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Content

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Editor's Notes

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Welcome to the Volume 48 No. 3 of *The Bond Lawyer*.

In this Edition

In this edition, Tony Martini provides additional observations regarding the amended SLGS regulations, Private Letter Ruling 202435006 confirming (or toasting?) that a facility that included a bourbon, whiskey, and gin tasting room was not "a store the principal business of which is the sale of alcoholic beverages for consumption off premises," and also toasting the release of 5th Edition of NABL's *Model Bond Opinion Report*.

Drew Kintzinger reports in this edition on the flurry of SEC activity with respect to municipal advisors, including Dave Sanchez' remarks at *The Bond Buyer* Infrastructure Conference Infrastructure conference and administrative settlements with one entity concerning unregistered municipal advisory activities and with several registered municipal advisors over recordkeeping.

Second Installment of Municipal Securities Retrospective

Paul Maco, Rick Weber, and Drew Kintzinger continue their fascinating journey through the historical development of federal securities regulation of the municipal market. Again, in addition to "precious" moments in history such as the New York City financial crisis and resulting SEC report and the Washington Public Power Supply System default and resulting SEC report, there is, again, a "prescient" moment when, in a 1976 speech to the securities industry, an SEC Commissioner suggested the SEC had an existing tool in Section 15(c)(1) of the Exchange Act to address municipal disclosure by issuers through regulation of broker-dealers. That is somewhat (albeit weirdly) reminiscent of Glinda the Good Witch of the North telling Dorothy she had the power all along to get back to Kansas.[1]

Municipal Market Field of Dreams?--Blockchain Municipal Bonds

On May 2, 2024, the City of Quincy, Massachusetts, issued $9,615,000 of general obligation bonds for main roadways and sidewalk repairs. This might have been a relatively routine

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[1] Interesting side note is that "Glinda" was the name given to the Good Witch of the North in the 1939 film version of *The Wizard of Oz,* but not in the original book titled *"The Wonderful Wizard of Oz"* by L. Frank Baum and published in 1900.

financing for this city located outside Boston and the birthplace of John Hancock and John Adams, as well as John Quincy Adams[2]; however, this offering by a history-rich municipality was also history making in that it is the first reported publicly offered municipal transaction utilizing blockchain technology. I will not go into the details of the technology because my understanding of blockchain is more fleeting than my understanding of new markets tax credits. As explained in the official statement for the transaction,[3] on the highest superficial level, this application of blockchain technology essentially utilizes an alternative book-entry registration system to the system run by the Depository Trust and Clearing Company (DTCC). There are similarities to the familiar DTCC system in that ownership of the Quincy bonds is still in book-entry form; however, sale and trading of the Quincy bonds is managed solely on Onyx Digital Assets, a "private, permissioned blockchain platform" operated by J.P. Morgan Chase. The Quincy bonds are registered in the name of the securities intermediary and beneficial interests are recorded in digital assets accounts through broker-dealers, custodians, and other participants on the platform. At first, I thought maybe the bonds would be payable in digital currency, but that is not the case. The city did receive cash proceeds from the sale of the bonds and will make cash transfers to pay debt service (by transferring funds to its blockchain deposit account on the platform). Beneficial owners will receive debt service payments through the transfer of funds from the city's blockchain deposit account to the participants blockchain deposit account and then subsequent credit the beneficial owner's blockchain deposit account. So what, one might ask, is the difference between this and DTCC's process and why now?

Questions along those lines were asked at a recent colloquium of the American College of Bond Counsel. Additionally, the Quincy Mayor, CFO, and Strategic Asset Manager joined *The Bond Buyer* June 25, 2024, podcast with Lynne Funk[4] and provided additional insight. One of the driving forces behind the city's decision to utilize the blockchain technology structure may have been the prospect of providing greater access to its bonds for local residents, greater security in financial transactions, improving market efficiency and liquidity, and playing its part in moving the municipal market into the new technological age. Eric Mason, the Quincy CFO, also talked about the transaction with Bloomberg in an episode of *"The Close"*[5] and also an episode of the *"Public Money Pod"* presented by the Center for Municipal Finance of the University of Chicago Harris School of Public Policy[6] as well as other presentations. He is a big

[2] The city is named for Col. John Quincy, the maternal grandfather of Abigal Adams (spouse of John Adams and mother of John Quincy Adams), at least according to Wikipedia. https://en.wikipedia.org/wiki/Quincy,_Massachusetts

[3] Official Statement available here. https://emma.msrb.org/P21804543-P21384806-P21824954.pdf

[4] Read the transcript of the podcast here. https://www.bondbuyer.com/podcast/blockchain-technology-meets-munis-in-quincy-massachusetts

[5] https://www.bloomberg.com/news/videos/2024-05-13/the-city-using-blockchain-to-bring-munis-to-investors-video

[6] https://player.captivate.fm/episode/4b00056d-77fe-4106-a916-76628a277fd5/

believer in, what he calls (and maybe others) the democratization of the municipal market and is not reluctant to suggest a “penny par” bond may be available in the future with investors being able to trade municipal bonds, view interest payment receipts, and other things on an app on their phone. He also said it is easier for the city to use the blockchain platform for debt service payments because the city simply transfers funds directly on the platform without the intervening step of wiring funds to a paying agent who then wires funds to DTCC for further credit to DTCC Participants.[7] The panelists at the ACBC colloquium confirmed the use of blockchain technology in this manner removes steps in the payment process and also removes redundancies in record keeping. Mr. Mason also hopes it ultimately removes barriers in access to bond sales resulting in greater access to local investors. Additionally, while blockchain may not be completely “unhackable,” it is viewed as much more difficult to hack than traditional financial systems and, thus, perhaps more secure.[8]

All of those seem to be laudable goals in the journey to a more tech-friendly market, however, layering on concepts such as investor suitability, trustee held payment funds, state law restrictions regarding authorized denominations, issuer restrictions on purchaser sophistication, and similar legal and practical concepts, it appears there may be many issues (some unique to the municipal market) that will need to be addressed as the expansion of blockchain into the municipal market continues.

Interestingly (in terms of timing, anyway), DTCC, along with Clearstream and Euroclear, in consultation with Boston Consulting Group, announced in late May 2024 “a new blueprint to build a digital asset ecosystem for the industry.”[9] The white paper speaks to the development of the ecosystem for which the paper outlines a set of principles addressing potential risks and controls and supports an industry-wide collaboration for that development.

From the executive summary of the white paper:

> This white paper presents a comprehensive set of risk management principles and controls designed to unlock the transformative nature of distributed ledger technology (DLT) in the realm of digital asset securities (DAS), excluding cryptocurrencies. It outlines an industry-wide risk and control framework, which serves as a guide to navigate the current set of challenges, fostering operational excellence in financial markets driven by DLT. Through this structured approach, the white paper aims to facilitate the adoption of tokenization into the financial markets, paving the way for its substantial role in the evolution of finance.

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[7] For an overview of the DTCC process see the 2017 NABL publication at https://www.nabl.org/resources/demystifying-dtc-the-depository-trust-company-and-the-municipal-bond-market/?imis_login=true&IMISTOKEN=OHdDVWDETzhovr8KH3xQ913ocXlIbyOE

[8] https://www.technologyreview.com/2019/02/19/239592/once-hailed-as-unhackable-blockchains-are-now-getting-hacked/

[9] https://www.dtcc.com/dtcc-connection/articles/2024/may/29/building-the-digital-assets-ecosystem

> DTCC, Clearstream, and Euroclear have developed the Digital Asset Securities Control Principles (DASCP), utilizing our combined decades of experience to effectively manage regulatory compliance and reduce operational risks. This set of principles outlines a safe and efficient ecosystem, identifies potential risks specific to DAS, and provides appropriate recommendations for controls to mitigate these risks. In fostering these functions, the DASCP framework is designed to be asset class agnostic and technologically neutral, ensuring its adaptability to the diverse operational requirements of organizations across the financial ecosystem.
>
> The primary objective of this white paper is to catalyze comprehensive understanding, foster collaboration, and spearhead further advancement within the digital asset ecosystem. To ensure our approach remained objective and well-informed, a comprehensive analysis was conducted. It included reviews of approximately 100 regulations, white papers and expert discussions across multiple jurisdictions, as well as over 20 interviews with key market participants and technology vendors.
>
> The initial development of the DASCP marks the beginning of a more expansive initiative. The DASCP will serve as a baseline to help propel the industry toward standards. To ensure the framework remains reflective of the latest industry developments, we plan to transition the stewardship of these principles to an industry association. We believe that a neutral third-party industry association is best positioned to align the digital asset ecosystem on prioritizing, identifying, agreeing, and adopting standards. This move is designed to position the association to actively engage with the broader ecosystem. This involvement is crucial for the DASCP to serve not just as a set of guidelines but as a dynamic catalyst that drives the conversation forward. DTCC, Clearstream, and Euroclear are committed to advising and supporting this work as it continues.

I know I am not the only one who has never considered the municipal market (or the broader financial market for that matter) as an “ecosystem” or that it would be a good thing to adopt “tokenization” into the municipal market. But my frame of reference for ecosystems is largely based upon science fair projects undertaken in elementary and middle school (either by me or my kids (or both)) and the reference to tokens evokes memories of subways and game arcades and, more recently, bank approvals for wire transfers (there are already apps for that!). Implementation of this new ecosystem is likely years away, but it is probably time we bond lawyers start to appreciate the fact that 10 years from now (or sooner), most of our bonds may very well be issued as tokenized digital assets.

5th Edition of the Model Opinion of Bond Counsel

As Tony Martini mentions in his column, on September 10, 2024, NABL released the 5th Edition of the *Model Bond Opinion Report*.[10] This release was nearly five years in the making and represents the collaborative effort of a diverse cross-section of NABL members, including by way of geography and practice focus. The 5th edition builds on the work of the prior committees (ad-hoc or otherwise) who produced the first four editions, as well as the 2009 supplement regarding opinions on Build America bonds. Tony provides some of the highlights from the 5th Edition and I can attest to the fact that the project committee discussed, revised, re-revised, and re-revised some more, the narrative language in the report to, as best we could as a committee, provide insight into the current opinion practice among NABL members. Special kudos to Allen Robertson, in particular, for his mindful approach to this project, including informing the project with insight from his experience and that of others on opinion projects outside of NABL, including those of the Working Group on Legal Opinions Foundation for which Allen has been NABL's unofficial representative for a (very) long time.

And now, please enjoy the rest of this edition of *The Bond Lawyer*.

[10] https://www.nabl.org/resources/model-bond-opinion-report/

Federal Securities Law

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As we approach the close of the federal fiscal year September 30, the SEC's Enforcement Division has released numerous administrative settlements regarding unregistered municipal advisor activities and "off-channel" communications conducted by municipal advisors.

A Note on the Recent United States Supreme Court Term

In recent columns, I have followed the ***Jarkesy*** case, challenging the SEC's use of its in-house administrative court proceeding in lieu of proceeding in federal court. On June 27, 2024, in ***Securities Exchange Commission vs. Jarkesy***, the Supreme Court held that the Seventh Amendment entitles defendants to a jury trial when the SEC seeks civil penalties for securities fraud. Consequently, the SEC may no longer pursue these claims through in-house enforcement proceedings On a related note, on June 28, 2024, the Court decided ***Loper Bright vs. Raimondo***, an administrative law case overruling the *Chevron* deference doctrine that had instructed courts to defer to an agency's reasonable interpretation of ambiguity in a law that the agency enforces.

Currently, much legal jurisprudence is being authored about these decisions, and there are notes of direct relevance for the municipal bond lawyer. First, the ***Jarkesy*** holding is limited to actions in which the SEC seeks civil penalties for fraud. It does not quash the use of the in-house adjudication forum for, say, a Rule 15c2-12 violation matter or a municipal advisor rule violation. However, as noted in this column over recent years, the SEC maintains many "arrows in its quiver" in municipal securities proceedings, including administrative settlement or bringing an enforcement action in federal court. With the in-house administrative court forum under judicial review in recent years, the Enforcement Division has nonetheless actively pursued administrative settlements involving municipal securities, and, when emphasizing a critical violation such as materially misleading financial disclosure or issuer officer misconduct, proceeding in federal district court.

Second, in ***Loper Bright***, Chief Justice Roberts writes for the majority that notwithstanding overruling the *Chevron* doctrine, "[I]n an agency case in particular, the court will go about its task with the agency's 'body of experience and informed judgement' among other information, at its disposal." It is difficult to envision a court ignoring the significant body of knowledge that Commission Staff has developed about municipal securities law when making a decision. A recent example is Chief U.S. District Court – Western District of New York Judge Elizabeth Wolford's March 2024 lengthy and explanatory rulings in favor of the SEC and denying defendants' motions for judgement on the pleadings in the ***City of Rochester and Rochester School District*** litigation.

In short, the ***Weiss*** case (bond lawyer) and the ***Bradbury*** case (underwriter), each of which the Commission brought through its in-house adjudication forum and are significant municipal bond cases, will not reoccur after ***Jarkesy***. And after ***Loper Bright***, a court may reach out to resources such as NABL reports or third party disclosure guidelines to better understand and not simply accept Commission viewpoints on municipal securities market regulation.

Enforcement – Focus on Municipal Advisor Activity

The past federal fiscal year, through August, has been relatively quiet from the Enforcement Division-Public Finance Abuse Unit. As previously reported, two litigation matters, ***SEC vs. City of Rochester and Rochester School District*** (accuracy of financial disclosures) and ***SEC vs. Oppenheimer*** (Rule 15c2-12 limited offering exemption) are reported in public court dockets to be in varying stages of settlement resolutions.

However, in late August and September, the Enforcement Division released a flurry of settlements regarding municipal advisor activities. One action pertained to unregistered parties providing municipal advisory services. Eleven actions, affecting twelve municipal advisors, pertained to "off-channel" communications and record-keeping violations. While these actions are limited to unregistered or registered municipal advisors, the settlement orders nonetheless offer insights in how the Public Finance Abuse Unit is approaching the roles and responsibilities of municipal market participants.

On August 27, 2024, the SEC released ***In the Matter of Tensquare, LLC and Karl Jentoft***, citing willful violations of Exchange Act Section 15B by firm entity and individual for failing to register when providing municipal securities advice to charter school borrowers in eight bond offerings. In this no admit/no deny settlement, the SEC Order describes the firm as providing consulting services to charter schools including assistance with real estate development and school improvement, including assistance with project financing and construction management. However, the SEC found that on certain occasions, the firm, through an individual partner, provided advice regarding the issuance of municipal securities:

The advice that Tensquare and Jentoft provided to the charter schools included: (a) advice on the structure, timing, and terms of the offerings; (b) providing information on debt financing structuring options, including the sale of municipal securities; (c) advising on current interest rates; (d) participating in the bond pricing process; and (e) soliciting and selecting underwriters for the bond offerings. Tensquare's advice was particularized to the specific needs, objectives, and circumstances of its clients.

Importantly, the Order notes that Jentoft was aware of the municipal advisor registration requirements, but the firm never registered with the Commission. Consequently, the firm violated the registration requirements of Section 15B(a)(1)(b) of the Exchange Act and Jentoft caused the firm's violation of the Exchange Act. A cease and desist order was applied to both firm and individual. The firm was censured. The firm was ordered to pay disgorgement (ill-gotten gains from fees charged to the charter schools), with interest. The firm was fined a civil penalty of $50,000 and individual Jentoft was fined a civil penalty of $40,000.

The context to this action is that someone (whether an individual or a firm) that views the services provided as mainly real estate development services and project development consulting may cross over into rendering municipal advice in the eyes of the SEC. As a follow on to this enforcement action, in a September 17, 2024, speech by Dave Sanchez, Director of the Office of Municipal Securities, delivered at the Bond Buyer Infrastructure Conference and posted at sec.gov, Director Sanchez provided the following, additional guidance (footnotes omitted and can be found at: https://www.sec.gov/newsroom/speeches-statements/sanchez-speech-unregistered-municipal-advisory-activity-09-17-24):

Who Are Municipal Advisors?

So, who are municipal advisors? Broadly speaking, municipal advisors assist municipal entities and obligated persons on the terms of bond offerings, investment of bond proceeds, and the structuring and pricing of related products.

A "municipal advisor" is any person (who is not a municipal entity or an employee of a municipal entity) that:

> provides advice to or on behalf of a municipal entity or obligated person 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 a solicitation of a municipal entity or obligated person.

Key here is advice. As you may suspect, "advice" is not subject to a bright-line definition. Instead, the determination of whether a person provides advice to, or on behalf of, a municipal entity or an obligated person regarding municipal advisory activity will depend on all the relevant facts and circumstances. For purposes of the municipal advisor definition, advice includes, without limitation, recommendations that are particularized to the specific needs, objectives, or circumstances of a municipal entity or obligated person with respect to municipal financial products or the issuance of municipal securities, based on all the facts and circumstances. Advice excludes, among other things, the provision of general information that does not involve a recommendation regarding municipal financial products or the issuance of municipal securities.

The focus of the advice standard is whether or not, under all of the relevant facts and circumstances, the information presented to a municipal entity or obligated person is sufficiently limited so that it does not involve a recommendation that constitutes advice.

The Exchange Act provides that municipal advisors and any person associated with such municipal advisor has a fiduciary duty to their municipal entity clients, prohibiting municipal advisors from engaging in any act, practice, or course of business that is not consistent with their fiduciary duty. Although the Exchange Act does not provide that municipal advisors are deemed to have a fiduciary duty insofar as their advice is to non-municipal entity obligated person clients, some state fiduciary or agency laws may, depending on the facts and circumstances, apply to municipal advisor engagements with such obligated persons. Municipal advisors do have other obligations to obligated person clients, such as a duty of fair dealing and a duty of care under current Municipal Securities Rulemaking Board ("MSRB") rules.

Now that I have laid out the regulatory framework, I want to summarize the key takeaways:

First, the Commission applies the term "municipal advisory activities" to a range of activities, including, but not limited to developing financing plans, assisting in evaluating different financing options and structures, and evaluating and negotiating terms.

Second, advice is not subject to a bright-line definition. Advice includes a recommendation regarding municipal financial products or the issuance of municipal securities. The determination of whether a recommendation has been made is an objective inquiry and a key factor that the Commission will consider

> is whether the recommendation reasonably would be viewed as a suggestion to take action or refrain from taking action.
>
> Third, any person engaging in municipal advisory activity will be considered a municipal advisor and have a fiduciary duty to their municipal entity client, unless an exclusion or exemption applies.
>
> Finally, under federal securities law, a person must register with the Commission and the MSRB prior to engaging in municipal advisory activities. Any person that engages in municipal advisory activity prior to registering with the Commission and the MSRB as a municipal advisor violates Section 15B(a)(1)(B) of the Exchange Act.

In his Speech, Director Sanchez also focuses on advisory activities in the P3 space, a topic that will be addressed in a future column.

In recent investigations, the SEC has been frustrated by use by broker-dealers and other securities professionals (investment advisors, rating agencies) of "off channel" communications: sending and receiving corporate communications on personal devices using applications with "ephemeral messaging". This has caused an inability of regulators to obtain text messages from employees' personal devices, creating an absence of record-keeping from such personal devices and third-party messaging platforms. Consequently, the SEC has brought numerous enforcement actions based on record-keeping violations with substantial financial civil penalties. Municipal market professionals have not been exempt from these enforcement initiatives.

In August 2024, the SEC announced settlements involving numerous underwriters, including firms that offer and sell primarily municipal securities and also firms that provide municipal advisor services. On September 17, 2024, the SEC announced settlement orders with 12 independent municipal advisor firms regarding record-keeping violations for "off-channel" communications. *See* https://www.sec.gov/newsroom/press-releases/2024-132. These were all admission orders as distinguished from no admit/no deny orders. The "violations construct" is uniform across the Orders: failure to maintain books and records as required by MSRB Rule G-8; failure to preserve records under MSRB Rule G-9; violation of MSRB Rule G-44 for failure of a municipal advisor to maintain a supervisory system; and, consequently, violation of Section 15B(c)(1) of the Exchange Act for contravention or violation of MSRB rules. The "remedies construct" across the Orders is a combination of acknowledgement and credit for remedial efforts; undertakings for training on record-keeping and an obligation to comply with the training undertakings; cease and desist; censure, and substantial civil money penalties.

Notable in these Orders is that each order offers "for example" details of the types of "off-channel" communications that were occurring and what the SEC viewed as constituting municipal advice. These "for example(s)" can be helpful in addressing a perceived lack of specific regulatory guidance on what constitutes communications “relating to municipal advisory activities”. Rule 15Ba1-8 under the Exchange Act requires municipal advisors to maintain originals or copies of all written communications, regardless of format of such communications, “relating to municipal advisory activities.” The “for examples” can be read as providing further, specific guidance on “relating to municipal advisory activities.”

While many of us may not represent municipal advisors, the Enforcement activities with respect to these municipal market professionals are instructive: the need to be aware of the boundaries on exceptions from municipal advisor characterization, including the lawyer exception to the rule; the detailed fact-specific nature of the investigations; the importance of policies and procedures on all matters municipal securities; and the possibility of Enforcement “credit” where self-policing and remedial action steps have previously been taken by a defendant target.

Rulemaking Ahead-- FDTA

This column shares updates on case law and enforcement activities at the end of federal fiscal year 2024. As previously covered in NABL’s *Weekly Wrap* and at www.nabl.org, on August 2, 2024, the SEC released its draft of the Proposed Joint Rule on the Financial Data Transparency Act Joint Data Standards. See https://www.sec.gov/rules-regulations/2024/08/s7-2024-05#33-11295proposed. The comment period is underway, and we will monitor and report on latest progress in our next column.

On to the busy Fall months!

The Tax Microphone

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My communique will be brief this time around. Overall, it's been a quiet summer on the tax guidance front.

SLGS Regulations Redux

In the last number of *The Bond Lawyer*, I reported on the finalization on March 4, 2024, of a package of proposed amendments to the regulations that govern Treasury's State and Local Government Series (SLGS) program for the investment of proceeds of tax-exempt and other tax-benefited obligations. A copy of the final rulemaking can be found at www.govinfo.gov/content/pkg/FR-2024-03-04/pdf/2024-04380.pdf. You may recall that the changes made in this regulatory package went effective with respect to SLGS subscriptions made on and after August 26, 2024, just a few weeks ago. I won't rehash the details of the new SLGS regulations that I covered in my last column, but there are a couple of additional highlights, mostly procedural or programmatic, that have percolated into my consciousness over the summer, and I want to call them out for your consideration.

First, the new rules permit SLGS subscribers to save their subscriptions without submitting them. This may be helpful to those who want to input the details of the SLGS securities on the SLGSafe platform but then want to hit the "pause button" to check their work or to get a colleague or supervisor to sign off before submission. In all events, however, the saved subscription must be submitted to the Bureau of Fiscal Services on the same date that it is created; otherwise, it will be deleted, and the subscriber will have to re-start the subscription on a subsequent business day, using the applicable SLGS rates for that subsequent day.

Next, in addition to the provision in these regulations requiring a subscriber to certify that the term to maturity of the SLG security being acquired is not longer than reasonably necessary to carry out the governmental purpose for which the SLG security is being acquired (which I discussed in my last column), subscribers must also certify that eligibility changes with respect to the funds invested or the issuer investing in the subscribed SLG security will be communicated to Treasury "as soon as possible." On reflection, it seems to me that bond lawyers (or other third-party professionals) who are subscribing SLGS on behalf of their issuer clients may want to get some backstopping from their issuers as to both of these certifications prior to submitting a SLGS subscription.

Additionally, the new SLGS regulations limits the changes that can be made at settlement to the maturity dates of SLGS securities specified in the subscription. The term to maturity of a SLGS certificate of indebtedness can be increased by no more than 30 days; that of a SLG note by no more than 6 months and of a SLGS bond by no more than one year. Though I doubt that these new limitations will have much of a practical impact on people handling SLGS subscriptions (because in my experience SLGS maturity dates are not fiddled with once a subscription has been made), it is noteworthy that prior to the promulgation of the new rules, SLGS maturity dates could be adjusted right up to settlement with no restrictions.

Another evolution in these regulations is the imposition of a mandatory lead time requirement of five days for the settlement of SLGS demand deposit security redemptions of $500 million or more. Treasury demand deposit instruments are generally, and colloquially, thought of as highly liquid "overnight" investments, though prior to the release of the new SLGS rules package, the regulations did require a minimum lead time of three days for redemptions of SLG demand deposit investments of over $10 million.

Finally, I fibbed a little when I said that I would not rehash the reporting on the new SLGS rules that I covered in my last column. There is one bit of ground I'd like to return to for a moment, regarding the newly added requirement that SLGS subscription identify information about the bond issue to which the subscription relates in a manner that reflects the "Issue Description" used on the Electronic Municipal Marketplace Access (EMMA) platform of the Municipal Securities Rulemaking Board (to the extent information about the bond issue is reported on EMMA). I've been talking to my colleagues about the new SLGS rules, and some of them have noted that in their experience, a disclosure document might not be posted on EMMA for a particular bond issue until sometime after the transaction team wants the SLGS relating to the issue to be subscribed (which is almost always on the bond pricing date). Whether the timing gap is a couple of hours or a day or two, the transaction team will presumably want to coordinate to assure that the "Issue Description" that is subsequently to be generated on EMMA for the bonds is consistent with what is disclosed to the Bureau of Public Services in the SLGS subscription.

I realize the foregoing is something of a hodgepodge, but I thought I'd put these ruminations on paper for the benefit of NABL members who may find themselves preparing SLGS subscriptions over the next few months, while the new regulations are still being digested. As a parting note, there is a handy one-page "Quick Reference Guide" that has been posted on the changes implemented by the new rules, which can be accessed at www.treasurydirect.gov/files/government/slgs/slgsafe/res-qrg.pdf. SLGSafe users can also call the Bureau's help desk at (304) 480-5299 with questions about SLGS subscriptions.

Private Letter Ruling 202435006

In this private letter ruling, released on August 30, 2024, the IRS determined that a business engaged in distilling, storing, and selling various alcoholic spirits, including bourbon, gin and whiskey, was not "a store the principal business of which is the sale of alcoholic beverages for consumption off premises" within the meaning of Section 144(c)(6)(B) of the Internal Revenue Code. The PLR discloses that the owner/landlord of the premises housing the distillery operation requested the ruling with regard to its tenant because it intended to qualify as a "qualified opportunity zone business" (QZOB) for purposes of Internal Revenue Code Section 1400Z-2(d)(3). The QZOB statute requires, in turn, that a QZOB not be a trade or business described in Code Section 144(c)(6)(B).

The ruling notes that although "most" of the alcoholic beverages to be produced by the distiller would be sold to distributors, the distiller's operation would also include a "tasting room" on the premises, at which retail customers can not only sample the booze produced "in situ" but also purchase these products for consumption off premises. References are made to the various square footage allocations within the facility for different aspects of the operation, and also to expectations as to the relative amounts of gross revenues generated by different types of sales, though all of the figures are of course redacted in the public print of the ruling. The ruling also notes that the distiller had agreed to a lease restriction to ensure that no more than "h" percent of its annual gross sales revenue would be derived from the sale of its alcoholic products for consumption off premises and that under the lease, the distiller is required to maintain detailed records and to report the details, presumably on a reasonably current basis, to the landlord.

If you've stuck with me this far, it probably won't surprise you to learn that the upshot of the analysis in this ruling turns on the word "the." That is, the distiller's operation, as described in the ruling, was not an operation the principal purpose of which is the sale of alcoholic beverages for consumption off premises. Not much of a stretch.

As noted above, this is a ruling under Code Section 144(c)(6)(B). Code Section 144(c), as some of you may recall, establishes the statutory conditions for the issuance of tax-exempt "qualified redevelopment bonds". And of course, no one in the history of mankind has ever rendered an approving tax-exemption opinion with respect to qualified redevelopment bonds (okay, I may be exaggerating, but not much; I'm pretty sure they're not seen much in the municipal market), so perhaps this ruling looks like a "so what" moment. And it may be, but exactly the same statutory language appears in Code Section 147(e), in the litany of prohibited facilities that generally applies across the board to tax-exempt qualified private activity bonds. Connecting these dots, then, it seems that this ruling could have some relevance to practitioners who are considering tax-exempt small issue bond financings under Code Section 144(a) (aka "small issue IDBs" for manufacturing facilities) to construct brewery or distillery facilities that happen to have a tasting room in their building design plans. As Stan Lee used to quip in the Marvel Comics, 'nuff said.

Footnote on Section 6417 Guidance

And now, a brief update on a topic I touched on in my last two columns, having to do with the question whether Code Section 6417 subsidy payments when received are treated for under Sections 103 and 141-150 of the Code as "proceeds" of tax-exempt bonds that have been issued to finance costs of the eligible project that gives rise to the subsidy. About six months ago, in my Winter 2024 posting, I had stated that the final Section 6417 regulations, released on March 4 of this year, did not confirm, as had been requested by commenters in connection with the release of proposed Section 6417 regulations in 2022, that these subsidy payments would not be treated as tax-exempt bond proceeds. I also noted in the Spring 2024 number of *The Bond Lawyer* that NABL on March 7, 2024 (i.e., three days after the release of the final Section 6417 regulations, more or less like a ship passing in the night) has reiterated its request for comfort on this point as part of its annual IRS Priority Guidance Plan submission.

It turns out that Treasury and the IRS had indeed provided an explicit assurance on this point on March 4, though not in the final Section 6417 regulations themselves. Instead, the regulators addressed this point in the Section VII.A of preamble to the regulations, where they confirmed "that section 6417(a) provides that the applicable credit is treated as a payment against the tax imposed by subtitle A and, therefore, the amount received as an elective payment is not proceeds of a tax-exempt bond issue." Thanks to Michela Daliana at Katten Muchin Rosenman LLP for calling this to my attention and helping me to correct the record!

Release of 5th Edition of NABL's Model Bond Opinion Report

Finally, I want to call attention to a watershed event for us bond lawyers: the release on September 10, 2024, of the much-anticipated fifth edition of NABL's Model Bond Opinion Report. The fifth edition, hot off the presses as I write this, comes more than 20 years after its predecessor. It's sure to offer a number of new perspectives and insights based on evolutions in bond counsel opinion practice and market developments over the past couple of decades, and I have no doubt that the newest edition will continue to serve as a benchmark resource for NABL's membership in coming years.

Though I have not fully digested its contents, I understand that the fifth edition offers new commentary on several aspects of our tax opinion practice, including a new section on "no adverse effect" opinions; a new section on the rendering of bond counsel opinions with respect to tax-exempt draw-down loans; a discussion of the considerations associated with addressing “stated interest” and/or “amounts properly treated as interest” for federal tax law purposes in bond counsel opinions (think, for example, of tax-exempt obligations that may be characterized as “contingent payment debt instruments” under the original issue discount rules); and a discussion of the use of the words “excluded” and “excludable” in bond counsel opinions to describe the tax-exempt nature of interest on bonds and other obligations (spoiler alert: either word is okay).

Congratulations to NABL President Carol McCoog, to Dawn Bookhart, the Chair of NABL’s Committee on General Law and Practice, to Kristin Franceschi, Allen Robertson, and Tyler Kalachnik, the Co-Chairs of the subcommittee that produced this new edition of the Model Bond Opinion Report, and to all the other project participants who contributed to the production of this important update.

Federal Regulation of the Municipal Securities Market:

A (Not so) Brief History and Retrospective (Part 2)

By Andrew R. Kintzinger[1], Paul S. Maco[2], and Fredric A. Weber[3]

In the first article of this series,[4] we recounted events leading to the regulation of municipal securities dealers. We noted that, in considering municipal securities reform legislation in 1975, Congressional committees confessed that they were unaware of any abuses by municipal securities issuers that would warrant regulation. In this article, the second of the series, we explore the New York City and Washington Public Power Supply System (WPPSS)[5] securities defaults and how they led to the adoption of Rule 15c2-12 and the regulation of primary offerings by regulating underwriters.

New York City Securities Default

In October 1974, the Division of Enforcement of the Securities and Exchange Commission (SEC) were busy pursuing antifraud cases against brokers and dealers, exempt from registration under the Securities Exchange Act of 1934, for the fraudulent sale of often worthless municipal bonds to unsophisticated individuals. The brokers and dealers were known as "Bond Daddies," and the Enforcement Division had been pursuing them over the past several years, as noted in the

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[4] *See* "Federal Regulation of the Municipal Securities Market: A (Not so) Brief History and Retrospective (Part 1)," *The Bond Lawyer,* Vol. 48, No. 3.

[5] "WPPSS" has come to be pronounced "whoops," for understandable reasons.

prior article in this series.[6] At the same time, the SEC was providing assistance to Congress, and SEC Commissioners were giving speeches, to repeal the exemption. (One such speech was delivered on October 31, 1974, Halloween, to the Municipal Finance Officers Association (today's GFOA) by Commissioner John R. Evans, with a theme suited for the season, "Securities Markets Should Not Be 'Trick or Treat.'"[7] Meanwhile, a municipal financial whale was about to breach.

The precarious financial condition of the City of New York was not on the SEC's radar at the time. As the SEC would relate three years later in the August 1977 *Staff Report on Transactions in the Securities of the City of New York*, the condition of the City's finances were not on anyone's radar, although a blip or two might have been noted when, during the period between October 1974 and March 1975 (when the last public offering of the City's securities occurred), the City and its underwriters decreased the minimum denomination of City notes from $100,000 to $10,000 "in order to penetrate the individual market more effectively."[8] As concluded in the *Staff Report*, "Faced with a marketing problem caused by the saturation of the market through previous billions of dollars of City issues and the growing doubts of the financial community as to the City's financial status, the City and the underwriters reached out for the smaller investor. . . . This had the effect, at least in part, of shifting the risk for financing the City from the City's major banks and large institutional investors to individual investors."[9]

As related in the *Staff Report,* in June and July 1975, the Municipal Assistance Corporation (MAC), which was created by the State of New York when the City could no longer access financial markets, sold $1 billion of its bonds to the public, and made additional sales of $2 billion through October 1975, to provide the City with funds to continue providing essential services. On November 15, 1975, the State Legislature enacted the Moratorium Act, which suspended enforcement of short-term obligations of the City outstanding on November 15,

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[6] *See supra, n.4.*

[7] Commissioner Evans told the municipal officials "Contrary to the situation which existed in the past, when municipal securities were purchased almost entirely by wealthy individuals and institutions who were aware of possible hazards and could protect themselves, today these securities are also being sold to individuals who need protection. We were all saddened when we discovered recently that some returning Vietnam prisoners of war became involved in what was obviously more of a trick than a treat." He continued to describe the facts in the injunctive action against R.J. Allen & Associates Inc. as well as the cases brought in Tennessee and against the Paragon Securities Company. https://www.sechistorical.org/collection/papers/1970/1974_1031_EvansTrick.pdf

[8] 1977 *Staff Report on Transactions in the Securities of the City of New York* (*Staff Report*), Introduction and Summary, pp. 4 & 5, together with the full report, is available at: https://www.sec.gov/info/municipal/staffreport0877.pdf

[9] *Id.,* Chapter Four, Report on the Role of the Underwriters, pp 72-23.

1975, because the City was unable to meet its maturing obligations, an event that has become known as the New York City "default." The New York State Court of Appeals (the state's highest court) declared the Moratorium Act unconstitutional one year and four days later. Six weeks later, the SEC began its "investigation concerning transactions in the securities of the City and related matters," as announced in a January 8, 1976, Commission news release.[10]

The *Staff Report* presents results of the SEC staff's 19-month investigation into the sale of approximately $4 billion in short-term City notes between October 1974 and March 31, 1975, when the debt markets closed to new borrowings by the City. The Report includes a 260 page almost day-by-day *Chronology of Events* as well as chapters examining accounting and financial reporting practices and the roles of the City and Its officials, the underwriters, the rating agencies, and bond counsel.

The Chronology of Events begins with an October 1, 1974, memorandum to Harrison J. Goldin, Comptroller of the City, examining "unsound budgeting and accounting practices," at the same time the City began marketing notes to retail investors. It ends with an April 8, 1975, report by Moody's confirming its "A" rating for New York City bonds, its MIG-1 rating for City bond anticipation notes and its MIG-2 rating for all other City notes, at the same time when markets had closed to City obligations.

As the *Staff Report* relates, the City issued short-term debt to "appear to comply with the legal requirement that it balance its operating budget." The borrowings were to pay current expenses. The City's estimated operating deficit at June 30, 1975, the close of its fiscal year, was in excess of $5 billion. Yet nowhere was this disclosed, least of all to the individual investors.

Among the *Staff Report's* key findings and conclusions were the following:

- The City's "unsound accounting and reporting practices, and the system of internal controls on which financial data of the City was based . . . successfully obscured the City's real revenues, costs and financial position. Substantial weaknesses in the City's system of internal accounting control caused financial information to be inherently unreliable. Many . . . accounting practices were specifically designed to assist the City in its budget-balancing exercises by prematurely recognizing revenues and postponing expenses to unrelated future periods. The increase in revenue recognition was accomplished by the accrual of revenues, including federal and New York State aid receivables and real estate and other local taxes, which were unearned, uncollectable or nonexistent. The essentially cash-based accounting for City expenditures failed to recognize significant costs incurred but unpaid during the year, including millions of dollars annually in pension costs, which were calculated based on outdated actuarial assumptions and paid two

[10] *Id.*, Chronology, pp. 258-260.

years later. These were significant factors which contributed to the City's financial difficulties and enabled it to borrow funds from the public which could not be supported by its sources of revenue."

- "The Mayor and the Comptroller misled public investors in the offer, sale, and distribution of billions of dollars of the City's municipal securities from October 1974 through at least March 1975."

- "As the fiscal crisis became particularly severe in early 1975, the underwriters continued to offer and sell City notes to the public as safe and secure investments without significant risks. At the same time, certain of the underwriters were in the process of reducing or eliminating their holdings of the notes. . . . As the crisis worsened, the principal officers of the underwriters became actively involved in discussions concerning the City's fiscal crisis, the continued marketability of City securities, and the inadequacy of the disclosures being made to the investing public. Nonetheless, in early 1975, they proceeded without adequate disclosure with offerings of over $1.5 billion of City notes."

- The rating agencies "appear to have 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."

- "Bond counsel, when on notice of circumstances that called into question matters basic to their opinions, should have conducted additional investigation. It also concludes that bond counsel, who continued with their engagement having knowledge of information material to investors, should, in view of the particular circumstances, have taken reasonable steps to satisfy themselves that such material facts were disclosed to the public."

- In response to questionnaires sent by the SEC to individual investors, a majority stated they had never before invested in municipal securities, nearly 80% believed when investing that the City's bookkeeping and accounting practices were excellent or good, and the City was in good or excellent financial condition, and 90% invested in part because they believed an investment in City securities was "safe and secure."[11]

The New York City default and resulting *Staff Report* has had lasting consequences in at least two respects:

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[11] *Staff Report,* Introduction and Summary, p. 7 and 8; Ch. Four, Role of the Underwriters, p.2; Ch, Five, Role of the Rating Agencies, p.31; Ch. Six Role of Bond Counsel, p. 81; Introduction and Summary, p. 10 (in order of bullet points).

First, the chapters on the City's accounting and reporting practices and the respective roles of the City and its officials, the underwriters, the rating agencies, and bond counsel established a baseline institutional impression of each practice or class of professionals upon the Commission, its staff, and Congressional committees. These impressions would echo when responding to future problems in the municipal securities market (e.g., perceived shortfalls in issuer disclosure in WPPSS, Orange County, and San Diego, underwriter due diligence in WPPSS and Orange County, bond counsel's performance in WPPSS, and pension accounting in San Diego).

Second, perhaps more significantly, the Report impressed the Commission, its staff, and Congressional committees with the harm inadequate disclosure can inflict upon individual investors, underscored by the City's decision to lower the minimum denominations of new City securities from $100,000 to $10,000 and responses to the SEC's investor questionnaires. The harm to individual investors would provide fuel for forces inside and outside Congress to pursue federal regulation of municipal securities disclosure.

Commissioner Evans, speaking to a Public Finance Conference of the Securities Industry Association (SIA) in October 1976, noted that the Securities Exchange Act Amendments of 1975 "left untouched the exemption for municipal securities issuers from the registration requirements of the Securities Act." He added:

> The regulatory provisions of the '75 Amendments with respect to municipal securities had not yet begun to take effect when the fiscal crisis in New York City surfaced. Attention was suddenly focused on the risks associated with New York's securities, on whether appropriate disclosure had been provided to investors, and on the question of who should be liable for the offer and sale of such securities if full and fair disclosure had not been provided.[12]

One of several responses to that question was the introduction in Congress of a bill to remove the exemption for municipal securities in the Securities Act and another bill to amend the Securities Exchange Act to require certain municipal issuers to prepare annual reports and to prepare and disseminate disclosure documents in connection with new issues of securities.[13] These bills never became law. Nor did subsequent legislation to alter the exemption for

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[12] John R. Evans, Commissioner, Securities and Exchange Commission, Responsibilities and Liabilities for Municipal Offerings, before the Public Finance Conference of the Securities Industry Association, Scottsdale, Arizona, October 29, 1976 ("Evans Speech"), p.2, available at: https://www.sechistorical.org/collection/papers/1970/1976_1029_EvansPublic.pdf.

[13] S, 2574, 94th Cong., 2d Sess. 91975) introduced by Senator Eagleton and S. 2969, 94th Cong., 2d Sess. (1976) "The Municipal Securities Full Disclosure Act of 1976," introduced by Senator Williams.

municipal securities, mandate municipal securities disclosure or otherwise increase federal regulation of issuers of municipal securities.[14]

In his speech to SIA, after noting that the general antifraud provisions apply to underwriters in municipal securities transactions, Commissioner Evans turned to Section 15(c)(1)[15] of the Exchange Act, which prohibited the use by brokers, dealers, and municipal securities dealers of a "manipulative, deceptive, or other fraudulent device or contrivance." He noted that the Commission's authority to construe this section was an available tool for use by the SEC, although at the time there had been "no judicial or administrative development of the parameters of Rule 15c1-2."[16] He was prescient to do so before this particular audience. As would happen little more than a decade later, rather than seeking legislative relief, the SEC would turn to these provisions to address problems in the markets for both municipal securities and over-the-counter equities.

The work of the Commission regarding New York City had not finished with the *Staff Report*. A Final Report of the Commission[17] was delivered to Senator William Proxmire on February 5, 1979.[18] The cover letter explained that with the Report, "the Commission has determined to conclude its investigation In the Matter of Transactions in the Securities of the City of New York. In the Report and its attached Appendix containing the *Supplemental Staff Report*, the Commission asserted that "the problems associated with New York's financial crisis , , , demonstrate the compelling need for a statutory framework which would provide the basis for clearer understanding by issuers and other participants in the municipal securities markets of their responsibilities and which would seek to assure that public disclosures by municipalities are reliable and accurate.[19]

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[14] Both bills are discussed in *Federal Regulation of Municipal Securities: A Constitutional and Statutory Analysis,* Dule L. Journ., Vol. 1976: 1261, available at: https://scholarship.law.duke.edu/cgi/viewcontent.cgi?article=2604&context=dlj

[15] Subsequently split into Sections 15(c)(1) and (2).

[16] Evans Speech, *supra,* pp. 8-9.

[17] Securities and Exchange Commission *Final Report In the Matter of Transactions in The Securities of The City of New York*, February 5, 1979 (the "Final Report"), available at: https://www.sechistorical.org/collection/papers/1970/1979_0205_SECNewYork.pdf

[18] Senator Proxmire was the Chairman of the Committee on Banking, Housing and Urban Affairs of the U.S. Senate. The report, as explained in the cover letter from SEC Chairman Williams, was in connection with the Committee's oversight responsibilities relative to the New York Seasonal Financing Act of 1975 and the New York City Loan Guarantee Act of 1978.

[19] *Final Report*, *supra* n. 17, pp. 7-8.

In its Conclusion the SEC Final Report stated, "In the Commission's view, the most critical deficiency in existing municipal securities practice is in the area of municipal accounting and financial reporting."[20] The Report closed with a Commission concern, about which, after much Congressional prodding, it would itself act 17 years later, using its authority under Section 15(c)(1)[21] of the Exchange Act and Rule 15c1-2:

> This discussion of the disclosure problems in the municipal securities markets has concentrated upon the underwriting process. Nevertheless, the Commission is also concerned about the quantity and quality of information available to participants in the secondary trading markets. Currently, investors must rely on the knowledge and care taken by individual dealer representatives, the municipal annual reports (if available), ratings (if current), and their own ability to follow municipal, fiscal, and financial developments in the press. The disclosure system should provide for disclosure of material information in the secondary, as well as the primary, market.
>
> The Commission stands ready to make its knowledge and experience available to the Congress to achieve an appropriate legislative solution to the deficiencies in the issuance and marketing of municipal securities, of which the New York City matter was a unique but instructive example.[22]

A Brief Interlude between Defaults During Which Quite a Bit Happened

Seven and a half years transpired between the New York City default and the next major municipal securities market default. Those years witnessed substantial developments in the municipal securities market, issuer disclosure practices, and the regulation of municipal securities dealers.

Municipal Securities Market Developments. When the Final Report was released, financial markets in the United States were changing rapidly. The Report observes that,

> municipal securities markets were once almost the exclusive province of institutional investors located in or near the issuing municipality. Today, these markets are nation-wide in scope and rival the corporate securities markets in both number of issues and their dollar value . . . markets now include many

[20] *Id*., p. 25.

[21] Subsequently reenacted as Section 15(c)(2)(D).

[22] Final Report, *supra* n. 17, p.. 27.

> middle-income public investors attracted by the tax advantages provided by federal tax laws to holders of municipal securities.[23]

As support for this assertion, the Report notes "this trend is evidenced by the proliferation of publicly-owned investment companies which invest in municipal bonds," citing statistics for sales to the public of unit-trust funds and observing "the Tax Reform Act of 1976 allowed tax exempt status to be passed through to share-holders in "open-end" municipal bond funds as well. In the years 1976 and 1977, shares in thirty-three such funds were offered to the public and the total net assets of these funds reached $2.3 billion." Unit investment trusts, growing in popularity, would play a key role as purchasers of municipal securities in the municipal market's next disaster.[24]

At the same time, the U.S. economy was undergoing stagflation, "the simultaneous appearance of slow growth, high unemployment, and rising prices."[25] Year-over-year inflation was running above 11% in August 1979 when Paul Volker became Chairman of the Federal Reserve Board. On October 6, 1979, Chairman Volker announced a shift in focus of the Federal Open Market Committee from managing the day-to-day federal funds rate to managing the volume of bank reserves in the system and thereby tightening the growth of money supply. Inflation peaked at 11.6% in March 1980, while the federal funds rate reached a record high of 20% in late 1980. Inflation began to decline, falling to 6.1% in early 1982 and then to 3.7% in 1983. Unemployment rose over this time, reaching a peak at 10.8% in late 1982 before entering a steady decline. While apparently an effective remedy for stagflation, Volker's medicine was hard on the American people. The rise in interest rates wreaked havoc on savers and savings banks. Regulation Q, part of the Glass-Steagall Act, imposed interest ceilings on savings accounts and prohibited payment of interest on checking accounts entirely. As interest rates mounted to double-digits, depositors in capped-rate savings accounts were desperate for an alternative. Developments in the mutual fund industry provided one – the tax-exempt money market fund. Municipal bond funds had been introduced in 1961. The 1976 Tax Reform Act formalized the tax exemption afforded to municipal bond funds, and although, unlike bank deposits, they were not federally insured, tax-exempt money market funds provided a safe haven in inflationary times and enabled investors to write a check or otherwise withdraw funds while earning interest on their investment in the fund. Tax exempt money market funds also provided a stable source of short-term borrowing to state and municipal governments and stimulated growing financial

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[23] *Id*., pp. 6-7.

[24] *Id*.

[25] https://www.investopedia.com/terms/s/stagflation.asp

innovation in the municipal bond market through creation of instruments such as variable rate demand notes.[26]

MFOA Guidelines. Municipal issuers and their finance officers took note of the newly increased regulatory oversight of the municipal market and the changing investor mix. In response, issuers began to evaluate and address their disclosure practices. In 1976, the Municipal Finance Officers Association (MFOA) published *Disclosure Guidelines for State and Local Government Securities*. The first edition of *the Guidelines* addressed fundamental concepts of good disclosure practices such as informing investors of their ability to impose and collect taxes, discussing financial performance and describing an issuer's accounting practices. The first edition emphasized that the *Guidelines* were a voluntary approach to disclosure considerations and were not intended to create any disclosure requirements or any legal obligation to provide any specified information or to create legal standards for issuer liability.[27]

While the *Guidelines* noted that failure to comply with one of its suggestions would not necessarily result in a securities law violation, the voluntary recommendations did play a role in improving issuer disclosure practices. As one example, in recommending disclosure of current interim financial information if an official statement is dated more than 120 days after the issuer's last fiscal year, the *Guidelines* effectively helped to bring financial disclosure for airports, government hospitals and other municipal enterprises more in line with disclosure for registered corporate securities, where "bring downs" of stale financial information is required.

The SEC took note of the impact of voluntary disclosure efforts in the municipal market. In a 1988 Commission report, the SEC noted that, according to a 1984 survey, local government issuers of tax-exempt general obligation debt had been providing "increased levels of information to prospective investors" since 1975[28] Citing the New York City Final Report, the SEC indicated that "[t]o the extent that issuers comply with the MFOA guidelines, substantial improvements in the quality of municipal disclosure have been achieved."[29] However, the SEC

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[26] See *Investment Company Regulation: The Intricacies of an "Enlightened Partnership" Regulation and Innovation, 1967-1979 Regulation and Innovation Conservative Reform, Growth by Exemption* in the SEC Historical Society, from which this paragraph is drawn, available at: https://www.sechistorical.org/museum/galleries/icr/icr04_regulation_and_innovation.php

[27] For an excellent account of the origin and development of the MFOA and GFOA Guidelines, see "The Origins of Good Disclosure: John Petersen and the GFOA Disclosure Guidelines" by Dean Pope, the *Municipal Finance Journal*, Vol. 33, No. 4/Vol. 34, No. 1, Winter/Spring 2013.

[28] SEC Report on Municipal Securities Market Regulation (Sept. 22, 1988), available at https://www.sechistorical.org/collection/papers/1980/1988_0922_SEC_Municipal.pdf, n. 36.

[29] *Id*. n. 17.

remained concerned that the voluntary *Guidelines* alone would not sufficiently address concerns about investor protection.

The MFOA became the Government Finance Officers Association (GFOA) in 1983. It continued the voluntary guideline approach with the release of revised GFOA *Guidelines* in 1979, 1988 and 1991. The Commission noted improvements in municipal disclosure due to the evolution of the *Guidelines*, but the Commission also observed in a 1988 Commission report that the quality of disclosure varied widely, and that disclosure of financial information was inconsistent, making it difficult for investors to make meaningful comparisons.[30] The Commission therefore concluded that reliance on purely voluntary efforts was not an adequate response to the need for increased investor protection.

Nonetheless, the development and revision of the *Guidelines* played a critical role in the Commission Staff's approach to proposing Rule 15c2-12. In its proposing release for Rule 15c2-12 in 1988, Staff commented:

> Notwithstanding the problems illustrated by the Supply System's disclosure [see "The WPPSS Default and SEC Investigation" below], the Commission recognizes that significant changes have taken place in the practices associated with the distribution of municipal securities since the events that led to the release of the New York City Staff Report. Municipal issuers have increased substantially the quality of disclosure contained in official statements. The voluntary guidelines for disclosure established in 1976 by the Government Finance Officers Association ("GFOA"), which are followed by many issuers, permit investors to compare securities more readily and greatly assist issuers in addressing their responsibilities.[31]

In the interval between the New York City default and the WPPSS default discussed below, the introduction of the *Guidelines* -- and the willingness of the issuer community to discuss and debate voluntary good disclosure practices -- may well have fended off direct line-item disclosure mandates from Congress or the Commission.

MSRB Initial Rulemaking. Under the direction of executive Director Frieda Wallison, the MSRB developed basic qualification, recordkeeping, and uniform practice rules in the initial years following its 1975 creation. The rules appeared to focus in part on protecting investors from unscrupulous broker-dealers and in part on protecting broker-dealers from each other.

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[30] *Id.*

[31] SEC Rel. No. 34-26100 (Sept. 22, 1988) n. 23.

The MSRB's initial focus was on defining a "bank dealer"[32] and "separately identifiable department or division of a bank"[33] to establish the application of its rules to banks and bank personnel. It then proposed Rules G-2 through G-6[34] and G-7[35] to (a) establish operational capability, professional competence, and fidelity bond requirements for municipal securities firms and their professional employees, (b) impose related record-keeping requirements; and (c) include dealers' financial advisory services to issuers among regulated conduct.[36] (The latter rule established an uneven playing field between dealer and independent financial advisors that was not leveled until 2010.) As amended to respond to comments, the proposed rules were approved by the SEC,[37] although subsequently amended to defer effective dates.

After adopting additional recordkeeping requirements, the MSRB next proposed Rules G-11 through G-15 to regulate securities transactions. Rule G-11 regulated the sale of new issue securities during the underwriting period, including syndicate priority and allocation rules.[38] Rule G-12 codified uniform industry practices for the processing, clearance, and settlement of inter-dealer transactions.[39] Rules G-13 and G-14 established uniform rules for the dissemination of quotations and transaction reports.[40] Rule G-15 imposed confirmation and disclosure requirements for municipal securities transactions.[41] (The G-15 disclosure requirements addressed only terms of securities and transactions, not information related to the issuer's credit. The latter would not be addressed by rule until the SEC adopted Rule 15c2-12 more than a decade later.)

The SEC approved Rules G-12 through G-15 shortly after they were proposed.[42] It did not approve G-11 until more than a year after it was proposed, however, and the MSRB did not formally propose the rule until it had circulated three exposure drafts and responded to nearly

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[32] Municipal Securities Rulemaking Board, 41 Fed. Reg. 10503 (March 11, 1976).

[33] Municipal Securities Rulemaking Board, 41 Fed. Reg. 32803 (August 5, 1976).

[34] Municipal Securities Rulemaking Board, 41 Fed. Reg. 10686 (March 12, 1976).

[35] Municipal Securities Rulemaking Board, 41 Fed. Reg. 22651 (June 4, 1976).

[36] Municipal Securities Rulemaking Board, 41 Fed. Reg. 31273 (July 27, 1976), 41 Fed. Reg. 49685 (November 10, 1976).

[37] *Id.*

[38] Municipal Securities Rulemaking Board, 43 Fed. Reg. 39200 (September 1, 1978).

[39] Municipal Securities Rulemaking Board, 42 Fed. Reg. 46445 (September 15, 1977).

[40] Municipal Securities Rulemaking Board, 42 Fed. Reg. 15160 (March 18, 1977).

[41] Municipal Securities Rulemaking Board, 42 Fed. Reg. 46436 (September 15, 1977).

[42] Municipal Securities Rulemaking Board, 42 Fed. Reg. 46445 (September 15, 1977).

100 comments. Rule G-11 was controversial both because it required dealers to disclose customer information that could be used by competitors and also because it did not assure an opportunity for unaffiliated public investors to purchase new issue securities.[43]

Finally, to complete its initial rulemaking, the MSRB proposed Rules G-17 through G-33 "to codify basic standards of fair and ethical business conduct for municipal securities professionals."[44] Rule G-17 required that they "deal fairly with all persons" and not engage in "any deceptive, dishonest or unfair practice." It established "the general standard for conduct of a municipal securities business," while succeeding rules elaborated on the general standard with respect to specific subjects, including the suitability of recommendations and transactions, professional advertising, the administration of discretionary and other customer accounts, supervision of employees, the determination of prices and commissions, disclosures in connection with new issues, and advertisements of new issues.[45] Rule G-23, as proposed, would have prohibited acting as both an underwriter and a financial advisor to the issuer with respect to the same securities.[46] In response to comments, to avoid unnecessarily restricting the flexibility of issuers, the MSRB amended its rule proposal to permit a financial advisor to underwrite an issue if it terminates its financial advisory relationship with respect to the issue and obtains issuer consent after certain disclosures to the issuer.[47] After the MSRB filed substantive amendments to its fair practice rule proposals, they were approved by the SEC in the fall of 1978.[48]

In adopting its initial rules, the MSRB had to resolve differences among its directors. "There was contention between members from Wall Street firms and those representing regional broker-dealers, and friction between large firms, which could afford to undertake new regulatory tasks, and small firms less able to do so."[49]

In 1978, Christopher "Kit" Taylor became Executive Director. Under his direction, the MSRB began removing information monopolies that disadvantaged bond buyers. For example, it

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[43] Municipal Securities Rulemaking Board, *supra* n. 38.

[44] Municipal Securities Rulemaking Board, 42 Fed. Reg. 49586 (September 28, 1977).

[45] Municipal Securities Rulemaking Board, 42 Fed. Reg. 49586 (September 28, 1977).

[46] Municipal Securities Rulemaking Board, 43 Fed. Reg. 41111 (September 14, 1978).

[47] *Id.*

[48] Municipal Securities Rulemaking Board, 43 Fed. Reg. 50526 (October 30, 1978).

[49] The Municipal Securities Rulemaking Board Gallery on Municipal Securities Regulation, The Great Compromise, Securities and Exchange Commission Historical Society, available at https://www.sechistorical.org/museum/galleries/mun/mun03b_mun_board.php.

adopted rules requiring that yield to maturity be disclosed and that all bonds bear CUSIP numbers. In the words of David Clapp, a former Goldman Sachs banker and MSRB board member, for the first time "people could identify one bond issuer from another."[50]

The WPPSS Default and SEC Investigation

Construction of WPPSS Projects Nos. 4 and 5 began in 1976 and 1977, respectively, in the years immediately after the New York City default. The first long-term bonds to finance the projects were sold in February 1977.[51] The late 1970s experienced very high inflation and corresponding Federal Reserve increases in interest rates. Consequently, it was not a propitious time to finance the expansion of a large construction project. As one summary of what would become known as the "Whoops" financing explains:

> In the late 1970s, material and labor costs soared as inflation entered into the double digits. By the early 1980s, interest rates skyrocketed as the Federal Reserve choked off inflation. The five plants were supposed to cost $4.1 billion. By 1981, the tab was $23.8 billion and rising. WPPSS was issuing $200 million in bonds every 90 days to become the top bond issuer in the United States.[52] Then it became clear that the Northwest would not need all that electricity after all.[53]

After receiving further increases in the Projects' estimated construction costs, WPPSS imposed a moratorium on construction of the two projects in late May 1981 and terminated the projects

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[50] *Id.*

[51] September 1988 *Staff Report on the Investigation in the Matter of Transactions in Washington Public Power Supply System Securities, The Division of Enforcement United States Securities and Exchange Commission* (Staff Report) available at: https://catalog.archives.gov/id/295124828; the SEC Historical Society also provides a copy at: https://www.sechistorical.org/collection/papers/1980/1988_0901_SEC_WPPSS.pdf.

[52] One of your authors remembers seeing racks of WPPSS bonds at the Signature Company, completely filling a tall cart when most large issues would occupy only a few shelves. (For those of more tender years, the Signature Company enabled bond issuers to sign two dozen bonds at a time through physically linked cartridge pens. Since bonds were then issued primarily as bearer bonds in $5,000 denominations, each of which required a manual signature, this service saved days of signing time and arthritic pain.)

[53] SEC Historical Society, *The Municipal Securities Rulemaking Board Gallery on Municipal Securities Regulation, The Great Compromise "Whoops"* available at: https://www.sechistorical.org/museum/galleries/mun/mun03c_whoops.php

in January 1982.[54] The last bond sale occurred in March 1981. It was the fourteenth since the first sale in February 1977. At the time of the last sale, Project No. 4 was 16% complete and Project No. 5 was 11% complete. The face value of the issued bonds was $2.25 billion, the original estimate of the total cost of both projects. Two years later, on May 13, 1983, the Supply System failed to pay monthly debt service deposits with the bond trustee for Projects Nos. 4 and 5. [55]

The projects were intended to supply electric power to 88 publicly owned utilities ("Participants") in three different States in the Pacific Northwest. To enable the projects to be financed, the Participants had entered into agreements ("Participants' Agreements") under which they were obligated to pay the costs of WPPSS share of the projects regardless of whether the projects were completed. After WPPSS announced a moratorium on construction, the Participants' Agreements were quickly challenged.

Residents of an Oregon city were first to file suit. A year later, the Oregon trial court held Oregon Participants lacked legal authority to enter into the Participants' Agreements, but the Oregon Supreme Court reversed the decision on March 20, 1984, holding that Oregon Participants had authority to enter into the Participants' Agreements.

In the meantime, Chemical Bank, the Trustee for the Project Nos. 4 and 5 bonds, initiated a declaratory judgment action in Washington State court to establish the validity of Participants' Agreements. In late 1982, the court ruled that Washington Participants had legal authority to enter into the Participants' Agreements. However, seven months later, the Washington State Supreme Court reversed, ruling that Washington Participants were not authorized to enter into the Participants' Agreements, and it subsequently affirmed its decision on rehearing. Shortly after the Washington State Supreme Court ruling, the Idaho Supreme Court ruled that Idaho cities did not have authority to enter into the Participants' Agreements.[56]

As the Bond Buyer put it, "everything that could go wrong did."[57]

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[54] Enforcement Staff Report, p.2

[55] *Id*. 1 & 2.

[56] *Id*., 40-41.

[57]) Howard Gleckman, "WPPSS: From Dream to Default," *The Bond Buyer,* January 1984, cited in SEC Historical Society, MSRB Gallery on Municipal Securities Regulation, The Great Compromise, "Woops," available at: https://www.sechistorical.org/museum/galleries/mun/mun03c_whoops.php#ftn.

After the Washington Supreme Court ruling, the Commission commenced its investigation into offers and sales of the WPPSS bonds. Key findings of the investigation are summarized in the Staff Report:[58]

- During the period of the sales of the bonds, each successive forecast showed a smaller forecasted increase in power demand. Moreover, the actual demand for power in the years during the sale of the bonds turned out to be less than even the reduced forecasts. Although the official statements substituted the new forecasts for the old, and deficits were still indicated, they did not show the decline in the forecasts from one official statement to the next or that the reduced forecasts exceeded actual use. This information would have indicated that the forecasts might be overstated and could continue to decline.

- With the exception of one sale, the underwriters purchased the bonds from WPPSS through a competitive bid procedure, as provided under Washington State law.

- The underwriters did not conduct due diligence-type investigations to verify the adequacy of disclosure by WPPSS in connection with the sales of Projects Nos. 4 and 5 bonds. During the staff's investigation, the underwriters contended that they had no legal obligation to conduct an investigation and it was not industry practice to do so in competitive sales of municipal bonds.

- The initial Moody's rating of A1 and the Standard and Poor's rating of A+ were maintained throughout the four years of bond sales, despite growing problems with the projects. The ratings reassured investors and permitted unit investment trusts, or UITs, to continue purchasing the Projects Nos. 4 and 5 bonds.

- Sponsors of UITs purchased increasingly large amounts of Projects Nos. 4 and 5 bonds for UITs. Ultimately, approximately 25% of all Projects Nos. 4 and 5 bonds were held by UITs, though, because of internal diversification limits, the bonds seldom composed more than 7 1/2% of any individual UIT's portfolio. These purchases provided important support to the financing program. Purchases of Projects Nos. 4 and 5 bonds by UITs increased even as the problems with the projects were increasing. The sponsors, which usually were also members of the underwriting syndicates, denied that they purchased the bonds at the request of their bond underwriting departments. The purchases, however, helped the market for the bonds and indirectly resulted in a distribution of the bonds to individuals as part of the diversified UIT portfolios. The principal immediate cause of the increasingly large purchases appears to have been that the UITs competed

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[58] *Id.*3.

intensely on the basis of investment yield. As the yield of the Projects Nos. 4 and 5 bonds went to a premium even over similar high-yielding bonds, the sponsors purchased the bonds for the high yield.

- Despite indications of legal difficulties with the take-or-pay provisions and lack of legal precedent on the issue, counsel issued an unqualified opinion without taking action to have the legality of the Participants' Agreements determined. In prior Pacific Northwest power projects in which counsel had issued unqualified opinions, test cases had been brought or legislative changes were sought to resolve legal uncertainties. Counsel testified that they did not even consider bringing a test case to determine the authority of Washington municipal corporations to enter into the Participants' Agreements.

The key points made by the Division of Enforcement in the Staff Report echoed the findings made a decade earlier in the *Staff Report on Transactions in the Securities of the City of New York*. To the SEC or Congress, the release of the New York Staff and Final reports would appear to have had little discernable effect on the conduct of the issuer, financial advisors, underwriters, counsel, or rating agencies and the sponsors of investing UITs with regard to the bond issues for Projects 4 & 5.

The WPPSS *Staff Report* was released September 22, 1988. A second report, captioned, "*Report of the Securities and Exchange Commission on Regulation of Municipal Securities*,"[59] was issued by the Commission that day and sent to relevant Congressional committee chairs. It provides the background and rationale for regulatory actions the Commission chose to take, in lieu of enforcement action, following the WPPSS default. The regulatory actions included (1) proposing Rule 15c2-12; (2) publishing an interpretation of the legal standards applicable to municipal underwriters, based upon judicial decisions and previous administrative actions, emphasizing that underwriters must, in conjunction with review of offering documents, have a reasonable basis for believing the key representations concerning any municipal securities that they underwrite; (3) requesting comment on a proposal by the MSRB and members of the industry to establish a central repository to collect information concerning municipal securities (and comments generally concerning the need for and specific issues relating to a repository); and (4) initiating a project to evaluate the UIT industry and to determine whether any regulatory changes are needed.[60] In short, the Commission chose to use its regulatory authority under

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[59] Available, together with cover letter from Chairman David S. Ruder to Senator William Proxmire and Congressman John D. Dingell, at: https://www.sechistorical.org/collection/papers/1980/1988_0922_SEC_Municipal.pdf

[60] *Id.*

Section 15(c)(1)[61] of the Exchange Act, received under the Securities Exchange Act Amendments of 1975, to address the quality of disclosure in the municipal securities market.

In its report, the Commission explained that it chose not to pursue an enforcement action following the WPPSS offerings in part because they reflected shortfalls in the regulation of municipal securities transactions "that might be addressed more appropriately by regulatory or legislative initiatives."[62] That may reflect recognition by the SEC that an enforcement case would have been weak, given reliance by the parties on opinions of counsel and the questionable materiality of other disclosure had the opinions been correct. The WPPSS default was, however, sufficient to support regulatory action. On the same day as its release of the WPPSS reports, the Commission proposed Rule 15c2-12 and summarized the Commission's view of the securities law duties of municipal securities underwriters. We will explore that development in the next installment in this series. Stay tuned.

[61] Subsequently reenacted as Section 15(c)(2)(D).

[62] *Id.* When the SEC explained its response to problems in the municipal bond market, it was also wrestling with over-the-counter market fraud and market manipulation of thinly traded stock known as "penny stocks," which also harmed small investors. As with the municipal market, the Commission had first turned to enforcement. However, that proved inadequate. Consequently, as with the municipal market, the Commission employed its regulatory powers over broker-dealers to address problems in the over-the-counter market for corporate securities. It proposed an amendment to Rule 15c2-11 to require a reasonable basis for quotations. The amendment was proposed in September 1989 and adopted in April 1991. Amended Rule 15c2-11 would serve as a model when the Commission subsequently expanded Rule 15c2-12 to address the secondary market in municipal securities.