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**Remarks of**

**David S. Ruder  
Chairman**

**United States Securities and Exchange Commission**

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**UNDERWRITER RESPONSIBILITIES IN  
MUNICIPAL BOND OFFERINGS AFTER WPPSS**

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**The views expressed herein are those of Chairman Ruder and do  
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Introduction

It is a great pleasure for me to speak before the Investment Association of New York. Looking out at an audience and seeing so many full heads of dark hair fills me with a sense of adventure and opportunity. "Adventure" because you have survived the black days of October 1987, and because you will be participating in the securities markets of the future. "Opportunity" because you will be extremely influential in our financial markets for years to come.

Before launching into my primary subject for this evening, I cannot resist offering you a few words of advice regarding your prospective adventures and opportunities in the coming years.

First, the chances are that the securities markets of the next decade will be dramatically different than the markets we know today. They will be automated, institutional, international, and complex. Those of you who succeed in mastering those markets will have immense opportunities.

Second, as members of the securities industry you have special responsibilities to create and operate honest securities markets. Although the various exchanges, the National Association of Securities Dealers, the Securities and Exchange Commission, and U.S. Attorneys may engage in regulatory and law-enforcement activity, the burden of creating

an honest market must fall on its participants. I urge you to follow the highest ethical standards and to cooperate in the establishment of industry supervisory practices that promote fair and honest markets.

Today's Securities and Exchange Commission Actions

As most of you know, the Commission today released its staff report on the Washington Public Power Supply System (WPPSS) municipal revenue bonds and announced that it had decided to close its WPPSS investigation without authorizing an enforcement action. The decision to refrain from an enforcement action was a difficult one, since the WPPSS Staff Report identified several areas in which disclosures regarding the Supply System were deficient. The decision was made after reviewing the facts in the context of legal standards and industry practices, measuring the potential drain on Commission resources which would result from complicated and protracted litigation, and noting the existence of massive private damage litigation.

Although the Commission decided not to pursue an enforcement remedy, we were very concerned about the apparent failure of the system for underwriting municipal bonds to operate in a way resulting in adequate disclosure. We were also concerned over the obvious parallels of the WPPSS matter with New York City bond problems which occurred more than a decade ago.

This morning the Commission met in a public meeting and approved the following actions designed to improve the municipal bond disclosure system:

1. It published for comment proposed Rule 15c2-12, which would require municipal securities underwriters to obtain municipal issuer disclosure documents, to review them, and to distribute them to investors.

2. It published its interpretation regarding the legal obligations of municipal securities underwriters, stating that underwriters must have a reasonable basis for believing in the accuracy of key representations contained in offering documents for municipal securities.

3. It requested comment on a recent proposal by the Municipal Securities Rulemaking Board (MSRB) to establish a central repository to collect information concerning municipal securities.

4. It announced a special project to inspect unit investment trusts in order to identify possible regulatory changes.

These actions are extremely important. Let me share with you their background and content.

Since 1933, the municipal markets have become nationwide in scope, and state and local government obligations now are a major factor in the United States credit markets. Currently, over \$720 billion of municipal debt is held by investors, and in 1987 new offerings accounted for \$114 billion. At the same

time the investor base for municipal securities has become more diverse, with households accounting for slightly more than one-third of direct holdings.

As I have indicated, the Commission's actions today reflected its concern about the current quality of disclosure in certain municipal offerings. Before taking those actions, the Commission examined the WPPSS Staff Report, the existing regulatory framework applicable to the issuance and sale of municipal securities, the report and actions relating to the 1975 New York City fiscal crisis, and industry and regulatory developments since then relating to the issuance and sale of municipal securities.

#### The Washington Public Power Supply System Default

Between 1977 and 1981, the Washington Public Power Supply System issued tax-exempt municipal revenue bonds to finance the construction of two nuclear power plants, Nuclear Projects Nos. 4 and 5. Construction of Projects 4 and 5 was terminated in June 1982 due to cost overruns, to the Supply System's inability to continue to sell bonds to finance construction costs, and to growing skepticism regarding the need for the power to be provided by the Projects. Although eighty-eight public utilities in the Pacific Northwest had agreed to provide funds sufficient to pay the bonds whether or not the Projects were ever completed (the so-called "take or pay" provisions), the Washington and Idaho Supreme Courts invalidated the obligations of those utilities. In 1983 WPPSS defaulted on

\$2.25 billion in principal and approximately \$5 billion in interest.

The WPPSS Staff Report raises serious questions concerning whether the official statements for WPPSS bonds adequately disclosed significant facts. Among other things, the Staff Report describes facts that call into question the Supply System's disclosure regarding the estimated cost to complete the Projects, the ability of the Supply System to meet its growing financing needs, the projected demand for power in the Pacific Northwest, and the extent to which the participating utilities continued to support the Projects.

The Staff Report raises questions about the role played by representatives of the Supply System and others who participated in the preparation of the official statements, particularly in the later Supply System offerings. It indicates that representatives of the participating utilities knew some of the information that was not disclosed to investors.

Importantly, the Staff Report states that the underwriters considered themselves "as part of the audience" for disclosures in the official statements and did not attempt to verify disclosures.

The Staff Report states that sponsors of unit investment trusts used nonspecific quality evaluation procedures that merely relied on ratings, and that these sponsors continued to purchase Project 4 and 5 bonds at a time when problems associated with the Projects may have been known.

The Staff Report also states that limitations in the rating process may have contributed to the continued high ratings of the WPPSS bonds.

Finally, the Staff Report indicates that bond counsel did not take steps such as introducing legislation or bringing test cases which might have been valuable in determining the validity and enforceability of the participating utilities' agreements. It also indicates that bond counsel did not disclose that legal authority issues had caused them to exclude certain participating utilities' agreements from their opinions.

#### The New York City Crisis and Regulatory Responses

The Commission's WPPSS investigation and the Staff Report were particularly disturbing to me because they raised issues regarding the obligations of participants in the sale of municipal securities that are hauntingly similar to those raised as a result of the Commission's investigation more than a decade ago concerning the sale of municipal securities of the City of New York.

The New York City Staff Report revealed that from October 1974 through April 1975, a period during which underwriters

distributed approximately \$4 billion in short-term debt, New York City had serious, undisclosed financial problems. When a decision was made to disclose potential problems in the face of the worsening budget crisis, some underwriters denied that they had any duty to "rummage around" to determine whether, in fact, there would be revenues available to retire a contemplated offering of notes. The New York City Staff Report concluded that, in varying degrees, the participants in the underwriting process, including the principal underwriters, bond counsel, and rating agencies, had failed to meet their responsibilities to the investing public.

Since the release of the New York City Staff Report, significant changes have taken place in the practices associated with the distribution of municipal securities. Municipal issuers have increased substantially the quality of disclosure contained in official statements. For instance, voluntary guidelines for disclosure were established in 1976 by the Government Finance Officers Association (GFOA) and were updated in 1988. These guidelines are followed by many issuers, permit investors to compare securities more readily, and greatly assist issuers in addressing their disclosure responsibilities. Additionally, when an issuer voluntarily prepares disclosure documents, the MSRB's rules now require that the documents be distributed to investors. Specifically, MSRB Rule G-32 requires that if an official statement is prepared by or on behalf of the issuer, it must be delivered to

investors even if the underwriter must produce copies at its own expense.

Perhaps the most disturbing fact about the issues raised by the Supply System default is that these issues arose after the New York City problems had been thoroughly reported, after the subsequent voluntary improvements in municipal disclosure, and after regulatory actions such as adoption of MSRB Rule G-32. Read together, the WPPSS Staff Report and the New York City Staff Report demonstrate a continued potential for abuse in the municipal securities area. The amounts of money involved in the 1975 default by New York City and in the 1983 WPPSS default each exceeded the largest corporate default in history. In addition there have been additional smaller defaults in municipal securities, as well as downgrades in municipal securities' ratings that have adversely affected investors.

Reviewing this history and the current environment for underwriting and sale of municipal bonds, the Commission decided to take action. Let me describe that action in greater detail.

Proposed Rule 15c12-2

Proposed Rule 15c12-2 would require underwriters of issues of municipal securities having an aggregate offering price in excess of ten million dollars to obtain and review a nearly final official statement before bidding for or purchasing the securities. The proposed rule would also require that

underwriters of such municipal offerings contract with the issuer to obtain final official statements in sufficient quantities to make them available to purchasers in accordance with rules established by the MSRB. Underwriters would also be required to provide copies of preliminary and final official statements to any person upon request. This rule would assure that official statements are available to both underwriters and investors, and, most notably, would require underwriters' review.

#### Municipal Underwriter Reasonable Basis Obligations

The Commission today also published an interpretation of the legal standards applicable to municipal underwriters when they review municipal bond disclosure documents. It emphasized that underwriters must have a reasonable basis for believing the truthfulness and completeness of the key representations made in municipal disclosure documents. This responsibility arises from the implied recommendation about the securities being offered that an underwriter makes to its customers when it participates in an underwriting.

As you are aware, issuers of municipal securities are not required to make detailed disclosures of the type mandated for corporate issuers by the Securities Act of 1933 Act (1933 Act). In the absence of specifically mandated disclosure standards, the underwriter's review of disclosure concerning the financial and operational condition of the issuer assumes added importance as a means of guarding the integrity of new

offerings. Investors in the municipal securities markets are entitled to depend on accurate disclosure in considering whether to buy the offered securities, and they should be able to rely on the reputation of the underwriters participating in an offering.

In publishing an interpretation rather than a rule proposal regarding the responsibilities of underwriters in municipal securities offerings, the Commission expressed its view regarding the law as it presently exists under the anti-fraud provisions of the federal securities laws. It should be noted that failure by underwriters to live up to their responsibilities under these laws may give rise to civil liability under scienter-based provisions such as Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934 or may lead to Commission disciplinary action based upon those provisions or upon negligence-based provisions such as Section 17(a) of the 1933 Act.

While municipal underwriters generally appear to recognize a responsibility to assess the accuracy of disclosure documents used in negotiated offerings, the Commission is not convinced that the practice is universally followed in negotiated offerings. The interpretation emphasizes the existence of underwriter obligations in negotiated offerings.

Underwriters in competitive underwritings apparently consider themselves to have virtually no responsibility regarding confirmation of the accuracy of the offering

disclosure documents. The interpretation clearly rejects this contention, and emphasizes the existence of underwriter obligations even in competitive offerings.

Obligations in All Municipal Offerings

The Commission's interpretation articulates basic guidelines regarding obligations of municipal securities underwriters in both negotiated and competitive offerings. Under the interpretation, underwriters in all municipal offerings should, at a minimum, review the issuer's disclosure documents in a professional manner for possible inaccuracies and omissions. A number of factors are relevant in determining the reasonableness of a municipal underwriter's assessment of the truthfulness of the key representations contained in disclosure documents. These factors include:

1. the extent to which the underwriter relied upon municipal officials, employees, experts, and other persons whose duties provide them knowledge of particular facts;
2. the type of underwriting arrangement (e.g., firm commitment or best efforts);
3. the role of the underwriter (manager, selling group member, or selected dealer);
4. the type of bonds being offered (general obligation, revenue, or private activity);
5. the past familiarity of the underwriter with the issuer;
6. the length of time to maturity of the bonds;

7. the presence or absence of credit enhancements; and
8. whether the bonds are competitively bid or are distributed in a negotiated offering.

#### Obligations in Negotiated Offerings

In negotiated municipal offerings where the underwriter is involved in the preparation of the official statement, the underwriter's efforts should involve an inquiry into key representations in the official statement, drawing upon the underwriter's experience with the particular issuer and with other issues, and upon knowledge of the municipal markets. Sole reliance on the representations of the issuer will not suffice.

The role of the underwriter in assessing the accuracy of the issuer's key disclosures is of particular importance where the underwriting involves an unseasoned issuer.

#### Obligations in Competitively Bid Offerings

With respect to competitively bid offerings of municipal securities, members of the municipal securities industry have argued that the uncertainty of the bidding process and time pressures associated with these offerings make it difficult for underwriters to conduct an investigation of the issuer or its statements. The Commission disagrees with this contention. The fact that an offering is underwritten on a competitive basis does not negate the underwriter's responsibility to perform a reasonable review. Nevertheless, the Commission recognizes that municipal underwriters may have little initial access to

background information concerning securities that have been bid on a competitive basis. Therefore, the fact that offerings are competitively bid, rather than sold through a negotiated offering, is an element to be considered in determining the reasonableness of the underwriters' basis for assessing the truthfulness of key representations in final official statements.

It is important to note, however, that nominal classification of an underwriting as competitive will not be relevant to the scope of an underwriter's review where there is little uncertainty about the choice of underwriters, or where other factors are present that would command a closer examination.

The Commission believes that in a normal competitively bid offering, involving an established municipal issuer, a municipal underwriter generally would meet its obligation to have a reasonable basis for belief in the accuracy of the key representations in the official statement where it reviewed the official statement in a professional manner, and received from the issuer a detailed and credible explanation concerning any aspect of the official statement that appeared on its face, or on the basis of information available to the underwriter, to be inadequate. In reviewing the issuer's disclosure documents, therefore, underwriters bidding on competitive offerings should stay attuned to factors that suggest inaccuracies in the disclosure or signal that additional investigation is

necessary. If these factors appear, the underwriter should investigate the questionable disclosure and, if a problem is uncovered, pursue the inquiry until satisfied that correct disclosure has been made.

#### A Proposed Central Repository

The Commission is also requesting comment on a proposal by the MSRB to establish a central repository to collect information concerning municipal securities. The MSRB's proposal would call for the mandatory submission of official statements and certain refunding documents to a central repository, where information concerning new issues would be made available, for a fee, to interested parties. In its proposal, the MSRB expressed its belief that the repository would alleviate problems in offerings of municipal securities by allowing dealers executing transactions in new issues of securities to gain access to the information contained in official statements by way of in-house computer screens. The repository would also benefit the secondary market by allowing broker-dealers to supply complete information to customers trading in that market.

#### The UIT Inspection Project

The Commission has also announced a Unit Investment Trust Inspection Project. That project involves conducting special inspections of approximately 20 percent of the registered UITs with regard to: the decision process for selecting portfolio securities; the periodic valuation of these securities; UIT

underwriter sales practices; UIT secondary market operations; and investor experience in UIT liquidations. Following completion of that Project, scheduled for mid-1989, the Commission will decide whether to take regulatory action.

### Conclusion

The actions I have just described represent firm and responsible Commission policy. The actions were taken against the background of a mammoth default in WPPSS municipal government obligations in circumstances resembling the decade earlier New York City problem. One key fact in both situations was the lack of close scrutiny of offering documents necessary for the protection of investors. Particularly distressing to me was the fact that neither the underwriters nor the rating agencies accepted responsibility for reviewing the offering documents.

In evaluating our actions you may note that the Commission did not authorize enforcement action against any of the persons or entities involved in the WPPSS default. Nor did it suggest that a 1933 Act registration system be established for municipal securities. It did, however, request comments and cost benefit analysis regarding proposed Rule 15c2-12, regarding its interpretation of an underwriter's reasonable basis obligations, and regarding the suggested repository.

At the outset of these remarks I suggested that as members of the securities industry you have special responsibilities to create honest securities markets. Of course I believe the

Commission shares that responsibility. In my view, investors will not enter a market they believe is unfair because of dishonesty, shoddy sales practices, or informational disadvantages. I believe the steps regarding the disclosure system for municipal securities which the Commission took today will help to convince investors that they may have confidence in the honesty of our municipal securities markets.