Bond Case Briefs

Municipal Finance Law Since 1971

Muni Bond Market In Dogged Pursuit Of A Framework.

This article is the third of a six-part series on investor disclosure in the municipal bond market.

This piece discusses how both Securities and Exchange Commission (SEC) and the Municipal Securities Rulemaking Board (MSRB) continue to doggedly pursue disclosure improvements in the municipal bond market. Restricted by legislation from accomplishing that by regulating municipal bond borrowers directly, they have wisely applied the substantial powers they have to regulate market participants in order to enforce better disclosure from municipal borrowers. They have also encouraged what should be disclosed and the framework for that disclosure. But is there a constitutional solution that makes all this legal maneuvering moot?

In Dogged Pursuit

Limited by the Securities Act of 1933, Securities Exchange Act of 1934 and its founding legislation, the Securities Exchange Act 15B, the MSRB found its ability to compel municipal bond issuers to disclose hobbled.

But it could sure compel the underwriters and broker dealers selling and trading the bonds of those issuers. Having bulked up in 1994 with the adoption of further amendments to the Rule, the MSRB flexed its regulatory muscle to "deter fraud and manipulation" in the market. Disclosure was a big part of that deterrence strategy; municipal bond underwriters were compelled to get written disclosure agreements, in compliance with MSRB guidelines, from their bond issuer clients. If broker/dealers wanted to engage in the underwriting and secondary market trading of their primary market bond issues, they were required to get a continuing disclosure statement from an issuer.

No disclosure? No underwriting, no trading.

As the municipal bond market grew (in 1994, there were roughly $1.5 trillion in outstanding bonds compared to nearly $4 trillion today), the rule continued to be amended and expanded. Additionally, new technology was integrated into the solution. The MSRB created "Electronic Municipal Market Access" (EMMA) as the official source for municipal securities data and disclosure documents with mandatory filing requirements. Currently, there are 16 material event disclosures codified in the rule, requiring an issuer to post if one (or any) occur.

Constitutional Sidebar

Richard Ciccarone, president of Merritt Research Services (an Investortools Company) and a long-time municipal bond market veteran, offers a different perspective on the legal limitations oft cited in regard to disclosure. Ciccerone has not only given this subject considerable thought, but he dedicated a large part of his career to it. Back in 1986—well before the internet, "'big data," the MSRB, and EMMA—he was tapped to build out a municipal research database and software package that ultimately led to the creation of the Merritt System. Today, Merritt Research Services arguably offers subscribers the longest standardized time-series of municipal financial information in the world, with financial information (including annual audits) on over 12,000 municipal bond credit

obligors reporting entities.

Ciccarone contends that the Tower Amendment arguments overlook a constitutional issue, specifically the Commerce Clause. Congress has the power to regulate commerce "among the several states." The sale of a municipal bond—a debt security—across state lines constitutes commerce. Congress (or its agents and assigns—i.e. regulators) can therefore step in to impose rules and regulations on those securities. Issues of sovereignty may apply to any number of things but regulating the disclosure of securities in financial markets is not one of them, in Ciccarone's view. After all, municipal securities dealers fall under the regulation of the Securities Exchange Act 15B specifically because they engage in "interstate commerce to effect any transaction [inducing] the purchase or sale of any municipal security." If the purchase and sale of the goose's eggs can be regulated, why not the goose?

In any legal matter, there is always going to be counterargument. According to some legal-eagles, the reason the Commerce Clause argument doesn't apply to municipal bonds is two-fold. They object, in the first place, to the Goose's Eggs analogy on the grounds that the issuer isn't engaging in interstate commerce; rather, the underwriter is. The issuer's bonds might be sold and distributed across state lines by others, but the issuers themselves aren't doing that. It's a thread-thin line perhaps, but it is a line nonetheless. They also object to the matter of the matter of the sovereignty issue as set forth under Article 10 of the US Constitution. Issuers of municipal bonds are public entities, municipal securities dealers are private entities. This is a crucial regulatory distinction: the feds can regulate private companies, but they cannot impose regulations, at least in this regard, on states.

If there is a legal conflict between the Constitution's Commerce Clause, Article 10, and the Securities Acts of 1933 and 1934, it can only be resolved by one body: the Supreme Court. Currently, there are no cases regarding this matter on the Court's docket.

Encouraging a Disclosure Framework

While the SEC and MSRB might not be able to establish a disclosure framework for the municipal bond market by direct fiat, they actively use their bully pulpit and big stick oversight powers to offer disclosure guidelines to the market and its borrowers. Recently, they took advantage of both.

The SEC and MSRB released a public statement on May 4, 2020, *The Importance of Disclosure for our Municipal Markets*, in which it offered quite explicit guidance to "encourage" issuers on what and how to disclose. (Note the word "encourage" is applied no less than thirteen times in the SEC's May 4 statement. Seven of those specifically refer specifically to municipal issuers, the first one in the introductory paragraph.)

This statement is consistent with the long-standing position on disclosure by these regulators. "Investor access to accurate, timely, and comprehensive information about municipal issuers and their securities has long been a focus of the SEC," stated Rebecca Olsen, the Director of the Commission's Office of Municipal Securities. She continued, "[SEC] Chairman Clayton and I thought it was important to highlight this focus in light of the potentially significant effects of COVID-19 on the finances and operations of many municipal issuers."

Explicit Language

For example, the release explicitly encourages borrowers to provide investors with forward-looking statements during this time, including five very clearly detailed bullet points explaining the why and the how. To those timid souls fretting about potential liability—there are no "safe harbor" rules on

the governmental side preventing potential legal action for forward looking statements—the SEC promises that such good-faith, forward-looking disclosure would not be "second guessed".

The regulators didn't stop there. The statement goes on to offer four very specific "examples of information" that might be disclosed, such as Federal, State and Local Aid and Sources of Liquidity. It goes even further. For a "helpful guide" to frame municipal disclosure practices and procedures, it points to Regulation Fair Disclosure (65 FR 51716). Reg FD codifies best practices for corporate issuers. Interpret that as you will, but it sure sounds something like 'if the corporate market can do it, the municipal bond market can too.'

The statement also points to the many reports for "other governance purposes" municipal issuers routinely prepare and release. This provides critical information not only to internal and external government administrators, but to investors as well.

Important point: Reading through all this, one cannot help but notice that the vast majority of this guidance and encouragement outlined here apply regardless of the state of public health. These are just good disclosure practices, regardless of Covid-19. The SEC and MSRB have set out some very clear "best practices."

These may not be regulations, but the SEC is speaking loudly and has a big stick to back up its statements. It is entirely possible that what is "'encouraged" now could eventually appear as must-haves in disclosure agreements. Borrowers are encouraged to listen.

Read the first two articles of this series:

Covid-19: The Tipping Point For Municipal Disclosure?

Municipal Bond Market Disclosure: Through The Legal Looking Glass

Next in the six-part series: The SEC and MSRB aren't the only one's setting out disclosure standards in the municipal bond market. Investors, borrowers, bond counsel and broker/dealers all have their very distinct—and sometimes opposing—views.

Forbes

by Barnet Sherman

Sep 21, 2020