td>Travels Indemnity Co.</td>
</tr>
<tr>
<td>Continental Casualty Co.</td>
</tr>
<tr>
<td>Dowa Dire &amp; Marine Insurance Co. Ltd.</td>
</tr>
<tr>
<td>Folksam International Insurance Co. Ltd.</td>
</tr>
<tr>
<td>Fremont Indemnity Co.</td>
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<tr>
<td>Home Reinsurance Co.</td>
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<tr>
<td>INA Reinsurance Co.</td>
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<tr>
<td>Kemper Reinsurance Co.</td>
</tr>
<tr>
<td>Pohjola</td>
</tr>
<tr>
<td>Taisho Marine &amp; Fire Insurance Co. Ltd.</td>
</tr>
<tr>
<td>Universal Reinsurance Corp.</td>
</tr>
<tr>
<td>Second Layer stop-loss (%)</td>
</tr>
<tr>
<td>North American Reinsurance Corp.</td>
</tr>
<tr>
<td>Prudential Reinsurance Co.</td>
</tr>
<tr>
<td>Hannover Reinsurance Co.</td>
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The New York Times, Jan. 8, 1984, at F10, noted several other municipal bond insurers including Financial Guaranty Insurance Company, Industrial Development Bond Insurance, Industrial Indemnity, Old Republic Insurance Company, and Continental Casualty Company. Most of these firms are recent entrants.

59. In contrast, Moody's largely ignores the additional protection afforded insured municipal bonds and rates the bond itself exactly as it would uninsured bonds. Merrill Lynch, supra note 57, at 1.

60. The New York Times, Jan. 8, 1984, at F10, estimated the cost of insured municipal bonds to the issuer to be about one-fifth of one percent below the yield on uninsured bonds. To phrase this another way, the MBIA Annual Report 1 (1982) estimated municipal issuers in 1982 received interest costs savings of $149 million while paying premiums of $46 million. The methods by which premiums are calculated are described in Merrill Lynch, supra note 57, at 13-14 & 33 and promotional literature distributed by MBIA and AMBAC. Currently premiums range from one half of one
municipal issuers. But the basic approach of the two municipal bond insurers is similar. If either insurer issues coverage, the policy guarantees that all bondholders will receive timely payments of the full amount of principal and interest. The default risk of the bond effectively is eliminated. Material misrepresentations or omissions by the issuer become irrelevant. Even if the issuer could not make a premium or interest payment, the bondholder would be guaranteed timely payment in full. Municipal bond insurance, in effect, is an alternative to a compulsory municipal issuer disclosure system. It is important to underline, therefore, that so far only a small minority of long-term municipal debt is insured.

In the aftermath of the 1974-1975 New York City crisis, there were three serious proposals to subject municipal issuers to federal securities regulation.

The most far-reaching proposal, initially offered in 1975 by Senator Eagleton, would have repealed the exemption in the 1933 Securities Act for obligations of state and local governments. Assuming that the SEC exercised its rule-making authority under section 3(b) of the Act and exempted municipal issues of $5 million or less, this would have meant during the first nine months of 1983 that a total of 1,877 long-term municipal issues would have been subject to SEC review before they could be declared effective and sold to the public. In

percent to 2-1/2 percent of the total principal and interest charges, with premium rates adjusted for the risk to the insurers of a municipal bond.

61. A 1980 Merrill Lynch, supra note 57, at 3-4, evaluation noted that MBIA had primarily insured general obligation and monopoly utility revenue bonds while a majority of AMBAC insurance had been written for nonutility revenue bonds, such as hospitals and housing bonds. A second difference between the two insurers was that MBIA usually received complete disclosure of financial, economic, and legal information while AMBAC sometimes did not. MBIA advertises that most of its bonds would have received a rating of "A" or better in the absence of insurance. In its first nine years, 1,967 bonds and note issues have been insured by MBIA without a default. MBIA Annual Report 4 (1982). In contrast, only 69 1/2 % of bonds insured by AMBAC earned ratings of "A" or better. Through December 31, 1982, AMBAC had paid $1.8 million on 12 claims to insured municipal bondholders since its inception in 1971.


64. Public Securities Association, supra note 7, at Table 6B. A total of 4,742 long-term municipal issues were sold in the first nine months of 1983. Some 2,865 issues were for $4.99 million or less. To put the 1,877 municipal issues the Eagleton bill would add to the SEC's review burden in context, in 1982, the Commission reviewed a total of 4,744 issues under the 1933 Act. 48 Sec. Ann. Rep. 108 (1982).
1975, however, section 3(b) only permitted exemption of issues up to $500,000. Again employing figures for the first nine months of 1983, this would have meant the addition of 4,263 potential municipal issues to SEC regulation (or, 5,684 issues when the figure for the first nine months of 1983 was annualized). In February 1976, SEC Chairman Roderick Hills testified to a Senate Banking Subcommittee that "[t]he massive obligation is one we simply could not meet. Even if the Congress were to greatly expand our budget, it would be years before we had a staff trained in those matters." 

There were also constitutional law questions raised about the Eagleton Bill. These questions stemmed from the Supreme Court's 1976 decision, National League of Cities v. Usery. In Usery, the court held that Congress could not require states and their subdivisions to comply with the minimum wage requirements of the Fair Labor Standards Act because "there are attributes of sovereignty attaching to every state government which may not be impaired by Congress, not because Congress may lack an affirmative grant of legislative authority to reach the matter, but because the constitution prohibits it from exercising the authority in that manner." The Court explained that by attributes of state sovereignty it meant "functions essential to separate and independent existence." Wage levels, in part, satisfied this definition, because, "judged solely in terms of increased costs in dollars, these allegations show significant impact on the functioning of the governmental bodies involved." Among other things, the Court found payment at the rates required by the Federal Fair Labor Standards Act would require a "forced relinquishment of important government activities," and a displacement of "state policies regarding the manner in which [the states] will structure delivery of those governmental services which their citizens require." In a concurring opinion, Justice Blackmun opined that the majority "adopts

65. Public Securities Association, supra note 7, at Table 6B. Note, Disclosure, supra note 35, at 1039, somewhat misleadingly observed that in 1975 the SEC processed 844 corporate filings; and during that year there were 8,080 municipal securities offerings. The 8,080 figure for municipal securities offerings is inflated, since the number of municipal securities that would be exempt from registration because of size or intrastate issuance have not been subtracted.


68. Id. at 845.

69. Id.

70. Id. at 846.

71. Id. at 847.
a balancing approach, and does not outlaw federal power in areas such as environmental protection where the federal interest is demonstrably greater and where state facility compliance with imposed federal standards would be essential."

Arguably, the Eagleton Bill would not offend the tenth amendment of the Constitution employing the analysis of the Usery case. First, there is a crucial factual distinction between the imposition of federal minimum wage standards to the purely intrastate activities in Usery and federal regulation of municipal securities sales. The disclosure provisions of the 1933 Securities Act do not apply to purely intrastate securities sales. They apply only to interstate sales. Nothing in the Eagleton Bill would have prevented a municipal issuer from selling intrastate or other securities exempt from the Act. Second, the costs to the state and their subdivisions of compliance with the Federal Fair Labor Standards Act were much emphasized in Usery. In contrast, it is unclear that compliance with the federal securities acts would impose net costs. The greater likelihood is that the costs of preparing documents for filing with the SEC would be less than the savings the municipalities would enjoy because the reduced risk of their issues would reduce interest costs. In any event, the net costs of registering with the SEC invariably will be far lower than the costs in Usery which allegedly had "a significant impact on the functioning of the governmental bodies involved" and caused a "forced relinquishment of important activities." Finally, a balancing of the federal interest in maintaining honest interstate securities markets against the state or municipal interest in the sale of its securities inevitably must favor the federal interest. The 1933 Securities Act is not merit regulation. It does not afford the SEC the power to prevent a security from being sold in interstate commerce as long as the issuer makes full disclosure of material information. So perceived, the Act is no more a threat to state sovereignty than the often enforced requirements that a state honestly complete various forms to receive federal entitlements. A state's "sovereignty" could be threatened by the Securities Act only if the state insisted on selling

72. Id. at 856. See also Casey & Smith, supra note 35, at 659-62; Comment, Municipal Bonds, supra note 28, at 592-602; and Note, Federal Regulation, supra note 14, at 933-39.


74. Approximately this occurred when corporate issues first had to register with the SEC. See Seligman, The Historical Need for a Mandatory Corporate Disclosure System, 9 J. Corp. L. 1, 45-51 (1983).
a security accompanied by a fraudulent prospectus. 75

Nonetheless, concerns about overburdening the SEC and violating the Constitution apparently influenced the drafting of the second municipal issuer proposal, a bill offered in December 1977 by Senator Harrison Williams. 76 The Williams bill would have required each issuer of municipal securities with outstanding principal amount exceeding $50 million to prepare an annual report in accordance with SEC rules and regulations. 77 The Williams bill also would have required each municipal issuer to prepare a securities distribution document in accordance with SEC rules and regulations. The SEC specifically was directed to "avoid repetition of information" in the distribution docu-

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77. Section 13A(b)(1) of the proposed bill, 123 Cong. Rec. S 19268. Section 13A(b)(2) further provided that the report shall be prepared within 150 days after the close of the fiscal year and shall contain the following information:

(A) a description of the issuer, its executive officials, the principle facilities and operation;

(B) a description of any material changes or interruptions in the issuer's operations over the past five years;

(C) a description of the issuer's borrowing policies, debt, debt structure, including, where material, information regarding the indebtedness of overlapping State and local governmental entities, and any relevant trends involving such indebtedness over the last five years;

(D) a description of any legal limitations on the incurrence of indebtedness by the issuer;

(E) a description of any material contingent liabilities, leases or commitments of the issuer;

(F) a description of any defaults, postponements, delays or other modifications with respect to the payment of principal or interest of any outstanding debt of the issuer within the past twenty years, including the terms of any succeeding arrangements;

(G) a description of the issuer's tax authority and any legal limitations thereon, tax structure and collection experience over the past five years, including the nature and amounts of taxes levied, tax rates, assessment and collection procedures, and any anticipated change in tax structure including such procedures over the next five years;

(H) a description of any significant economic and demographic data and relevant trends over the past five years affecting the issuer;

(I) a description of the issuer's major taxpayers;

(J) a description of the issuer's major revenue sources other than taxes and amounts received over the past five years;

(K) a description of Federal or other governmental assistance to the issuer, any major changes or interruptions of such programs in the past five years to the issuer, and any anticipated changes or interruptions over the next five years;
ment if data already had been disclosed in the annual report. There were several exceptions to these disclosure requirements. Neither applied to municipal securities subject to substantially similar state laws or regulations. A municipal securities distribution document did not have to be prepared for several categories of securities that would have been exempt from the 1933 Securities Act including intrastate and privately placed offerings. In addition, the SEC was empowered to classify distribution documents according to their nature and circumstances and prescribe different disclosure requirements for each class. An accompanying section-by-section analysis of the Williams bill explained, ”[T]hus, for small issues of municipal securities (e.g., less than $5,000,000) the Commission could prescribe disclosure requirements less comprehensive than those for larger issues.”

When a municipal security was subject to the Williams bill, it did not initially have to file with the SEC and wait for the Commission to declare the registration statement effective. Instead, the SEC was limited to prescribing the information which would have to be disclosed, specifically including the accounting methods to be followed in the preparation of financial statements. Purchasers of municipal

(L) a description of any pending legal proceedings which may materially affect the issuer’s outstanding debt securities or the sources of payment therefor;
(M) the issuer’s current budget and a description of budget procedures and budget achievement experience over the past five years;
(N) a description of the issuer’s pension or other employee retirement plans, including the means of financing such plans;
(O) a statement of any holdings of the issuer’s securities by trust or pension funds associated with the issuer;
(P) financial statements in such detail and form and for such periods not exceeding the past five fiscal years as the Commission may prescribe, which financial statements for any year commencing on or after December 31, 1980, shall be audited and reported on by an independent certified public accountant or a qualified independent licensed accountant or examiner from an independent State agency authorized by law to perform such functions, in such a manner as the Commission may prescribe.

The SEC also was granted the power to add other similar information if necessary or appropriate in the public interest or to protect investors. Id. at § 13A(b)(4).

78. Id. at § 13A(c). This section also suggested, but did not require that the SEC, by rule or regulation, prescribe disclosure of 15 specified categories of information similar to those outlined in supra note 77.

79. Id. at § 13A(d)(1).
80. Id. at § 13A(d)(2).
81. Id. at § 13A(c)(5).
82. 123 Cong. Rec. S 19271.
83. Section 13(A)(e). The SEC repeatedly stressed its belief that the “creation of standards for disclosure” was an appropriate role for the Commission, See
securities accompanied by distribution documents containing material misrepresentations or omissions were empowered to bring damages actions against the issuer, the underwriters, and experts such as accountants or engineers who assisted in the preparation of the documents. Similarly, purchasers or sellers of municipal securities who relied on a material misrepresentation or omission in an annual report could bring suit.

These types of enforcement provisions represented an important compromise of SEC powers concerning corporate issuers. The Commission was deprived of the power to review municipal disclosure documents for accuracy and completeness before the accompanying securities could be sold to the public. This meant that some municipal disclosure documents would be publicly distributed containing material misrepresentations or omissions that SEC advance review could have prevented. On the other hand, the Williams bill enforcement provisions did empower the SEC to be the ultimate arbiter of municipal accounting provisions in the same fashion that it today is the ultimate arbiter of corporate generally accepted accounting provisions. The Commission also could prescribe what data had to be disclosed. This meant, for the first time, institutional investors, rating agencies, and the financial press would have a uniform standard of reference against which to assess a municipality’s disclosures. Perhaps most importantly, a private litigant would have clear standards in fraud suits against a municipality, its underwriters, or its accountants. The likelihood is that municipal concern to avoid fraud liability would ensure a high level of compliance with the SEC’s standards.

Depriving the SEC of powers to make an advance review of municipal disclosure documents also is supported by considerations of federalism. I am skeptical that the type of advance review required by the 1933 Securities Act would offend the Constitution. It would be unwise, nonetheless. The SEC would be endlessly in dispute with municipal issuers concerning their disclosure documents. On occasion, no doubt, local political officials would blame their municipality’s financial problems on the unwillingness of the SEC to permit them to sell securities. Moreover, even if SEC-municipal relations generally were

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84. Section 13A(g).
85. Id. at § 13A(j).
86. See supra text accompanying notes 67-75.
noncontentious, there is some truth to the argument that the federal government should not regulate the affairs of the states or their subdivisions any more than is absolutely necessary. Until the Commission has tried the second-best approach of the Williams bill, the necessity for advance SEC review of municipal disclosure documents is unproven.

However restrained, the approach of the Williams bill was vigorously opposed in 1976-1977 by the National League of Cities, the U.S. Conference of Mayors, and the Municipal Finance Officers Association. These organizations argued that municipal defaults were rare, that it was inappropriate for the SEC (or federal government) to regulate municipal securities sales, and that the Municipal Finance Officers Association then was making a major effort to improve disclosure standards.

With sufficient political support to enact the Williams bill not present, the SEC, in 1978, proposed a third approach to municipal securities issuance. The 1978 SEC bill would have solely subjected industrial development bonds to the registration requirements of the 1933 Securities Act. It seems that this half-a-loaf proposal was motivated by the Commission's recognition of political realities. Congress in 1978 could not be persuaded to enact a comprehensive municipal securities issuers disclosure bill. On the merits, the SEC 1978 proposal makes little sense. The SEC could not present evidence showing that industrial development bonds were more likely to be fraudulent than other municipal bonds. Indeed the leading cases in the municipal securities area (New York City then; WPPSS subsequently) quite clearly did not concern industrial development bonds. The most controversial IDBs were the small issue IDBs which, by definition, were issued for $10 million or less. As a practical matter, enactment of the SEC bill would have had the principal effect of causing a larger proportion of small issue IDBs to be sold in exempt issuances. Moreover, whatever arguments could have been mustered in favor of the SEC bill in 1978 are less persuasive today. Congress


88. No hearings were held on the bill nor was any vote taken on the bill. Goelzer, Shafer & Shahinian, supra note 14, at 497.

89. The SEC bill appeared in 124 CONG. REC. S 11384-11385 (July 20, 1978). See also accompanying statements at S 11385-11395; and In re Transactions in the Sec. of the City of N.Y.; Final Report, Fed. Sec. L. Rep. (CCH) at ¶ 81,248.

90. See supra notes 8-13 and accompanying text.
in 1982 somewhat limited the opportunity to sell small issue IDBs and currently is considering further limitations.\(^{91}\)

The WPPSS default and the consistent pattern of deficiencies in municipal disclosure documents most recently illustrated by the 1983 Arthur Young study earlier discussed\(^{92}\) should inspire a new federal effort to regulate municipal issuers. Much can be gained in the next round of Congress by building on the post-New York City crisis legislative history and on recent institutional changes in the municipal bond market.

The wisest approach to federal legislation would be to modify the 1977 Williams bill to meet current conditions. Specifically, the scope of the proposal should be narrowed. While the $50 million figure for disclosure through an annual report seems appropriate, the Williams bill should emulate the Eagleton bill and only regulate new municipal issues of $5 million or more. This is the current figure selected by Congress to distinguish small corporate issues, which the SEC may exempt, from larger corporate issues that may be subject to the 1933 Securities Act.\(^{93}\)

Congress also should exempt from federal municipal issuer disclosure legislation municipal issues of any size that are insured and receive the highest rating (today, AAA) from a reputable securities rating agency. The emergence of municipal bond insurance is a profoundly important event. The insurance provides a method by which municipal issuers may guarantee virtually risk-free investments to their securities investors. In that circumstance, protection by disclosure is redundant and unnecessary. Assumedly, if Congress enacted this exemption in a municipal issuer bill, municipalities would purchase the insurance whenever the net savings from the insurance (lower interest rate costs minus the cost of the insurance) exceeded the net savings (lower interest rate costs minus the costs of disclosure) from compliance with the new federal municipal issuer act. In either case, investors would benefit.

The exemption in the Williams bill for municipal issues that comply with substantially similar state regulation should be reformulated. While this provision may be justified on federalism grounds, it should be limited to identical state disclosure standards to avoid unnecessary conflicts between the SEC and state regulators.

91. See supra notes 10, 13.
92. See supra text accompanying notes 37-45.
Three other aspects of the Williams bill should also be addressed. First, the power of the SEC to investigate fraud in municipal issues and commerce fraud litigation should be explicitly stated. These powers arguably may be implied from existing securities legislation. Nothing is gained, however, by solely relying on implication. Secondly, a concluding provision of the Williams bill called for the establishment of a Municipal Securities Disclosure Advisory Committee to make recommendations to the SEC concerning municipal disclosure requirements. With the Financial Accounting Standards Board (FASB) and Municipal Finance Officers Association, among others, recently establishing a Government Accounting Standards Board (GASB), arguably it would be wiser for the SEC to have the same relationship to GASB which it currently has to FASB, and not employ an Advisory Committee. Finally, the Williams bill provided that a municipal issuer could be liable for damages up to the amount of the proceeds from the sale of a municipal security minus the current value of the security or relevant sales prices. The issuer or other defendants may further limit liability by proving that depreciation in the value of the security was not caused by its material misrepresentations or omissions. To ensure municipal compliance with the proposed act, it is important that a municipality or its officials maintain some potential liability. Unlike a corporation, however, whose shareholders have consciously assumed the risk of fraud losses when they invested, a municipality ultimately would impose the costs of its fraud losses on taxpayers who did not choose to bear this risk. It is appropriate, therefore, to attempt to limit the municipality's potential exposure to the minimum amount sufficient to ensure compliance with the act. One way this could be done would be by limiting municipal issuer liability to the personal assets of responsible officials. This, however, would run the risk of leaving investors without a full recovery if they successfully proved fraud. A better approach would be to permit the issuer to contract with the underwriter to shift all of the damages losses to the underwriters except a specified minimum percentage. This approach would ensure a full recovery to investors, limit municipal issuer liability and yet, also create an incentive for good faith compliance with the act by the issuer. Such a contract would not automatically operate. The underwriter and issuer

94. See supra note 14.
96. Id. at § 13A(g)(6).
would have to negotiate its costs and terms. The legislation creating this provision also should provide that the municipal issuer would have to bear a loss in excess of the contractual amount if the underwriters were bankrupt.

The ultimate advantage of adopting legislation as recommended here is two-fold. Improving the integrity of the municipal issuer disclosure process will benefit investors by reducing the risks of fraud and of default. Equally important is the probability that as the riskiness of municipal issues declines, net cost savings also will be enjoyed by the municipality's taxpayers.