



# **REPORT OF THE INTERAGENCY MUNICIPAL SECURITIES TASK FORCE**

**Matt Fong**  
*State Treasurer and Chair*

Dear Governor Wilson and Members of the California Legislature:

I hereby submit the *Report of the Interagency Municipal Securities Task Force* for your review and consideration. The Task Force was established at my direction in late 1996 to review the state's approach to the enforcement of its municipal bond laws. I had become aware of an increasing number of bond transactions that appeared to violate substantive state laws, and asked those state agencies with some jurisdiction in the area to review the problem.

The Task Force report concludes there is an enforcement void that encourages noncompliance with state bond laws. It also finds that local agencies bear substantial workout risk in issuing land-based securities, and that highly speculative bonds are being sold to unsophisticated investors. I encourage you to consider these findings and determine whether legislative action is needed to address them.

Most importantly, I urge you to take immediate action directing the California Department of Justice to initiate an ongoing program to ensure compliance with the state's municipal bond laws. The establishment of this program is needed to assure investors in California state and local government bonds that the California municipal securities markets will be kept free of unscrupulous practitioners and illegal transactions.

Warmest regards,

Matt Fong  
State Treasurer

# **Interagency Municipal Securities Task Force Members**

*California Debt and Investment Advisory Commission*

*California Department of Justice*

*California Department of Corporations*

*California State Bar*

*California State Treasurer's Office*

# **REPORT OF THE INTERAGENCY MUNICIPAL SECURITIES TASK FORCE**

## **FOREWORD**

Following the September 12, 1996 meeting of the California Debt Advisory Commission, State Treasurer Matt Fong asked representatives from the Commission, the state Department of Justice, the state Department of Corporations and the California State Bar to participate in an interagency task force on state law enforcement issues in the municipal bond market.<sup>1</sup> The establishment of the Task Force followed Treasurer Fong's request for federal and state investigations into nine separate financings executed under the state's Marks-Roos Local Bond Pooling Act. The financings in question gave rise to questions as to the adequacy of enforcement of the state's securities laws and municipal bond laws. Treasurer Fong established the Task Force to provide a forum for the participating agencies to reach a common understanding of the enforcement framework established by existing law and to develop cooperative arrangements for sharing information useful for enforcement actions.

The Task Force did not undertake a comprehensive review of municipal bond issuance to determine the extent of noncompliance with state laws. It reviewed selected examples of alleged noncompliance, heard presentations of federal securities regulators, and reviewed the legal responsibilities and operating perspectives of the state agencies involved. It has directed and reviewed the preparation of this report. With the exception of the California State Bar, the Task Force members have endorsed the findings and recommendations of this report.

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<sup>1</sup> Assembly Bill 1197 (Takasugi), effective January 1, 1997, expanded the Commission's mandate to include the development of a continuing education program for local agency investment officials and changed the Commission's name to the California Debt and Investment Advisory Commission.

## EXECUTIVE SUMMARY

Since the time that the Task Force was established in 1996, the U.S. Securities and Exchange Commission and the state Department of Corporations - the key federal and state securities regulators - have undertaken significant enforcement actions against certain municipal securities firms in California. The ongoing enforcement presence of these agencies is likely to improve the level of investor protection in the municipal bond market. But there are law enforcement problems which fall outside the jurisdiction of these agencies. Moreover, there are broad public policy issues emerging in the municipal bond market that merit the attention of state policymakers. These issues concern the financial and legal burdens that result from troubled bond issues, not just for investors, but for the local government issuers of these securities.

To provide the appropriate context for the consideration of these issues, much of this report is devoted to background information on municipal securities regulation in California. The key findings and recommendations of the Task Force are summarized below.

### ***SUMMARY OF TASK FORCE FINDINGS***

The Task Force reached three key findings concerning the problems facing California's municipal bond market. These findings are summarized below and form the basis of the policy recommendations of the Task Force, which follow:

#### **FINDING #1: *Lack of Enforcement Mechanisms Encourages Noncompliance With Municipal Bond Acts***

The state's municipal bond acts, as opposed to its securities laws, do not authorize the imposition of civil or criminal penalties for violations of their provisions, nor do they provide any other form of remedy or procedure for prosecuting such violations. Oversight and enforcement responsibilities are not assigned to any state or local agency. Rather, a self-regulatory model governs the municipal bond market, where the compliance of

municipal securities offerings with their authorizing state statutes is determined solely by the bond counsel retained by the issuer of the securities. Historically, this self-regulatory model worked well, because issuers and bond counsel tended to be conservative and municipal bond transactions were relatively simple. But the growing role of public finance in promoting economic development, coupled with the greater competition for business among bond firms, has led to very aggressive applications of the state’s municipal bond laws. The number of municipal bond offerings being issued today under aggressive interpretations of the state’s Mark’s-Roos Local Bond Pooling Act, in particular, points to a weakness in the self-regulatory model. Local agencies and bond counsel engaging in these aggressive interpretations of state law face little or no risk of exposure to liability for their actions. As a result, the state’s bond laws are evolving by precedent as new bond issues expand the frontiers of practice, rather than by considered legislative action. This is not to condemn innovative practices, which can produce legitimate cost savings and successful financings. However, they have been in a number of instances abusive and they violated the intent of their authorizing statutes. The self-regulatory model that served the municipal bond market well in the past appears to be inadequate to halt these abusive practices in the modern municipal bond market.

**FINDING #2: *Land-Based Bond Defaults May Pose Serious Risks to Local Agencies***

Since the governmental issuer of land-based securities is not responsible for debt service payments, local agencies traditionally have been advised that they face little or no financial risk in issuing securities to facilitate real estate development. In the past two years, there has been a record volume of bond defaults – that is, actual monetary defaults where investors do not get paid. One of the lessons learned from these defaults is that land-based bond defaults impose substantial “workout” costs on local agencies in the form of fees for professional services and lost staff time. Additionally, bond defaults place local agencies at risk of regulatory action and investor lawsuits.

**FINDING #3: *Speculative Bonds are Being Marketed to Unsophisticated Investors***

The securities laws require that securities brokers and dealers limit the recommendations they make to a client to those securities that are appropriate or *suitable* for that client. The Task Force found, however, that unsophisticated investors are being targeted, through mass advertising and other techniques, as customers for some of the most speculative municipal securities in the market today. The degree of credit risk present in the unrated sector of the municipal bond market today is at odds with traditional investor perceptions of municipal bonds as a safe investment. High levels of demand for high-yielding tax-exempt securities appear to be creating opportunities for abuse of the law.

These findings are discussed in more depth in *Section III: Task Force Findings*.

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**RECOMMENDATION:**

***The Legislature Should Direct the Department Of Justice to Establish a Municipal Bond Law Enforcement Program.***

In its discussions of the above findings, the Task Force came to the conclusion that specific recommendations to address the problems that have been identified should appropriately be developed with broader representation of industry groups, issuers and regulators. This approach was felt to be necessary so that any specific recommendations for changes in statutes are tested for workability and practicality, reflecting the concerns of all affected parties. This might be accomplished under the auspices of one of the Legislature's standing or special committees, or through an ad hoc task force of public and private parties.

Nonetheless, the Task Force believes it is appropriate to recommend that the Legislature act to fill the enforcement void in the state's municipal bond laws. The Task Force recommends that the Legislature direct the Department of Justice to initiate a program to review municipal bond offerings, focusing primarily on Marks-Roos bonds and other types

of debt with a high potential for abuse. The Task Force recommends that the Legislature and the Governor provide several new attorneys and support staff positions to develop the program, supported by a budget augmentation to pay their costs.



## OVERVIEW OF MUNICIPAL SECURITIES REGULATION

The regulatory structure for municipal securities has been likened to a mosaic, a set of interwoven laws and regulations that govern the conduct of securities industry professionals and impose obligations on issuers of municipal securities. The overriding goal of these laws and regulations is to protect investors and deter fraud in the market. The bedrock investor protection under law is the obligation for issuers of securities to fully disclose to investors material facts concerning securities offerings. The occurrence of a bond default (nonpayment of principal and/or interest) does not imply that investors were defrauded, as long as the credit risk was adequately disclosed to investors. At the same time, the securities laws recognize the vulnerability of investors in their business dealings with securities industry professionals, and require those professionals to deal fairly with investors.

Historically, federal and state regulation of the *issuers* of municipal securities - the state and local government agencies that issue bonds to finance streets, schools and other public buildings - has been framed by the principle of comity. This principle is that the issuance of securities by local public agencies and other political subdivisions of the state is essential for the public's well-being, and therefore should not be interfered with absent a compelling reason for doing so. As a result, municipal securities are exempt from all but the key antifraud provisions of the federal and state securities laws, which require full disclosure of material facts in securities offerings. Unlike the corporate market, in which securities offerings are subject to uniform disclosure requirements and direct review by the SEC, disclosure in the municipal market is determined at the local level, by the issuer of the securities, in conjunction with its lawyers and professional consultants.<sup>2</sup>

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<sup>2</sup> The SEC stresses that its review of registration statements for completeness and accuracy does not inoculate the issuer against disclosure-related liabilities. Nonetheless, the registration process for corporate securities obviously shapes disclosure practices and allows problems with individual offerings to be identified in advance, when they can still be corrected.

Most regulatory enforcement actions brought under the federal and state securities laws involving municipal securities concern disclosure misrepresentations or omissions. Essentially, such cases boil down to the charge that a person or persons involved in the securities offering - the issuer itself, its underwriter, financial advisor or other professional consultant - withheld or misrepresented material facts that an investor would have found important in reaching an informed investment decision. It cannot be assumed, however, that violations of the securities laws necessarily are detected and prosecuted with regularity. Until recently, the governmental oversight of the municipal bond market was fairly minimal, largely because the market's low payment default rate did not raise concerns about potential fraud and abuse. The limited scheme of regulation applicable to municipal securities thus has been largely untested to date.<sup>3</sup> The heightened enforcement activity of federal and state regulators may over time result in court decisions that serve to clarify the obligations of market participants under the law.

### ***The New Municipal Market***

Municipal finance in California has evolved over the past 20 years in ways that challenge conventional notions about the safety and essential public purpose of municipal securities. Largely in response to the fiscal constraints imposed by tax limitations and cutbacks in federal and state aid, local agencies in California have become much more aggressive in issuing debt for economic development and other nontraditional purposes. There have been new types of municipal securities introduced to the market - certificates of participation, Mello-Roos bonds and Marks-Roos bonds - and new forms of public entities created to issue them - nonprofit corporations, special districts, and public financing authorities. The degree of credit risk present in these new sectors of the

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<sup>3</sup> While the SEC has taken a number of enforcement actions against underwriters, bond counsel, financial advisors and other consultants to municipal governments, the body of actions taken against municipal issuers and public officials is surprisingly thin. The administrative cease and desist order consented to by Orange County in the aftermath of its bankruptcy represents the first SEC enforcement action ever taken against a general purpose local government. Apart from this case, the SEC has taken actions against just three municipal issuers, all small utility districts involved in fraudulent activities, in the mid 1970s, and three small issuers of land-based securities in 1998. The complaint against the Pacific Genesis Group filed by the state Department of Corporations in late 1997 represents the department's first action in connection with a municipal securities case.

municipal market belies traditional investor perceptions of municipal bonds as a safe investment, second only to federal government securities in terms of safety of principal. The complexity of many of the financing structures prevalent today has exacerbated the knowledge imbalance between industry professionals and their customers - both issuers and investors - and created new opportunities for fraud and abuse.

Traditional distinctions between public and private finance are becoming blurred. In the sphere of real estate development, most significantly, local agencies have assumed financing responsibilities that twenty years ago were commonly associated with commercial lenders, raising capital needed to finance public infrastructure in these projects through the issuance of Mello-Roos, Marks-Roos, and special assessment bonds. (Collectively, these are known as “dirt bonds” or “land-based securities.”)<sup>4</sup>

Land-based securities typically are issued to finance public improvements in new development projects - streets, sewers, schools, parks and the like. Inasmuch as debt service payments depend upon the successful development and sale of real estate, land-based securities pose a degree of risk that is uncharacteristic of municipal securities traditionally.

For many years, California’s robust real estate market masked the credit risk inherent in the land-based sector. But the protracted real estate slump that beset California in the early 1990s, and from which it has only recently emerged, has plunged land-based bond issues into default in record numbers. The chart on the following page illustrates the dollar volume of bond defaults in California between 1990 and 1997. These figures do not reflect any “technical” defaults where a legal requirement has been violated or a reserve fund was used to make a payment, but rather only those actual payment defaults where investors did not receive timely payment of interest and/or principal on their bonds.

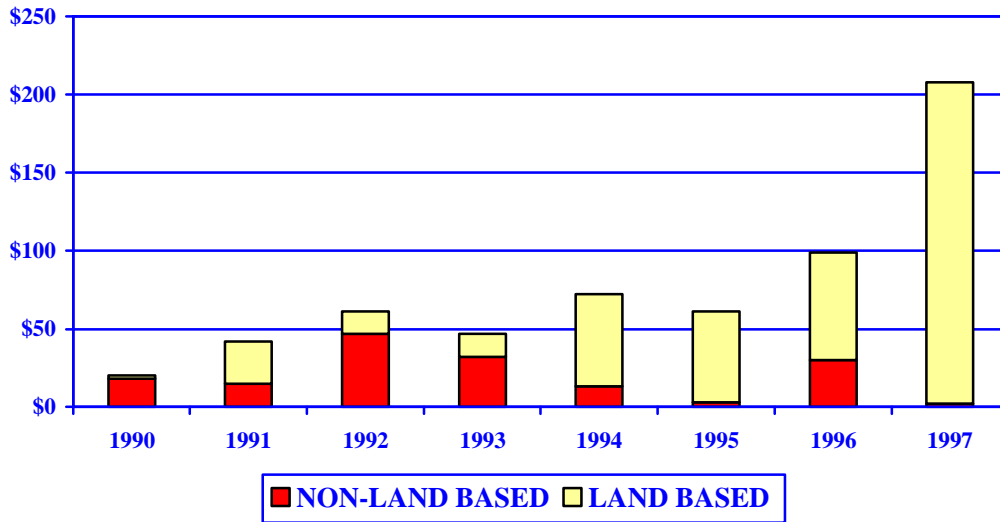
The record land-based bond defaults are occurring at a time when bond defaults are declining both nationally and in the other sectors of California’s market. The performance

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<sup>4</sup> Land-based financings are structured so that the governmental issuer bears no direct obligation for debt service payments. If property owners in land-based financing districts fail to pay their taxes, they

of land-based securities tends to lag the real estate market, as reserve funds, capitalized interest accounts and other sources of liquidity can forestall a bond default for a period of time. Land-based bond defaults thus are a lagging economic indicator of the real estate market.

### CALIFORNIA MUNICIPAL BOND DEFAULTS 1990 – 1997



Bond defaults are best understood as a relative phenomenon. For comparative purposes, it is more helpful to look at default *rates* than absolute *volumes* of bond defaults, since capital markets vary in size, and the effect of inflation makes it misleading to compare dollar amounts from different eras. Because of data limitations, it is easier to analyze the default rate for Mello-Roos bonds alone rather than that of the entire class of land-based securities. The default rate for Mello-Roos bonds alone is at least 5 percent, which is extremely high relative to any capital market or sector of the municipal market.<sup>5</sup> Various

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risk losing their property through foreclosure. If foreclosure fails to generate sufficient funds to pay delinquent principal and interest payments, bondholders risk investment losses.

<sup>5</sup> This analysis focuses on Mello-Roos bonds rather than all land-based securities due to data limitations. In gauging the credit risk posed by the issuance of municipal securities to facilitate real estate development, it is necessary to examine only those land-based securities actually issued to facilitate real estate development. Most Mello-Roos bonds and, to a lesser extent, special assessment bonds, satisfy this criteria, but some are issued to finance facilities in established areas. Marks-Roos bonds technically are not land-based securities, as they can be secured by any number of revenue sources and be used for any number of purposes, including real estate development. It also is true that debt service payments on tax allocation (redevelopment) bonds and other forms of local government debt may depend upon development activity and therefore contain speculative elements, like most land-based securities. Ideally, bonds issued for purposes other than real estate development should be excluded

research studies have established the default rate for the entire municipal market at less than 1 percent; and the default rate for the corporate securities market - which is highly regulated - at about 2 percent. Both the dollar amount and the default rate for land-based securities are at their highest levels since CDIAC began collecting data in the mid 1980s, and they are believed to represent the highest levels in municipal finance since the Depression.

The key question facing state policy makers is whether the regulatory framework for municipal securities has kept pace with the changes described above and affords adequate protections for investors and issuers. Ill-advised borrowing decisions have already brought certain small communities throughout the state to the brink of bankruptcy and put at risk the delivery of essential public services. In these cases, municipal bond industry professionals actively promoted fraudulent transactions to earn high fees. In other cases, professionals are openly flaunting both the letter and intent of the law. The perception by investors that a freewheeling atmosphere prevails in California's municipal securities markets also will have adverse impacts on credit ratings and debt service costs for other local agencies. The state's policy makers need to consider changes in the regulatory framework to ensure that the practice of municipal finance reflects the spirit and letter of the law, and serves to maintain the confidence of investors in California's municipal securities markets.

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from this analysis. But the data is not collected in a manner that would facilitate this analysis; only aggregate totals are available (total amount of Mello-Roos bonds issued, for example). This analysis presents the default rate for Mello-Roos bonds, then, because a much higher proportion of Mello-Roos bonds are issued for development purposes than are other forms of local debt. Thus, dividing the total par value of amount of Mello-Roos bond defaults to date (\$228.8 million) by the total new money Mello-Roos bond issuance to date, excluding refundings (\$4.8 billion), yields a default rate of 5.0 percent. This actually understates the default rate of Mello-Roos bonds issued for real estate development purposes, since the \$4.8 billion figure includes some bonds issued in developed areas.

## TASK FORCE FINDINGS

The Task Force reviewed the framework of municipal securities regulation, as discussed above and also met with a number of enforcement agency representatives to review how their regulatory duties are carried out. In addition, the Task Force reviewed a limited number of municipal bond issues to identify compliance issues and discuss jurisdictional questions. On the basis of its review, the Task Force reached several key findings concerning state law enforcement issues in California's municipal bond market. While interested persons might disagree as to the significance and policy implications of these findings, the findings themselves are factually incontrovertible. An informed discussion of the findings by policy makers is needed to establish the basis for any policy response.

### **FINDING #1: *State Bond Laws Lack of Enforcement Mechanisms Encourages Non Compliance***

The Task Force was initially established in response to the concern that nine separate municipal bond offerings were issued in violation of provisions of their authorizing state statute - the Marks-Roos Local Bond Pooling Act of 1985. The bond issues in question were at least highly irregular, if not illegal, in several important respects. Most notably, the member agencies of the joint powers authorities issuing the bonds had no connection, geographic or otherwise, to the development project being financed through the sale of the bonds. These agencies agreed to issue bonds for development projects outside of their jurisdictions in return for the payment of fees from the proceeds of the bond issues. (Essentially, these agencies agreed to "sell" their tax-exempt borrowing authority). The funds generated by the bond issues were used to retire private liens encumbering property owned by real estate developers. These developers were often years delinquent in payment of taxes and subject to pending private foreclosure on their property. Additionally, in several of these transactions, Indian Tribes and non-profit public benefit

corporations were included as member of the joint powers authorities issuing the bonds, although the law requires that members be “local agencies.”

In response to a request from Treasurer Fong concerning the legality of these transactions, the state Attorney General issued an informal opinion in August 1996, which addressed specific questions posed by Treasurer Fong. The Attorney General’s response, though in the form of an informal opinion that would be of limited value in any litigation, confirmed Treasurer Fong’s view concerning the illegal characteristics of these transactions. Among the Attorney General’s key conclusions were that (1) a joint powers authority member cannot receive a “fee” that exceeds its costs incurred in issuing the bonds; (2) a member agency of the joint powers authority must make a finding of public benefit prior to the issuance of bonds (and it must have some geographic nexus in order to make this finding); (3) an Indian tribe cannot be a party to a joint powers authority; and (4) proceeds of a bond issue may be not be used to retire private debts of real estate developers beyond what is directly required for acquisition of public property.

The investment banking firm that assembled these transactions has asserted the view that the Attorney General’s informal opinion merely confirms its view that the bond offerings were in fact perfectly legal. What should be of interest to state policymakers is not simply that certain state agencies and members of the public finance industry disagree as to the types of activities that are permitted under the Marks-Roos Act, *but that there is no forum for resolving this type of dispute.*

The municipal bond market theoretically is self-regulating with respect to the interpretation of the state’s bond laws. One of the three key roles of the bond counsel retained by the issuer is to determine whether the securities being offered are duly authorized under state law. The two other roles of the bond counsel are to opine on whether a securities offering qualifies for tax-exemption under federal and state law and that the issuance is valid. Bond counsel also participates in due diligence efforts to review the disclosure documents prepared for the offering for compliance with the securities

laws.<sup>6</sup> Of the three areas of law for which a municipal securities offering is reviewed for compliance by bond counsel – bond law, tax law and securities law – only the bond laws have no governmental agency specifically assigned to enforce them. The tax opinion of bond counsel may be challenged by the IRS or the state Franchise Tax Board. The completeness and accuracy of an issuer’s disclosure documents may be challenged by the SEC or the state Department of Corporations, or even by investors.<sup>7</sup> The bond laws, however, do not assign specific enforcement authority to any state or local agency, and do not authorize civil or criminal penalties for violations of their provisions. Although the California State Bar may review the unethical conduct of its members generally, it has never undertaken a specific review of bond counsel conduct.

The self-regulatory model may have served the municipal market well in the past, but it appears to be inadequate for the aggressive debt issuance practices and competition that characterizes the new municipal market. In the area of land-based securities, the types of development proposals for which a real estate developer may request financing exhibit a broad range of credit characteristics, from well-capitalized projects with low debt levels to highly leveraged projects exhibiting more speculative characteristics. Certain projects may be marginal candidates for public financing on purely financial grounds, for example, because of low value-to-lien ratios, while others may be marginal candidates because of legal uncertainties concerning, for example, the use of bond proceeds for private purposes. There are marginal situations outside the land-based area that also must be noted. In addition, much of the market today consists of lease-backed securities and other instruments which have no specific statutory authorization. These types of securities are being increasingly used to finance new types of borrowing – such as for pension costs and

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<sup>6</sup> It is becoming more common for issuers to retain a separate disclosure counsel to prepare disclosure documents and ensure their conformance with the securities laws.

<sup>7</sup> Under the securities laws, the issuer is primarily responsible for the content of its disclosure documents. But the issuer may rely on the advice of counsel, as long as that reliance is reasonable. Bond counsel may incur liability, therefore, for its advice to the issuer concerning disclosure. In a negotiated bond offering, the official statement and disclosure documents typically are drafted by the underwriter’s counsel, subject to the review of the issuer and its bond counsel and financial team. In a competitive bond offering, the disclosure documents typically are drafted by the issuer’s bond counsel or financial advisor.



health care premiums – based on new or evolving interpretations of the state’s statutes and constitutional debt limits.

The problem posed by the marginal financing proposals reviewed by the Task Force is that the bond industry professionals were compensated from the proceeds of bond issues, and therefore had a financial interest in finding a way for the marginal deals to go forward. These professionals would not have been paid had they not done the deals. Yet the specific issuers, who were much less experienced in these matters, relied on these professionals for advice concerning the feasibility and legality of these proposals. The lack of any oversight or enforcement mechanism for these marginal financing proposals encouraged creative interpretations of the law.

In discussing the problem of the noncompliance of municipal bond issues with state law, it is important to draw a distinction between the municipal bond acts in the Government Code and the securities laws in the Corporations Code. The former laws authorize local agencies to borrow money for various purposes; the latter constitute the investor protections that apply to securities offerings. The regulatory gap identified by the Task Force concerns enforcement of the state’s municipal bond laws, not its securities laws.

The state Department of Justice has the general authority to enforce state law, including bond laws, but the department cannot realistically exercise its full authority at all times. It must allocate its resources according to priorities consistent with those established in its budget by the Legislature and Governor. For the department to undertake an initiative to enforce the state bond acts, without the concurrence of the Legislature and the Governor, would raise difficult policy, resource and administrative issues. Although the Department could be very selective in its review of municipal bond issues, even a limited compliance review would require resources that the department does not now have.

**Finding #2: *Land-Based Bond Defaults May Pose Serious Risks to Local Agencies***

Because the governmental issuer of land-based securities bears no direct obligation to pay debt service, it has been common for agencies issuing these bonds to be advised that they face little or no risk in doing so. Certainly, it has been well understood that developers and other property owners risk losing their property through foreclosure if they fail to pay their taxes; and that bondholders risk investment losses if foreclosure does not generate sufficient funds to pay delinquent principal and interest payments. But in the wake of the record number of land-based bond defaults of the past two years, it has become apparent that local agencies face serious financial and legal risks when scheduled debt service payments are not made.

***Workout Costs***

When a development project falters and bonds default, the issuer is left to “workout” the failed transaction, incurring substantial, uncompensated costs for professional services and devoting countless staff hours to the tasks of placating angry bondholders and finding a new developer to take over the project. The Task Force concluded that many communities throughout the state - often small, unsophisticated entities with limited budgets – are struggling to meet workout expenses totaling in the hundreds-of-thousands and even millions of dollars. (These costs are distinct from the costs associated with any liabilities that these agencies may have incurred by violating the securities laws.) If it is possible to refinance the troubled bond issue, the agency may be able to recoup some small portion of its workout expenses. But if land values are not adequate - and in several instances they appear not to be - development activity will remain stalled. Under these conditions the agency will be forced to pay its workout expenses out-of-pocket, and the stalled project will act like an anchor on the community’s potential for economic growth.

In theory, an agency could wash its hands of the defaulted bond issue and refuse to undertake restructuring efforts. But practically speaking, an agency does not have this choice. A bond default usually is symptomatic of broader problems in the economy or

with the development project that culminate in the cessation of development activity - the developer either has run out of money to pay its suppliers and subcontractors, or can't move the completed product. Until the agency takes the initiative to rework the public financing portion of the project and, if necessary, attract a new developer, the unfinished project will continue to blight its landscape. Quite apart from aesthetic considerations, the agency also needs to be concerned about its reputation in the bond market. If it fails to lift a finger to salvage its own bond issue, its future bond offerings may not be well received by the rating agencies and investors.

### ***Fraud Liabilities***

Issuers of municipal securities are liable under state and federal securities laws for misrepresentations and omissions of material information in disclosure documents. "Materiality" is a judicially determined standard that depends upon the facts and circumstances of a particular case; consequently, there is no way to insulate issuers from the risks inherent in reaching disclosure decisions. In this regard, the municipal exemption from the registration and reporting requirements of the securities laws has been a mixed blessing for issuers of municipal securities. By not having to register securities offerings and file periodic reporting forms with the SEC or state Department of Corporations, municipal issuers obviously are spared the costs of doing so. Yet from a liability standpoint, municipal issuers are deprived of the sanctuary afforded by comprehensive regulation. Without knowing in certain detail their disclosure obligations under the securities laws, issuers are always vulnerable to second-guessing by regulators and investors. In the absence of direct review of municipal disclosure documents by the SEC or other regulatory authority, the adequacy of municipal disclosure is called into question only after the fact, in response to a bond default or other irregularity.

One consequence of the municipal bond market's scant regulatory history is that there is no body of case law applying the antifraud provisions of the securities laws to municipal securities transactions. Although precedents may be established by judicial rulings in private lawsuits brought under the general antifraud provisions, investors in municipal securities for the most part have not suffered the kind of damages that would have

engendered such lawsuits. In assigning liability under the federal securities laws, the courts take into consideration the conduct that gave rise to misrepresentations or omissions of material facts in disclosure documents. If public officials exercise “ordinary care” in preparing and reviewing official statements, the intentional or reckless misconduct necessary to support a fraud finding probably will not exist. Yet the standard of care expected of public officials in these matters is not defined in statute or by case law. The danger is that a bad result – a bond default or other irregularity - becomes sufficient cause for action, the pretext for assigning retroactive standards concerning disclosure and issuer conduct.

The SEC’s municipal enforcement initiative has raised the concern that issuers will be held to unreasonable standards; i.e., that elected officials with generalist backgrounds will be expected to review lengthy legal documents and spot any deficiencies therein. The SEC is on record as stating that issuers are primarily responsible for the content of their disclosure documents, and that a public official may not approve disclosure that it knows to be false nor recklessly disregard facts that may make the disclosure misleading. The active oversight role for public officials envisioned by the SEC appears to be at odds with the oversight practices of many local agencies, in which the authorization of bond issues and related disclosure documents amounts to nothing more than a “rubber stamp” of transactions conceived and executed by professionals. The record number of bond defaults in California over the past two years, coupled with the more aggressive enforcement posture of the SEC, make it more likely that disclosure documents and issuer conduct will come under the scrutiny of regulators and investors. But while the SEC may be expected to exercise restraint in exacting monetary penalties from public agencies and officials, the same may not be true of investors seeking to recover damages.

Whatever risks of civil or criminal liability that issuers face under the federal securities laws, those risks appear to be much greater under the state securities laws. Under state securities law, unlike federal securities law, the plaintiff does not have to demonstrate reliance on the disclosure misrepresentation or omission to support a fraud finding; the burden of proof is on the defendant either to show nonreliance by the plaintiff on the

disclosure, or that it (the defendant) exercised reasonable care in preparing the disclosure. Again, the question of what constitutes reasonable care on the part of the issuer or other defendant in a municipal securities transaction invites clarification.

Injured parties in securities transactions also have private rights of action under the common law of torts, contracts and fiduciary relations. Actions at common law are not subject to the strict statutes of limitations that apply to violations of the securities laws, and may over time provide the most effective remedies for investors and issuers suffering financial damages as the result of failed bond deals. Additionally, the common law principles of deceit and fraudulent misrepresentation can be applied to actions that are unrelated to disclosure and are remote from the purchase or sale of securities. For example, an issuer may allege that its financial advisor intentionally misrepresented the risks of a proposed bond offering and breached its fiduciary duty to the issuer by recommending that the bond sale go forward. (Conversely, the common law may be a source of liability for issuers of defaulted securities). The antifraud provisions of the securities laws, by contrast, are oriented toward disclosure and fraud in the purchase and sale of securities.

In summary, there remain unsettled questions concerning the fraud liabilities of issuers of municipal securities with respect to disclosure, the standard of care expected of public officials (both elected and appointed) in approving bond issues and disclosure documents, and the extent to which issuers can rely on their professional consultants. Although the SEC's municipal enforcement initiative has been the source of much anxiety in the public finance community, investors who have suffered damages as a result of bond defaults probably are more likely to bring actions against issuers and market professionals than securities regulators. The increasing perception by issuers of these risks may deter over time their issuance of high-risk securities, but there is no evidence of this effect as yet.

**FINDING #3: *Speculative Bonds Are Being Marketed to Unsophisticated Investors***

Although the presence of even a significant degree of credit risk in a municipal securities offering does not alone give rise to fraud liabilities, credit risk is the key determinant of the appropriateness or *suitability* of a security for different types of investors. Securities brokers are required by law to limit their investment recommendations to securities that are consistent with a customer's investment objectives and financial condition. Firms are required to maintain detailed records of their suitability determinations and to supervise their brokers' activities. Unlike the antifraud provisions of the securities laws, compliance with the federal and state suitability regulations cannot be achieved through disclosure of risk. Nor is it possible to justify or mitigate an improper suitability determination by simply offering a high yield on an investment. The suitability regulations reflect a paternalistic concern for investors, and assign the responsibility for assessing the investor's risk tolerance to the broker, not the investor.

Viewed in the context of suitability, the default statistics cited above serve as good circumstantial evidence that many land-based securities are not appropriate for certain classes of investors that ordinarily might be attracted to municipal securities - the proverbial "moms and pops" looking to invest their retirement savings, for example. Yet the Task Force uncovered evidence that highly speculative securities offerings, including at least one of the Marks-Roos transactions that were the subject of the state Attorney General's informal opinion, are being advertised in newspapers of general circulation and through 1-800 numbers. This use of mass advertising techniques to cultivate an investor base for highly speculative securities offerings raises serious questions about the compliance of certain municipal broker/dealers with federal and state suitability regulations. In all likelihood, the highly speculative characteristics of these land-based securities offerings make these securities suitable for only institutional investors, who are capable of assessing the credit risk of high yield securities, and for sophisticated retail investors who wish to allocate a portion of their portfolios to high yield securities.

The key analytical challenge that federal and state regulators face in applying suitability regulations to the land-based sector is identifying the credit risk present in individual bond offerings, which typically are not rated by the credit rating agencies. Except in the smallest bond issues (under \$1 million), the reason that the bonds are not rated is not due to cost, but to perception. Land-based securities issued during the early stages of development generally are not eligible for an investment grade credit rating. In the view of the credit rating agencies, these securities have predominantly speculative characteristics with respect to capacity to pay principal and interest in accordance with the terms of the obligation. Over time, investment bankers have found that it is easier to market unrated municipal bonds to investors than it is to market noninvestment grade rated bonds. Hence, issuers of land-based securities rarely request a rating, unless it is in conjunction with a refinancing in which some or all of the debt can achieve an investment grade rating.

Inasmuch as a suitability determination represents a match between a particular investor and a particular security on the basis of risk and other criteria, the absence of a credit rating certainly complicates the broker's task of qualifying a security as a suitable investment for an investor. The broker can assess the investor's risk profile by soliciting information concerning his or her net worth and investment portfolio, but in the absence of a credit rating, the broker cannot easily determine the level of credit risk present in a particular security. (Credit ratings, after all, are symbols representing relative degrees of credit risk.) There really is a continuum of risk in the unrated market. Many unrated bonds are relatively creditworthy, for example, unrated bonds issued by small water districts that cannot qualify for an investment grade rating because they do not serve a large enough area. The "municipal junk bonds" comprising the most speculative part of the unrated market, however, probably are not suitable for small, retail investors. As federal and state regulators begin to step up their enforcement of suitability regulations, consequently, they must grapple with how to assess diffused, uncategorized elements of credit risk present in land-based securities.

## TASK FORCE RECOMMENDATIONS

### RECOMMENDATION:

*The Legislature should direct the Department of Justice to establish a municipal bond law enforcement program.*

In its discussions of the above findings, the Task Force came to the conclusion that specific recommendations to address the problems that have been identified should appropriately be developed with broader representation of industry groups, issuers and regulators. This approach was felt to be necessary in order that any recommendations that might be advanced to policy makers would have been tested for workability and practicality, reflecting the concerns of all affected parties. This might be accomplished under the auspices of one of the Legislature's standing or special committees, or through an ad hoc task force of affected parties.

Notwithstanding the above, however, the Task Force believes it is appropriate to recommend that the Legislature act to fill the enforcement void in the state's municipal bond laws. The Task Force recommends that the Legislature direct the Department of Justice to initiate a program to review municipal bond offerings, initially focusing on Marks-Roos bonds and other types of debt with a high potential for abuse. The Task Force recommends that the Legislature and the Governor provide several new attorneys and support staff positions to develop the program, supported by a budget augmentation to pay their costs. The Department of Justice should be required to report back to the Legislature as to its plans for the operation of the enforcement unit, and any statutory changes needed to ensure its effectiveness, by March 1, 1999.



## **APPENDIX A**

### **Municipal Securities Regulatory Agencies**

#### **FEDERAL AGENCIES AND NATIONAL SELF-REGULATORY ORGANIZATIONS (SROs)**

In addition to the agencies below, a comprehensive review of federal regulators of the municipal market might also include Congress, which of course writes the laws that give broad shape to the nation's capital markets and periodically tinkers with the federal income tax exemption for municipal securities; the federal courts, which interpret federal law; the Internal Revenue Service, which enforces the federal tax laws and promulgates rules for determining the eligibility of certain transactions for tax-exempt financing. But matters concerning municipal securities are peripheral to these agencies; the workaday world of municipal securities regulation falls on the agencies discussed below.

#### **United States Securities and Exchange Commission**

The United States Securities and Exchange Commission (SEC), under the Chairmanship of Arthur Levitt, has made reform of the municipal market a top priority in recent years. In 1994, the SEC adopted a far-reaching continuing disclosure regulation for municipal securities, which for the first time mandates ongoing disclosure of financial information to the secondary market for municipal securities. At the same time, Levitt and the SEC also launched an initiative to end "pay to play" in the municipal market (the practice of awarding bond business to securities firms in return for campaign contributions). Also in 1994, the SEC persuaded the Municipal Securities Rulemaking Board (MSRB) to adopt a rule in prohibiting securities firms from engaging in municipal securities business with issuers for two years if the firm has made campaign contributions to officials of such issuers. More recently, Chairman Levitt convinced the American Bar Association to adopt a resolution that condemns play-to-play practices by lawyers and urges state and local lawmakers and bar groups to take action to ban such practices.

The SEC is authorized to seek injunctive relief in federal courts whenever it appears that any person is engaged in or is about to engage in any act or practice that would constitute a violation of the federal securities laws. The SEC also is authorized to institute administrative cease-and-desist proceeding and issue orders to enjoin persons from committing further violations of the securities laws. For example, the SEC brought both types of enforcement actions against the governmental entities and public officials responsible for the collapse of the Orange County Investment Pool.<sup>8</sup>

As the nation's top securities cop, the SEC sets the national agenda for policy affecting the nation's capital markets. Yet the SEC must contend with significant jurisdictional and resource constraints; it is not the monolithic entity that it may appear to be. The agency carefully "picks its battles"; choosing cases that involve specific practices it wishes to eradicate. The SEC alone, therefore, is not equipped to address the types of problems that led to the creation of the Interagency Task Force, such as violations of state borrowing laws, ethical breaches by bond lawyers, and the sale of unsuitable securities to investors. Rather, the SEC must work in concert with other government agencies and industry self-regulating organizations.

### **Municipal Securities Rulemaking Board**

The Municipal Securities Rulemaking Board (MSRB) is the self-regulatory organization charged with the primary rulemaking authority for municipal securities dealers. The 15 member MSRB is comprised in equal parts of securities firm representatives, bank dealer representatives and public representatives. The MSRB's rules prescribe standards of professional practice in five areas: professional qualifications; record keeping; fair dealing; confirmation, clearance and settlement of securities transactions; and dissemination of disclosure documents. The MSRB has no enforcement powers. Its rules are subject to SEC approval and are enforced by the NASD (for its member firms), bank regulatory

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<sup>8</sup> Former county treasurer Citron and deputy treasurer Raabe consented to a federal district court injunction barring them from further violations of federal securities laws. Additionally, Orange County, the Orange County Flood Control District and the Orange County Board of Supervisors consented to an administrative cease and desist order instituted by the SEC.

agencies (for bank dealers) and the SEC for all other brokers, dealers and municipal securities dealers.

Working closely with the SEC, the MSRB has promulgated several rules in recent years directed toward improving the integrity of the municipal market. As mentioned above, the MSRB in 1994 adopted Rule G-37, which generally bars securities dealers who contribute to municipal officials from underwriting negotiated bond issues or engaging in other business for those official's agencies for a period of two years following the contribution. In the view of most market participants, Rule G-37 essentially has eliminated "pay-to-play" in the municipal securities business, a longstanding problem that damaged the integrity of the market. In a similar vein, the MSRB in 1996 adopted Rule G-38, which requires dealers to disclose any arrangements they have with consultants to obtain bond business, and to obtain evidence of those arrangements in writing. The dealer must make written disclosure to a municipal issuer prior to the issuer's selection of any dealer in connection with the municipal securities business being sought, as well as make written disclosure of its consultant arrangements to the MSRB on a quarterly basis. Much like Rule G-37, Rule G-38 is intended to minimize the influence of politics and cash in decisions to award bond business so that considerations of expertise, merit and cost may prevail.

Under Rule G-14, the MSRB has established a Transaction Reporting Program to increase the amount of information available about the market value of municipal securities, i.e., to improve "price transparency." Since 1996, dealers have been required to report interdealer transactions to the MSRB each night through the automated comparison system operated by the National Securities Clearing Corporation (NSCC). The MSRB makes summary price and volume information about these transactions available in a daily report. If the interdealer trade data indicate that there were four or more trades of an issue during a day, the MSRB daily report includes the high, low and average prices, as well as the total par amount traded for that issue. Beginning in early 1998, retail and institutional customer transactions will be added to the Transaction Reporting Program. This change is intended to provide a centralized audit trail of municipal securities

transactions for the benefit of the SEC, the NASD and other agencies charged with enforcing federal securities laws and MSRB rules. This “surveillance database” will greatly enhance the ability of the enforcement agencies to identify excessive markups and other violations of law.

### **National Association of Securities Dealers**

Under the supervision of the SEC, the National Association of Securities Dealers (NASD) exercises significant regulatory authority over the over-the-counter securities markets (that is, securities not traded on an exchange). All municipal securities brokers and dealers are required to be members of the NASD and are subject to its regulation. As part of an overhaul of NASD operations in 1996, NASD Regulation, Inc. was established as a subsidiary of the NASD for the purpose of separating the NASD’s regulatory functions from the operation of the NASDAQ stock market. Through its field inspection programs, NASD Regulation monitors the sales practices of its 5,553 member firms and roughly 535,000 registered representatives in areas such as suitability of recommendations, unauthorized trading, fairness of commissions and markups, excessive activity (“churning”) in customer accounts, fraud, and price manipulation. NASD Regulation also offers arbitration and mediation services to enable investors and broker-dealer firms to resolve disputes, and a telephone inquiry service to provide investors with background information on securities firms and their sales personnel.

In the municipal market, NASD regulations are superseded by MSRB rules. The MSRB rules are enforced by NASD examiners, who conduct on-site examinations of municipal securities firms to determine their compliance with federal securities laws and MSRB rules. At the behest of the SEC, NASD Regulation is undertaking an initiative to more closely track dealer compliance with MSRB rules. NASD Regulation has been contacting dealer members to point out problem areas so that they understand the rules’ requirements on an ongoing basis, rather than wait for NASD Regulation examiners to discover rule violations after the fact. NASD Regulation is focusing its examiners’ attention on member compliance with Rule G-30, which requires municipal securities prices to be “fair and reasonable,” and the various MSRB record keeping and information dissemination rules.

The NASD Regulation disciplinary process begins with staff conducting on-site examinations of member firms and investigating allegations of wrongdoing that arise from customer complaints, disgruntled employees, or through automated surveillance, among other sources. Based upon its examination or investigation, the staff determines whether it is appropriate to file formal disciplinary proceedings or rely on informal measures<sup>9</sup>. Formal disciplinary proceedings are prosecuted by an NASD Regulation enforcement attorney before a hearing panel consisting of a hearing officer (a NASD Regulation attorney) and two members of the NASD District committee with jurisdiction over the firm or individual being charged. If the hearing panels find that violations have occurred, it may impose penalties including censures, suspensions, monetary fines and expulsions from the industry. The hearing panel's decisions are subject to appeal before different committees of NASD Regulation, and thereafter, the SEC, and ultimately, the U.S. Court of Appeals and the U.S. Supreme Court.

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<sup>9</sup> Prior to reforms enacted in 1997, NASD Regulation staff submitted their findings to the District Committee for its geographic region, consisting of elected representatives from member firms, which determined whether or not to file formal disciplinary proceedings.

## STATE AGENCIES

California's state securities laws parallel but predate the federal securities laws. As part of a national trend in the early part of the century toward the enactment of "blue sky laws" to curb fraudulent securities sales, California in 1913 established a statutory scheme for regulating the offer and sale of securities. As mentioned above, state law requires proposed securities offerings to meet a "fair, just and equitable" standard as determined through a merit review by the state Department of Corporations. Broad classifications of securities, including municipal securities, are exempted from this requirement, however.

### **California Department of Corporations**

Among its diverse responsibilities, the California Department of Corporations administers the state's securities laws and regulations. The Department's Securities Regulation Division qualifies certain securities for offer and sale (through a "merit review" process) and licenses and regulates broker-dealers and investment advisers pursuant to the Corporate Securities Law of 1968. The Department's Enforcement Division is responsible for the enforcement of all of the laws and regulations administered by the Department. The Enforcement Division's powers under state law are analogous to those of the SEC under federal law and include the issuance of administrative cease and desist orders to stop violations of the law; to deny, censure, suspend, revoke or take possession of licenses; and to censure, suspend, or bar individuals from participating in an industry. The Enforcement Division may bring civil injunctive actions to enjoin violations of the law and to obtain equitable remedies, including rescission, restitution, and penalties against violators. Additionally, the Department enforces state regulations on suitability of recommendations, permissible mark-ups, and supervision of agents that are similar to MSRB rules and NASD regulations.

The treatment of municipal securities under the state's securities laws is similar to that of federal law -- municipal securities are exempt from registration and reporting requirements but not the antifraud provisions of those laws. As with the federal government, the state

historically has not given priority to enforcing the fraud laws and broker-dealer regulations in the municipal market, inasmuch as municipal securities are exempt from the broader scheme of state regulation and have been perceived as safe investments. Yet in response to recent press reports concerning abuses, the Department has begun an active investigation into municipal securities cases and recently filed a lawsuit against one municipal securities firm.

### **California Department of Justice**

Under the direction of the state Attorney General, the Department of Justice enforces state laws, provides legal services to state agencies and in particular circumstances, to local agencies, and provides support services to local law enforcement agencies. As the state's top law enforcement agency, the Department of Justice has the general authority to enforce all state laws, including its bond laws. As with many other state laws, the bond acts applicable to local agencies do not specifically assign enforcement responsibilities to the department (or any other agency, for that matter). The department historically has not played an active role in enforcing bond laws applicable to local agencies. The department does assist state agencies in interpreting state law issues in connection with state bond offerings and serves as co-bond counsel on state securities offerings. In this capacity, the Department's role complements that of the private bond counsel retained by the state, who tend to focus more on federal securities and tax law issues.

The department regularly prepares legal opinions regarding the interpretation of state laws, including the municipal bond acts, when requested by public officials. The Attorney General's formal opinions, in the absence of a contrary court decision, are entitled to great weight, but are not controlling authority. The Attorney General does not and may not actively enforce compliance with its formal opinions. Local agencies and their bond counsel consequently may follow other interpretations of the law at minimal risk of exposure or liability.

## **California State Bar**

All lawyers practicing in California must be active members of the California State Bar. Among its many responsibilities, the State Bar is responsible for attorney discipline. The Bar was asked to participate in the Task Force to help examine the question of disciplinary action that may be taken against attorneys participating in unlawful bond offerings. Two representatives from the Public Law section of the Bar serve on the Task Force (the Public Law section consists of attorneys employed by public agencies and in private practice who represent public agencies or those who have dealings with public agencies).

The bond counsel is responsible for ensuring that a bond offering is duly authorized under state law, that it meet the requirements for tax-exemption under the federal and state laws, and that it complies with federal and state securities laws.<sup>10</sup> In opining on the validity of a bond offering, counsel is supposed to adhere to the very conservative standard put forth by the National Association of Bond Lawyers (NABL), which states that it would be unreasonable for a court to reach any other conclusion than that of the bond counsel.

## **California Debt and Investment Advisory Commission**

The California Debt and Investment Advisory Commission (CDIAC) was created by statute in 1981 to serve as the state's clearinghouse for information on public debt. The Commission collects and analyzes information on public debt issuance, provides ongoing educational programs and technical assistance to local agencies, and conducts research studies. The Commission publishes a monthly newsletter, *Debt Line*, which includes articles on topical issues in public finance and lists each municipal bond offering in the state for the previous month. Through its research reports, policy briefs, guidelines and educational programs, the Commission helps to improve public finance practices statewide.

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<sup>10</sup> It is becoming more common for issuers to retain a separate disclosure counsel to prepare disclosure documents and ensure their conformance with the securities laws.



Effective January 1, 1997, as mentioned above, the Commission's charge was expanded to include the provision of education and technical assistance in the area of public investments, and its name was changed to the California Debt *and Investment* Advisory Commission to reflect these new duties. The decision to increase the educational opportunities and information available to public agency officials responsible for investment decisions was part of the Legislature's response to the Orange County investment crisis of December 1994. In anticipation of its new responsibilities, the Commission began providing investment education in 1996, including seminars on investing public funds, a video on investment oversight, and guidelines for implementing the new investment law restrictions enacted by the Legislature in 1995 and 1996.

The Commission relies upon a small staff to carry out its work. The Commission also makes extensive use of the expertise of public and private finance professionals in carrying out its activities. Its Technical Advisory Committee, composed of public and private professionals, provides input on Commission projects, helps to maintain its awareness of developments, and often serves as faculty for Commission seminars. Commission staff maintains contact with local agency associations to learn about important issues and developments and to seek input and assistance in the production of Commission publications and seminars. Informal contact with individual local agency officials and private professionals help to ensure that staff is kept well informed.

The Commission is assigned no regulatory functions under state law. While the Commission's role is informational and educational, it often makes recommendations to the Legislature to address problems in the municipal market. In certain cases, it has referred information to federal and state law enforcement agencies. The Commission has shared its staff expertise and informational resources freely with these agencies as they have begun to step up their enforcement of municipal securities violations.