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Decades of Regulatory Exemptions Have Been to the Detriment of the Municipal Bond Market.

Two municipal market veterans, David Dubrow and Kent Hiteshew, delve into the history and current state of disclosure practices in the municipal bond market, highlighting the flaws in the current system. In a follow up, the authors will explore potential paths to reform and key components of a uniform standard of disclosure for municipal securities.

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While consistent with applicable securities laws, the customs and practices for preparing offering statements for tax-free municipal securities are functionally and practically flawed. This reality is to the detriment of the municipal bond market and its investors.

The four trillion dollar United States municipal bond market comprises a dizzying array of governmental issuer types and credit structures. These range from simple general obligation bonds of state and local governments to revenue bonds issued by government conduits and secured by real estate projects or certain other private enterprises granted access to tax-free debt by the federal tax code. Other than the applicability of the anti-fraud provisions of federal securities laws, however, offering statements for new municipal securities are exempt from uniform disclosure standards. This is distinctly different from corporate securities which are regulated under federal law. Consequently, while disclosure is required to be materially accurate, it is too often not user friendly and negatively affected by motivations of critical market participants. Inconsistent and confusing disclosure contributes to market opacity and illiquidity and prevents investors from being able to properly evaluate the full risks of their potential purchases.

Unregulated municipal disclosure practices can be adversely influenced by a number of factors. Issuers may view their disclosure as a marketing device to promote the sale of their bonds rather than an objective description of the security and its risks. Underwriters may not be sufficiently critical of proposed disclosure for fear of losing future business opportunities with the issuer. Appraisers and market experts hired by issuers or conduit borrowers may produce overly-optimistic reports to satisfy the needs of those that hire them. And lawyers, who draft offering statements, may be overly motivated by protecting themselves from legal liability thereby quoting dense legal documents rather than summarizing such documents in plain English. Overly legalistic document drafting is reinforced by cost pressures and over-reliance on precedent.

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