COMMENTS

Seeking "the SEC's Full Protection": A Critique of the New Frontier in Municipal Securities Enforcement

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INTRODUCTION

The municipal securities market has become increasingly complex over the past four decades. The market is over fifteen times larger today than it was in 1975, with an estimated $3.7 trillion of principal outstanding and around forty-four thousand distinct state and local issuers accessing the market to raise capital.[1] Regulators have cautioned that "[t]he opacity of this market is unrivaled,"[2] and they have expressed "deep[ ] concern[ ] that the perfect municipal storm may be brewing."[3] Exacerbating such fears is the increasing participation of individual or "retail" investors in the primary and secondary markets: through the 1970s, the majority of municipal bond purchasers were sophisticated investors, banks, and insurance companies; today, individual investors hold more than 75 percent of outstanding municipal securities.[4] Arthur Levitt Jr, former chairman of the Securities and Exchange Commission (SEC), has

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1 See US Securities and Exchange Commission, *Report on the Municipal Securities Market* *1 & n 1 (July 31, 2012), archived at http://perma.cc/2SU3-T985. Another source has estimated that there are sixty thousand municipal securities issuers in the United States. See Christine Sgarlata Chung, *Municipal Securities: The Crisis of State and Local Government Indebtedness, Systemic Costs of Low Default Rates, and Opportunities for Reform*, 34 Cardozo L Rev 1455, 1485 (2013). In 1975, there was $235.4 billion of municipal securities outstanding. SEC, *Report on the Municipal Securities Market* at *1 n 1 (cited in note 1).

2 Arthur Levitt Jr, *Muni Bonds Need Better Oversight* (Wall St J, May 9, 2009), archived at http://perma.cc/6MGH-A72J.

3 Elisse B. Walter, *Speech by SEC Commissioner: Regulation of the Municipal Securities Market; Investors Are Not Second-Class Citizens* (SEC, Oct 28, 2009), archived at http://perma.cc/D4NT-XSGY.

4 SEC, *Report on the Municipal Securities Market* at *v, 12 (cited in note 1).

urged reform in the municipal securities market precisely because individual, presumably less sophisticated investors "need the SEC's full protection."[5]

This heightened attention has culminated in a robust new regime of enforcement against municipal issuers who appear to have fraudulently misrepresented crucial aspects of their financial health to investors. Enforcement activity over the past six years has resulted in several notable SEC firsts: for the first time ever, the SEC has charged state governments with violating the antifraud provisions of the federal securities laws, secured monetary fines against local government officials and municipalities despite the traditional notion that government entities are immune from such penalties, and subjected official and legislative communications between local governments and their citizens to liability for fraudulent misrepresentation.[6]

This Comment serves two purposes. First, it presents a narrative of the SEC's recent enforcement activity in the municipal securities market, which recent scholarship has not yet provided. Second, it serves as a starting point for a much-needed critical analysis of the SEC's newly invasive role in public finance. Part I provides background on the form and function of the municipal securities market and highlights recent trends in SEC enforcement activity. It concludes by contextualizing the SEC's activity within the broader national dilemma of local fiscal distress. Part II casts doubt on the theoretical soundness of the SEC's core justification for heightened enforcement activity in this area—that is, the protection of unsophisticated bondholders through greater market transparency—by demonstrating that local residents suffer more-significant and more-immediate harms than outside investors do when an issuer commits disclosure fraud. Part III builds on this assertion by identifying the ways in which the SEC's recent activity is conceptually and doctrinally misguided. The analysis demonstrates that the SEC's current enforcement tactics are poorly tailored to the problems they are intended to remedy. The Conclusion argues that a punitive enforcement regime is not a wise solution to the widespread problem of fiscal mismanagement among local governments, and it then presents possible alternatives to the SEC's approach.

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[5] Levitt, *Muni Bonds Need Better Oversight* (cited in note 2).

[6] See Part I.C.

I. THE MUNICIPAL SECURITIES MARKET AND THE CHANGING ROLE OF THE SEC

The public market for municipal bonds is an important source of financing for state and local governments, and it provides individual investors with low-risk investment opportunities. While it bears similarities to the corporate-securities markets, the municipal market poses unique challenges to regulators, and Congress has made clear that the federal government should play a relatively limited role in overseeing government issuers. This Part provides background on the mechanics of the market and the relevant regulatory framework. Parts I.A and I.B introduce the fundamental components of the municipal securities market and the baseline legal regime that governs it. Part I.C surveys the SEC's recent enforcement activity against government issuers and officials, highlighting the novel doctrinal approaches that the SEC has pursued. Part I.D considers the interplay between the SEC's new frontier—which focuses narrowly on issuer disclosure in the bond market—and the more complex problem of fiscal distress currently plaguing many state and local governments.

A. The Form and Function of Municipal Bonds

To understand the context of the SEC's recent enforcement activity, it is important to note that municipal bonds are bought and sold in two distinct markets: the primary, or "new issue," market and the secondary, trading market. The primary market involves a municipal government's initial offering of a new bond issue to the investing public.[7] In a primary issuance, the issuer works with an underwriter and other third parties to develop a bond offering and to bring it to market.[8] The secondary market involves the open trading of bonds after their initial issuance.[9] Local governments play an important role in the primary market

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[7] See *The Underwriting Process* (MSRB), archived at http://perma.cc/DL8D-NEPZ ("Municipal bonds may be purchased in the initial offering of the bonds, typically through municipal securities dealers that underwrite the bonds. . . . This type of transaction may be referred to as a primary market transaction or a new issue transaction.").

[8] See id (noting that "the bond offering process is a coordinated effort among various professionals" and the issuing entity).

[9] *The Secondary Market Process* (MSRB), archived at http://perma.cc/A59B-AWX6 ("After the initial sales of a new issue have been completed in the underwriting process, the bonds may continue to be bought and sold throughout the life of the security in what is generally called the secondary market.").

by communicating with advisors and investors about the nature and purpose of a given issuance, but they are generally not involved in the secondary trading of their bonds (nor do they directly benefit from secondary trading). As this Section discusses, the primary market is an important source of capital for local governments, and much of the SEC's most aggressive recent enforcement activity focuses on the manner in which local governments communicate with their direct investors.

1. The primary market.

The primary municipal securities market "is critical to building and maintaining the infrastructure of our nation."[10] State and local governments (as well as political entities like school districts and public authorities) use bond issuances to fund public projects, provide cash flow, finance government operations, and facilitate the development of beneficial private projects.[11] Municipal securities are largely considered to be safe investments due to their traditionally low rates of default.[12] They also offer investors a meaningful tax advantage over traditional corporate debt: as long as certain Internal Revenue Service (IRS) regulations are met, interest payable on municipal bonds is not subject to the federal income tax.[13] The benefits of the tax exemption work both ways: by making municipal bonds more attractive to retail and institutional investors, state and local governments benefit from lower interest rates, making it easier and more cost-efficient for the government to finance public-development projects.[14] In this way, tax preferences act as federal subsidies for the development of national infrastructure. Indeed, the Congressional Budget Office estimated in 2009 that tax exemption for municipal bonds would result in an estimated

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[10] SEC, *Report on the Municipal Securities Market* at *1 (cited in note 1).

[11] See id; Chung, 34 Cardozo L Rev at 1463–64 (cited in note 1).

[12] See Chung, 34 Cardozo L Rev at 1460–62 (cited in note 1) ("Defaults are rare in this market because issuers pledge their full 'faith and credit' or taxing power (for general obligation bonds) and dedicated revenue streams (for revenue bonds) as security for bond offerings.").

[13] The federal tax exemption is governed by 26 USC § 103 and 26 CFR § 1.103-1(a). For a straightforward discussion of the federal and state tax regimes relevant to the municipal securities market, see Philip Fischer, *Investing in Municipal Bonds: How to Balance Risk and Reward for Success in Today's Bond Market* 109–27 (McGraw-Hill 2013).

[14] See Congressional Budget Office and Joint Committee on Taxation, *Subsidizing Infrastructure Investment with Tax-Preferred Bonds* *viii (Oct 2009), archived at http://perma.cc/GS7F-4252 (noting that tax preferences on municipal bonds subsidize local development by lowering the cost of debt).

$26 billion in forgone federal revenue each year between 2008 and 2012.[15]

There are two basic types of municipal securities: general obligation bonds and revenue bonds. The two instruments are distinguished by the nature of the capital that the issuer pledges to secure the note. General obligation bonds are payable from the general funds of the government issuer and typically entail the issuing entity's "full faith and credit."[16] In the context of municipal debt, the term "full faith and credit" has been subject to reinterpretation over time, but it is widely considered to entail a commitment of all the issuer's legally available funds, in addition to a "good faith" commitment by the issuer to raise revenues in order to meet repayment obligations.[17] As a result, these obligations implicate the issuer's taxing power—that is, government issuers can and increasingly do raise taxes to avoid default on general obligation bonds.[18] State and local laws may also impose requirements and limitations on a government issuer's commitments with respect to general obligation bonds. State law may, for example, require that debt service on outstanding bonds be paid before operating expenses.[19] Or it may specify that service on debt issued by cities is payable only from ad valorem taxes.[20] The nature of the general debt obligation is therefore a function of state law as well as the formal terms of the note being

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15 See id at *5. Some academics and lawmakers have recently questioned the impact and efficacy of the tax exemption. At least one senator has called for a complete elimination of tax-exempt status for municipal bonds. See Naomi Jagoda, *Sen. Coburn: Eliminate the Muni Tax Exemption* (Bond Buyer, Dec 9, 2014), archived at http://perma.cc/3D6N-GUE9 (citing Senator Thomas Coburn's recent report highlighting potential areas of federal tax reform). See also Harvey Galper, et al, *Municipal Debt: What Does It Buy and Who Benefits?*, 67 Natl Tax J 901, 922 (2014) (finding that the tax exemption benefits both higher-income households and lower-income households, the latter by decreasing the cost of public education); Greg Aikman, et al, *Municipal Industry Roundtable: Challenges to the Tax-Exempt Status of Municipal Bonds*, 33 Mun Fin J 11, 12–17 (2012) (explaining the potential negative consequences of eliminating the tax exemption, such as harming reliance interests, creating liquidity problems, and eliminating "an efficient source of capital for state and local governments").

16 Office of Investor Education and Advocacy, *Municipal Bonds: Understanding Credit Risk* *2 (SEC, Dec 2012), archived at http://perma.cc/K4WZ-WJTD.

17 Robert A. Fippinger, *The Securities Law of Public Finance* § 8:6.2[A] (PLI 3d ed 2011).

18 See id. See also Richard C. Schragger, *Citizens versus Bondholders*, 39 Fordham Urban L J 787, 797 (2012) (arguing that historically low municipal-default rates and the twentieth century's "rhetoric . . . of bondholder inviolability" may be due, in part, to the fact that taxation provides government issuers with a "fairly stable source of revenue"); Fippinger, *The Securities Law of Public Finance* at § 1:6.1 (cited in note 17).

19 See Fippinger, *The Securities Law of Public Finance* at § 1:6.1 (cited in note 17).

20 See *Sources of Repayment* (MSRB), archived at http://perma.cc/C5FC-TC57.

issued.[21] In the event of default on a general obligation bond, bondholders may retain the right to compel a tax levy or a legislative appropriation to cover debt service.[22]

Revenue bonds, on the other hand, do not carry a full faith and credit pledge by the issuer and are instead backed by a specified, limited source of revenue, such as the revenue that the issuer expects to derive from the operation of the financed project.[23] Revenue bonds issued to finance the construction of local water and sewer facilities, for example, might be paid out of revenues obtained through local assessments for the use of those utilities.[24] The pledge of revenues creates a security interest defined by the contractual terms of the bond, which often provide investors with protection in the event of Chapter 9 bankruptcy.[25] It is also important to note that issuers rely heavily on the advice of financial advisors in constructing and marketing their offerings.[26] Novel reinventions of the traditional municipal debt instruments and increasing reliance on third-party intermediaries have contributed complexity and volatility to the municipal-debt market.[27]

2. The secondary market.

In contrast to the corporate-securities market, the secondary market in municipal bonds is thin and illiquid. According to

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21 See Fippinger, *The Securities Law of Public Finance* at § 1:6.1 (cited in note 17).

22 See id (noting that "some form of mandamus to require the production of revenue would be available" to bondholders, depending on the provisions of state law). See also *Sources of Repayment* (cited in note 20).

23 See *Sources of Repayment* (cited in note 20) ("The issuer of a revenue bond is not obligated to pay principal and interest on its bonds using any source other than the source(s) specifically pledged to the bond."); Fippinger, *The Securities Law of Public Finance* at § 1:6.2 (cited in note 17) ("A revenue bond is limited to a specifically identified source of revenues.").

24 See Fippinger, *The Securities Law of Public Finance* at § 1:6.2 (cited in note 17).

25 See id (explaining that revenue bonds provide the bondholder with bankruptcy protection because the specified source of funds will be unavailable to other creditors). The structural and legal protections afforded to investors in general obligation and revenue bonds are analyzed further in Part II.A.

26 See Robert Zipf, *How Municipal Bonds Work* 196–97 (Prentice Hall 1995); *The Underwriting Process* (cited in note 7) ("[T]he bond offering process is a coordinated effort among various professionals [and the issuing entity]. ").

27 See, for example, Arthur Levitt, *Taxpayers Fleeced When Leaders Tap Muni Market: Arthur Levitt* (Bloomberg, Oct 21, 2009), archived at http://perma.cc/5KB7-QVML. See also Walter, *Regulation of the Municipal Securities Market* (cited in note 3) ("Municipal securities are securitized and both large and small municipalities use complex structured products and financial derivatives whose risks even sophisticated investors sometimes have trouble understanding.").

a 2012 report conducted by the SEC, municipal debt is traded on a "buy-and-hold" basis:[28] most investors buy municipal bonds in the primary market and hold them to maturity.[29] As a result, "the vast majority of municipal bonds and notes do not trade regularly in the secondary market,"[30] making it difficult to determine distinct trading or pricing patterns for a given bond.[31] Furthermore, there is no central exchange for the secondary trading of municipal bonds: all secondary trading is conducted over the counter through the use of brokers.[32] As the SEC has observed, reliance on intermediaries to conduct trades increases transaction costs for investors, who do not have open access to the same types of trading and pricing data available to investors in other markets.[33]

The SEC has dedicated attention to reforming the secondary market,[34] but its most recent and aggressive activity has focused on transparency in the primary market and on the nature of communications between issuers and direct investors. These issues are, therefore, the immediate focus of this Comment.

B. Backdoor Regulation of a Once-Backwater Market

The legal regime governing the municipal securities market is distinct from the more familiar corporate regulatory framework. The law with respect to municipal issuers has changed over time, but one core principle has remained constant: Congress has expressed a desire to limit the reach of federal regulatory agencies in the realm of public finance. Understanding the evolution and current state of the law in this area is crucial to analyzing and critiquing the SEC's new enforcement frontier.

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[28] SEC, *Report on the Municipal Securities Market* at *v (cited in note 1).

[29] See Paul Schultz, *The Market for New Issues of Municipal Bonds: The Roles of Transparency and Limited Access to Retail Investors*, 106 J Fin Econ 492, 494 (2012).

[30] Chung, 34 Cardozo L Rev at 1485 (cited in note 1). See also Schultz, 106 J Fin Econ at 494–95 (cited in note 29) ("The majority of trades, 8.8 million of 11.3 million, are investor purchases of bonds from dealers.").

[31] Chung, 34 Cardozo L Rev at 1485 (cited in note 1) (explaining that the resulting lack of price transparency in the municipal bond market makes it harder for both investors and taxpayers to assess the risks of any given bond).

[32] See SEC, *Report on the Municipal Securities Market* at *19–20 (cited in note 1).

[33] Id at *v–vi, 2, 123.

[34] See, for example, id at *112–50 (examining the structure and flaws of the secondary market and providing recommendations for improvement).

1. Limits on direct SEC regulation.

Until the mid-1970s, the municipal securities market was a "sleepy,"[35] "quiet backwater market"[36] with low investment risk and minimal regulatory oversight.[37] In fact, in passing the Securities Act of 1933[38] ("Securities Act") and the Securities Exchange Act of 1934[39] ("Exchange Act"), Congress deliberately exempted municipal securities from direct federal regulation.[40] At the time, regulation of municipal bonds seemed unnecessary in light of both the perceived sophistication of the institutional investors that dominated the market and the fact that abuses were uncommon.[41] More importantly, lawmakers were concerned that drawing local governments under the umbrella of federal oversight would run afoul of the constitutional principle of state sovereignty.[42]

By the 1970s, circumstances had changed: the market had grown to include a greater proportion of unsophisticated individual investors, and instances of fraud in the secondary market had risen.[43] Congress responded by passing the Securities Acts Amendments of 1975[44] ("1975 Amendments"), which established a limited scheme to regulate secondary market participants, including underwriters, brokers, and dealers.[45] The 1975

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[35] Christopher Cox, *Speech by SEC Chairman: Integrity in the Municipal Market* (SEC, July 18, 2007), archived at http://perma.cc/2ZR5-4HRR.

[36] Erik R. Sirri, *Speech by SEC Staff: Remarks to the 2008 Bond Attorney's Workshop of the National Association of Bond Lawyers* (SEC, Sept 17, 2008), archived at http://perma.cc/Z9EC-YDXB (noting that "some may have considered [the municipal bond market] a quiet backwater market in the past").

[37] See Chung, 34 Cardozo L Rev at 1456–58 (cited in note 1) (noting that, until the mid-1970s, "[i]nterest rates were steady and defaults were rare").

[38] 48 Stat 74, codified as amended at 15 USC § 77a et seq.

[39] 48 Stat 881, codified as amended at 15 USC § 78a et seq.

[40] As is discussed in Part I.B.2, issuers remain subject to the antifraud provisions of the federal securities laws, exposing them to SEC scrutiny and enforcement. Division of Market Regulation, *Staff Report on the Municipal Securities Market* *1, 9 n 9, Appendix A (SEC, Sept 1993), archived at http://perma.cc/PH99-QE5L.

[41] Id at *1, Appendix A.

[42] See id at *1, 8 n 3, Appendix A.

[43] Id at *3, Appendix A. The 1975 Amendments were also, and more directly, spurred by the New York City bond crisis of the 1970s. See Theresa A. Gabaldon, *Financial Federalism and the Short, Happy Life of Municipal Securities Regulation*, 34 J Corp L 739, 742 (2009).

[44] Pub L No 94-29, 89 Stat 97, codified as amended in various sections of Title 15.

[45] See *Securities Acts Amendments of 1975, Report of the Committee on Banking, Housing and Urban Affairs*, S Rep No 94-75, 94th Cong, 1st Sess 38–53 (1975), reprinted in 1975 USCCAN 179, 215–31. See also SEC, *Report on the Municipal Securities Market* at *27–29, 33–37 (cited in note 1).

Amendments also created "a new, but limited, self-regulatory organization,"[46] the Municipal Securities Rulemaking Board (MSRB), which holds primary rulemaking authority over the activities of private market actors.[47] The SEC retains jurisdiction over the MSRB's rulemaking activities and remains responsible for enforcement of the securities laws and rules promulgated by the MSRB.[48]

While the 1975 Amendments paved the way for increased oversight of private market participants, Congress remained reluctant to impose regulatory burdens on government issuers themselves. Congress preserved the long-standing exemption of municipal securities from both the registration requirements of the Securities Act and the mandatory periodic-reporting regime prescribed by the Exchange Act.[49] Both these exemptions remain in effect today.[50] Furthermore, a core provision of the 1975 Amendments—commonly referred to as the Tower Amendment—expressly prohibits the SEC and the MSRB from directly mandating public disclosures by municipal issuers prior to a primary bond issuance.[51] It establishes that

> [n]either the Commission nor the Board is authorized under this chapter, by rule or regulation, to require any issuer of municipal securities, directly or indirectly through a purchaser or prospective purchaser of securities from the issuer, to file with the Commission or the Board prior to the sale of such securities by the issuer any application, report, or document in connection with the issuance, sale, or distribution of such securities.[52]

The Tower Amendment is somewhat narrow: by its terms, it prohibits the SEC and the MSRB from regulating issuer disclo-

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46 S Rep No 94-75 at 46 (cited in note 45).

47 See id. See also SEC, *Report on the Municipal Securities Market* at *33–36 (cited in note 1).

48 S Rep No 94-75 at 47, 49–50 (cited in note 45).

49 See 15 USC § 77c(a)(2). See also Securities and Exchange Commission, Statement of the Commission regarding Disclosure Obligations of Municipal Securities Issuers and Others, 59 Fed Reg 12747, 12749 (1994) (interpreting 17 CFR Parts 211, 231, and 241).

50 See Luis A. Aguilar, *Statement on Making the Municipal Securities Market More Transparent, Liquid, and Fair* (SEC, Feb 13, 2015), archived at http://perma.cc/2C8W-VDUG (arguing that "Congress should repeal municipal securities' exemption from the Securities Act's registration provisions, and from the Exchange Act's ongoing reporting requirements").

51 15 USC § 78o-4(d)(1).

52 15 USC § 78o-4(d)(1).

sure practices only prior to—not after—a given bond issuance. Nonetheless, nothing in the existing securities laws affirmatively authorizes the SEC to require an issuer to provide continuing disclosure documents after an issuance has taken place and as bonds mature. As a result, the SEC has consistently interpreted the Tower Amendment to impose a strict limitation on its own ability to regulate issuer disclosures at the offering stage and over the lifetime of a bond.[53] As a result—and in stark contrast to the highly regulated disclosure system of the corporate-securities market—discretion as to the substance and timing of financial disclosures lies squarely with issuers.

As the Senate report advocating for the 1975 Amendments indicates, Congress's rationale for maintaining a light regulatory touch on issuers was twofold: first, in the words of the Senate report, a new approach to issuer regulation would represent a "radical incursion on states' prerogatives" (an oblique reference to baseline principles of state sovereignty); and second, Congress was "not aware of any abuses" by municipal issuers, such that the practical conditions of the market at the time simply did not warrant radical congressional action.[54]

The Tower Amendment's proscription does not, however, apply to private entities. Subsequent refinements of SEC and MSRB rules have therefore imposed disclosure and due diligence obligations on underwriters and other private firms involved in public issuances. Most notably, underwriters are required under SEC and MSRB rules to "obtain and review" offering and continuing disclosure documents prepared by the municipal issuer[55] at the time of offering and on an ongoing basis, and they must submit copies of those statements to the MSRB for inclusion in its central Electronic Municipal Market Access system (EMMA).[56]

The express carveout of municipal entities from direct SEC regulation has contributed to what many critics have called a

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53 Under the SEC's interpretation, "[t]he 1975 Amendments do not, by their terms, preclude the Commission from promulgating disclosure standards in municipal offerings, but there is no express statutory authority contained in the Exchange Act over disclosure by municipal issuers." SEC, *Report on the Municipal Securities Market* at *28 (cited in note 1). The SEC presumes that the absence of express authorization prevents it from taking steps to require issuers to file periodic postissuance disclosures.

54 S Rep No 94-75 at 44 (cited in note 45).

55 17 CFR § 240.15c2-12(b)(1).

56 See *Rule G-32: Disclosures in Connection with Primary Offerings* (MSRB), archived at http://perma.cc/LF5N-RX45.

piecemeal, backdoor disclosure regime.[57] Even when disclosures are made publicly available through EMMA, municipal issuers are not required to follow any specific SEC rules or general accounting standards in preparing them; issuers essentially have "carte blanche in designing their own financial statements."[58] As a result, disclosures lack uniformity, making it more costly for investors to collect and compare financial data across the market.[59]

2. Fraud liability and SEC enforcement.

While municipal issuers are not directly regulated, they *are* subject to the core antifraud provisions of the federal securities laws: § 17(a) of the Securities Act, § 10(b) of the Exchange Act, and Rule 10b-5, promulgated under § 10(b).[60] Fraud liability arose from the 1975 Amendments, which added governments and political subdivisions to the definition of "person" found in § 3(a)(9) of the Exchange Act.[61] Subsequent courts have agreed that, by thus expanding the scope of § 3(a)(9), Congress intended to subject municipalities to SEC enforcement under §§ 17(a) and 10(b), as well as to the implied private right of action under § 10(b).[62] This is yet another backdoor feature of the Tower Amendment's legal framework: issuer conduct is regulated not by ex ante procedural rules but rather by ex post litigation under the enforcement discretion of the SEC and through the action of private litigants.

57 See, for example, Gabaldon, 34 J Corp L at 746, 768–69 (cited in note 43) (noting that the current regulatory regime has been "coaxing municipal disclosure through the barn's back door").

58 Id at 752–53.

59 See Darien Shanske, *The Feds Are Already Here: The Federal Role in Municipal Debt Finance*, 33 Rev Bank & Fin L 795, 802 (2014) (noting that "the quality of disclosure varies widely and there are high transaction costs involved in collecting and assessing disparate data").

60 See SEC, *Report on the Municipal Securities Market* at *29 (cited in note 1).

61 1975 Amendments § 3(2), 89 Stat at 97, codified at 15 USC § 78c(a)(9). See also Fippinger, *The Securities Law of Public Finance* at § 15:2 (cited in note 17); *Green v Utah*, 539 F2d 1266, 1273–74 (10th Cir 1976) (holding that the expanded definition of the term "person" as including government entities does not abrogate sovereign immunity).

62 See, for example, *Sonnenfeld v City and County of Denver*, 100 F3d 744, 746–47 (10th Cir 1996) (holding that "Congress intended by its 1975 amendment to subject municipalities to the then well-established private right of action under § 10(b) when it expressly brought municipalities within the scope of that section"). See also Fippinger, *The Securities Law of Public Finance* at § 15:2 (cited in note 17) ("In short, the substantive antifraud provisions apply to any person, the definition of a person includes states and political subdivisions, and the SEC enforcement powers extend to any person acting in violation of the substantive provisions.").

The antifraud provisions differ in subtle but important ways. Section 10(b) makes it unlawful for any "person"—including, under the Tower Amendment, any government entity—"[t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device" in contravention of SEC rules and regulations.[63] Rule 10b-5 implements § 10(b) with prohibitions of specific fraudulent practices in connection with the sale of a security.[64] The elements of proof for a Rule 10b-5 claim are demanding: a private plaintiff must show that (1) the defendant made a false statement or omission of material fact (2) with scienter (3) "in connection with the purchase or sale of any security" that (4) the plaintiff justifiably relied on, and that (5) the material misstatement or omission proximately caused (6) the plaintiff's economic loss.[65] The SEC is relieved of the requirement to plead reliance.[66]

The materiality element is a site of potential ambiguity in the municipal context because of the unique ways in which local governments communicate with stakeholders. In general, an omitted or misstated fact is "material" if there is a substantial likelihood that a reasonable investor would have viewed the fact "as having significantly altered the 'total mix' of information made available" to the investing public.[67] The "total mix" generally includes information that exists in the public domain and is reasonably available to investors, including information circulated in general media.[68] But defining the outer bounds of the total mix is a fact-intensive inquiry that has been treated variably

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[63] 15 USC § 78j(b).

[64] Rule 10b-5 reads:

> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce . . . (a) To employ any device, scheme, or artifice to defraud, (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

17 CFR § 240.10b-5.

[65] *Dura Pharmaceuticals, Inc v Broudo*, 544 US 336, 341 (2005).

[66] See Fippinger, *The Securities Law of Public Finance* at § 14:1.1 (cited in note 17).

[67] *Basic Inc v Levinson*, 485 US 224, 232 (1988), quoting *TSC Industries, Inc v Northway, Inc*, 426 US 438, 449 (1976).

[68] See Thomas Lee Hazen, 4 *Treatise on the Law of Securities Regulation* § 12.9 (West 6th ed 2009).

among federal courts and the SEC, and there exist no clear judicial guidelines for applying the concept in the municipal context.[69]

The coverage of § 17(a) is broader. It governs all security sales—not just those associated with public offerings—and makes it unlawful for any "person" (1) "to employ any device, scheme, or artifice to defraud"; (2) to "obtain money or property" by means of material misstatements or omissions; or (3) to engage in any business practices that "would operate as a fraud . . . upon the purchaser."[70] Courts have held that charges under § 17(a)(2) or (3) can be tried under a negligence standard, rather than the higher scienter standard that applies to claims under §§ 17(a)(1) or 10(b).[71] In practice, many charges that might be brought under Rule 10b-5 can also be crafted to fit within the language of § 17(a), making this provision a more potent enforcement tool than § 10(b) itself. Importantly, even though the SEC is empowered to bring charges under § 17(a), the majority of courts have not recognized a private right of action under § 17(a)'s more permissive standard.[72] Private litigants face a higher threshold and a more limited set of tools in bringing fraud claims in both the municipal and the corporate contexts.[73] The SEC thus has significant leeway in designing the charges that it may bring against a municipal issuer.

The SEC has additional latitude in determining the procedural route of an enforcement action. In general, the SEC is empowered to bring a civil action against an issuer in federal district court for an injunction or civil penalties, but it may also pursue an administrative proceeding before an SEC administrative law judge (ALJ).[74] One of the SEC's principal tools in the

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69 See id. The SEC's recent attempts to apply the "total mix" concept to statements made by municipal issuers is analyzed more fully in Part I.C.2 and Part III.B.2.

70 15 USC § 77q(a).

71 See *Securities and Exchange Commission v Tambone*, 550 F3d 106, 125–27 (1st Cir 2008) (explaining that liability under § 17(a)(2) is broader than under § 10(b)); *Tellabs, Inc v Makor Issues & Rights, Ltd*, 551 US 308, 319 (2007) (confirming that private litigants must prove scienter under § 10(b)).

72 It is somewhat unsettled whether an implied private right of action under § 17(a) exists, but the majority of courts have declined to recognize such a right. See Michael J. Kaufman, 26A *Securities Litigation: Damages* § 19:1 (West 2014) (explaining that the Fifth, Eighth, Ninth, and Eleventh Circuits, as well as certain lower courts in the Sixth Circuit, do not recognize such a private right of action, and that the Second, Fourth, and Seventh Circuits have indicated a willingness to consider the same position).

73 See Fippinger, *The Securities Law of Public Finance* at § 14:1.1[A] (cited in note 17) (outlining the aspects of antifraud law and procedure that disfavor suits brought by private litigants seeking damages awards).

74 See id at § 15:1.

municipal context is the cease and desist order, an administrative remedy analogous to a court-ordered injunction.[75] In contrast to a court order, the SEC alone authors the terms of the cease and desist order, allowing it to "control[ ] the script" of a proceeding.[76] Respondents have the right to a hearing before an ALJ, who may affirm or deny the SEC's proposed order.[77] Final orders are appealable to the SEC directly and, thereafter, to a federal appellate court.[78] But the expense of the appeals process, in addition to the fact that courts grant the SEC considerable deference in administrative activities,[79] incentivizes parties to not challenge proposed cease and desist orders or to otherwise settle with the SEC before any charges are brought.[80]

C. "We're Here to Stay": Uncharted Territory in SEC Enforcement

In the wake of a 2012 review of disclosure practices[81]—and amidst a recent rise in instances of municipal fiscal distress[82]—the SEC has become increasingly aggressive in levying fraud charges against municipal issuers and local officials under

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75 See 15 USC § 77h-1. See also Fippinger, *The Securities Law of Public Finance* at § 15:8.2 (cited in note 17).

76 Fippinger, *The Securities Law of Public Finance* at § 15:8.2 (cited in note 17).

77 See id.

78 See id.

79 Federal courts review final SEC administrative orders under a "very deferential" substantial-evidence standard, under which the court asks whether a reasonable mind would accept the evidentiary record before the SEC as adequate to support the SEC's conclusion. *Dolphin and Bradbury, Inc v Securities and Exchange Commission*, 512 F3d 634, 639 (DC Cir 2008), citing *National Association of Securities Dealers v Securities and Exchange Commission*, 801 F2d 1415, 1419 (DC Cir 1986), and *Dickinson v Zurko*, 527 US 150, 162 (1999).

80 See Fippinger, *The Securities Law of Public Finance* at § 15:8.2 (cited in note 17). See also Sonia A. Steinway, Comment, *SEC "Monetary Penalties Speak Very Loudly," but What Do They Say? A Critical Analysis of the SEC's New Enforcement Approach*, 124 Yale L J 209, 226–30 (2014) (noting that parties are more incentivized to settle with the SEC because the uncertainty of pending litigation chills relationships with customers and demoralizes management).

81 See SEC, *Report on the Municipal Securities Market* at *56–111 (cited in note 1); Division of Enforcement, *Municipalities Continuing Disclosure Cooperation Initiative* (SEC, Nov 13, 2014), archived at http://perma.cc/6594-J974 ("[T]here is significant concern that . . . federal securities law violations involving false statements [in issuer disclosures] . . . may be widespread.").

82 At the same time that the SEC has increased scrutiny of disclosure practices among local issuers, a number of local governments have faced increasing financial pressures and even insolvency. Local fiscal distress is an important backdrop to the SEC's recent activity and is examined in more depth in Part I.D.2.

§ 17(a), § 10(b), and Rule 10b-5.[83] The majority of its recent activity has involved administrative cease and desist orders, in which local issuers have agreed to cease and desist from committing further violations of federal securities laws without admitting or denying the SEC's findings of fraud.[84] To bolster these enforcement efforts, the SEC launched the Municipalities Continuing Disclosure Cooperation Initiative (MCDC) in March 2014.[85] The MCDC was a wide-ranging self-reporting program offering the possibility of lenient settlement terms to issuers or private parties that admitted to violations of §§ 17(a) or 10(b) of the federal securities laws.[86] The program ended on December 1, 2014.[87] The SEC has declined to reveal either the total number or the substance of the reports that were filed,[88] but one source from the financial industry estimates that as many as one thousand issuers have confessed to a wide range of disclosure inadequacies.[89]

While the SEC has been reluctant to notify stakeholders of its enforcement strategy going forward, the municipal securities market has already seen a surge in enforcement activity in response to the various violations disclosed through the program.[90] By October 2015, the SEC had reached two rounds of settlements with municipal underwriters, and commentators expect the SEC to

[83] Andrew Ceresney, current director of the SEC's Division of Enforcement, recently declared that the area of municipal disclosure is "a place we're here to stay." Kyle Glazier, *SEC's Top Cop: More Muni Enforcement, Not Less* (Bond Buyer, Nov 10, 2014), archived at http://perma.cc/Y3BR-QAEG. This new focus comports with one of the Government Accountability Office's 2012 recommendations for improving the disclosure climate in the municipal securities market. See *Municipal Securities: Options for Improving Continuing Disclosure* *35–36 (GAO, July 2012), archived at http://perma.cc/PHF5-JP7T (suggesting that the SEC could use its antifraud authority as "leverage to improve issuers' adherence with continuing disclosure agreements").

[84] For a summary of recent SEC actions, see Appendix. For a discussion of the use of cease and desist orders in the realm of municipal finance, see Fippinger, *The Securities Law of Public Finance* at § 15:8.2 (cited in note 17).

[85] See Division of Enforcement, *Municipalities Continuing Disclosure Cooperation Initiative* (cited in note 81).

[86] See id.

[87] Id.

[88] See Kyle Glazier, *Gaunt: MCDC Enforcement Actions Will Make Clear SEC's Views* (Bond Buyer, Dec 11, 2014), archived at http://perma.cc/9L8S-C8C6.

[89] See Hilary Russ, *U.S. Towns, Schools Admit to Failing to Filing Financial Disclosures* (Reuters, Dec 1, 2014), archived at http://perma.cc/QG6Z-QRJW (noting that issuers have revealed "minor bookkeeping errors or filings late by a few days, as well as serious breaches," and that the violations being disclosed are "all over the map").

[90] See Glazier, *Gaunt* (cited in note 88) (reporting that the SEC's Division of Enforcement plans to pursue actions against issuers and financial intermediaries who have come forward through the MCDC).

turn its attention to state and local issuers next.[91] Despite the slow pace of enforcement following the MCDC, increased scrutiny in this area has already led to several novel applications of securities law. Each of these novelties will impact the SEC's approach toward issuer settlements going forward.

1. The SEC has pursued enforcement actions against state governments.

In 2010, New Jersey entered into an administrative settlement with the SEC, making it "the first state ever charged by the SEC for violations of the federal securities laws."[92] Since then, the SEC has settled with two additional states[93] for fraudulently failing to disclose significant pension liabilities and other material financial risks to bond investors in violation of § 17(a). As a condition of each settlement, the states agreed to cease and desist from "committing or causing any violations and any future violations" of securities laws and to improve their internal disclosure processes, but they were not required to admit any wrongdoing nor were they subject to monetary fines.[94] The settlement with New Jersey explicitly states that, "as an issuer of municipal securities, [New Jersey] is subject to the antifraud provisions of the federal securities laws."[95] A similar assertion of

[91] See Jack Casey, *22 MCDC Settlements with Firms to Be Followed by Another Round* (Bond Buyer, Sept 30, 2015), archived at http://perma.cc/2CEK-YAL2; Andrew Ackerman, *SEC Charges Municipal Underwriters with Making False Statements* (Wall St J, Sept 30, 2015), archived at http://perma.cc/5GMW-HJNS.

[92] *SEC Charges State of New Jersey for Fraudulent Municipal Bond Offerings* (SEC, Aug 18, 2010), archived at http://perma.cc/N6JK-2ENE.

[93] The SEC filed cease and desist orders against New Jersey on August 18, 2010, against Illinois on March 11, 2013, and, most recently as of this writing, against Kansas on August 11, 2014. See generally Order Instituting Cease-and-Desist Proceedings pursuant to Section 8A of the Securities Act of 1933, Making Findings, and Imposing a Cease-and-Desist Order, *In the Matter of State of New Jersey*, Securities Act of 1933 Release No 9135, SEC Administrative Proceeding No 3-14009 (Aug 18, 2010) (available on Westlaw at 2010 WL 3260860) ("*New Jersey* Order"); Order Instituting Cease-and-Desist Proceedings pursuant to Section 8A of the Securities Act of 1933, Making Findings, and Imposing a Cease-and-Desist Order, *In the Matter of State of Illinois*, Securities Act of 1933 Release No 9389, SEC Administrative Proceeding No 3-15237 (Mar 11, 2013) (available on Westlaw at 2013 WL 873208) ("*Illinois* Order"); Order Instituting Cease-and-Desist Proceedings pursuant to Section 8A of the Securities Act of 1933, Making Findings, and Imposing a Cease-and-Desist Order, *In the Matter of the State of Kansas*, Securities Act of 1933 Release No 9629, SEC Administrative Proceeding No 3-16009 (Aug 11, 2014) (available on Westlaw at 2014 WL 3896055) ("*Kansas* Order").

[94] *New Jersey* Order at *14–16 (cited in note 93); *Illinois* Order at *8–11 (cited in note 93); *Kansas* Order at *6–8 (cited in note 93).

[95] *New Jersey* Order at *14 (cited in note 93).

state liability is notably absent from the two more-recent settlement agreements with Illinois and Kansas,[96] but these states did not challenge the SEC's authority to assert the charges.

2. The SEC has expanded the basis for fraud violations to include any public statement made by municipal governments or officials, even outside the context of securities disclosures.

In a 2013 administrative settlement, the SEC alleged that the city of Harrisburg, Pennsylvania, violated § 10(b) and Rule 10b-5 by making materially misleading statements about the city's failing financial health in its budget report, in its annual and midyear financial statements, and in the mayor's State of the City address.[97] The SEC announced that this was "the first time that [it had] charged a municipality for misleading statements made outside of its securities disclosure documents."[98] Simultaneously with its press release announcing the settlement, the SEC issued an investigation report warning public officials that their public statements are part of, and can impact, "the total mix of information available to the market" in their securities.[99] As discussed in Part I.B.2, the "total mix" inquiry is the standard for defining materiality in a fraud claim under § 17(a) or § 10(b). The SEC has, therefore, clearly established that misleading information contained in public statements can lead to liability under the federal securities laws.

3. Monetary penalties against government entities and officials are now a central—and controversial—focus of

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[96] Unlike the *New Jersey* Order, which specifically asserts that states are liable under § 17(a), the *Illinois* Order and *Kansas* Order describe the mandates of that provision more broadly. *Illinois* Order at *9 (cited in note 93) ("Issuers of municipal securities are responsible for the accuracy of their disclosure documents."); *Kansas* Order at *7 (cited in note 93) ("Issuers of municipal securities must ensure that financial information contained in their disclosure documents is not materially misleading.").

[97] See Order Instituting Cease-and-Desist Proceedings pursuant to Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order, *In the Matter of the City of Harrisburg, Pennsylvania*, Securities Exchange Act of 1934 Release No 69515, SEC Administrative Proceeding No 3-15316, *2 (May 6, 2013) (available on Westlaw at 2013 WL 1869030).

[98] *SEC Charges City of Harrisburg for Fraudulent Public Statements* (SEC, May 6, 2013), archived at http://perma.cc/G5VV-K84H.

[99] US Securities and Exchange Commission, *Report of Investigation in the Matter of the City of Harrisburg, Pennsylvania concerning the Potential Liability of Public Officials with Regard to Disclosure Obligations in the Secondary Market* (May 6, 2013), archived at http://perma.cc/L9AF-CGPA.

the SEC's enforcement program.

In a further attempt to add teeth to its antifraud enforcement authority, the SEC has successfully pursued monetary penalties against several city officials and at least one municipal government.[100] In a 2010 settlement in the Southern District of California, the former City Manager, Auditor and Comptroller, Deputy City Manager for Finance, and City Treasurer for the city of San Diego all agreed to personally forfeit a combined total of $80,000 to settle charges that they violated § 17(a) for failing to inform investors of the city's underfunded-pension liabilities.[101] In another first-of-its-kind enforcement action, the Greater Wenatchee Regional Events Center Public Facilities District of Washington recently agreed to pay $20,000 in a cease and desist proceeding in which the SEC alleged that the district made materially false statements regarding a revenue bond issued during the 2008 financial crisis.[102] The SEC has secured monetary penalties from several additional municipal officials since these settlements[103] and has announced that it will "continue to look for opportunities to hold individuals personally accountable for their roles in breaking federal securities laws."[104]

Some portion of the SEC's recent zeal for monetary penalties stems from the Dodd-Frank Wall Street Reform and Consumer Protection Act[105] ("Dodd-Frank"), which authorized the SEC to impose monetary penalties in cease and desist proceed-

[100] See Appendix.

[101] See *Former San Diego Officials Agree to Pay Financial Penalties in Municipal Bond Fraud Case* (SEC, Oct 27, 2010), archived at http://perma.cc/G8TD-82V8 (noting that this was "the first time that the SEC had secured financial penalties against city officials in a municipal bond fraud case"). The settlement was reached after the SEC filed charges against the officials in the United States District Court for the Southern District of California. See generally Complaint for Violations of the Federal Securities Laws, *Securities and Exchange Commission v Uberuaga*, Civil Action No 08-0621 (SD Cal filed Apr 7, 2008).

[102] See Order Instituting Cease-and-Desist Proceedings pursuant to Section 8A of the Securities Act of 1933, Making Findings, and Imposing Remedial Sanctions and a Cease-and-Desist Order, *In the Matter of the Greater Wenatchee Regional Events Center Public Facilities District*, Securities Act of 1933 Release No 9471, SEC Administrative Proceeding No 3-15602, *12 (Nov 5, 2013) (available on Westlaw at 2013 WL 5914980).

[103] See, for example, *SEC Charges Allen Park, Mich. and Two Former City Leaders in Fraudulent Muni Bond Offering for Movie Studio Project* (SEC, Nov 6, 2014), archived at http://perma.cc/D5ZA-NL9F (noting that the Allen Park mayor has agreed to settle the suit against him for a $10,000 monetary penalty). For a discussion on the implications of this case, see Parts I.C.4, II.C.

[104] Glazier, *SEC's Top Cop* (cited in note 83) (paraphrasing remarks by Ceresney, director of the SEC's Division of Enforcement).

[105] Pub L No 111-203, 124 Stat 1376 (2010).

ings against any person.[106] As discussed in Part I.B.2, the term "person" under § 3(a)(9) of the Exchange Act now includes municipal issuers.[107] Prior to Dodd-Frank, the SEC was permitted to pursue monetary penalties against a municipal entity or official only through civil suits filed in federal district courts—not through administrative proceedings.[108] One effect of Dodd-Frank was to expand the SEC's options and discretion in levying monetary fines against any violators of the antifraud provisions.

However, the legal propriety of demanding civil penalties from government officials is unclear and has recently proved to be controversial. As the Supreme Court has long held, government officials are entitled to immunity from private damages suits as long as they are performing discretionary functions.[109] This doctrine of qualified immunity is designed to "balance[ ] two important interests—the need to hold public officials accountable when they exercise power irresponsibly and the need to shield officials from harassment, distraction, and liability when they perform their duties reasonably."[110] As such, the doctrine protects any officer who "reasonably believes that his or her conduct complies with the law."[111] The question whether this doctrine shields public officials from federal enforcement actions, in addition to private suits, is unsettled.[112]

The Eleventh Circuit acknowledged the novelty of the question in a brief, unpublished opinion issued September 5, 2014, in *Securities and Exchange Commission v City of Miami*.[113] The court affirmed the lower court's holding that Michael Boudreaux, a former Miami budget director who allegedly contributed to misrepresentations contained in several of the city's bond-offering documents, was not entitled to the immunity defense

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106 Dodd-Frank § 929P(a)(1), 124 Stat at 1862–63, codified at 15 USC § 77h-1(g).

107 See text accompanying notes 60–62.

108 See Fippinger, *The Securities Law of Public Finance* at § 15:4.3 (cited in note 17).

109 *Harlow v Fitzgerald*, 457 US 800, 817–18 (1982) (holding that as long as public officials do not violate "clearly established statutory or constitutional rights of which a reasonable person would have known," their performances of discretionary functions are protected from liability).

110 *Pearson v Callahan*, 555 US 223, 231 (2009).

111 Id at 244.

112 See *Securities and Exchange Commission v City of Miami*, 2014 WL 4377831, *2 (11th Cir) ("Neither this court nor any of our sister circuits has addressed the issue of whether municipal officials are entitled to qualified immunity in a SEC enforcement action under the federal securities laws.").

113 2014 WL 4377831 (11th Cir), cert denied, *Boudreaux v Securities and Exchange Commission*, 135 S Ct 2890 (2015).

against the SEC's suit for monetary penalties.[114] The reasoning was relatively sparse: The court noted that "there is no history at common law of civil immunities being applied as a defense to federal enforcement actions,"[115] but it failed to acknowledge the substantial body of case law questioning the efficacy of monetary sanctions against government actors.[116] It further failed to observe that SEC enforcement actions against public officials are themselves relatively uncommon.

In December 2014, the Eleventh Circuit declined to rehear the decision, leading Boudreaux to file a petition for a writ of certiorari with the Supreme Court on March 17, 2015.[117] The precise question presented was "[w]hether a government officer performing discretionary functions is entitled to a defense of qualified immunity when facing monetary penalties under a federal statute."[118] The Court denied certiorari on June 29, 2015,[119] signaling that the imposition of penalties on issuers will remain contentious as the SEC tests the bounds of liability in this market.

4. The SEC has invoked control person liability to bring charges against a city official.

Consistent with its declared focus on individual liability as "the most effective deterrent" of fraudulent disclosure,[120] the SEC alleged in November 2014 that Gary Burtka, former mayor of Allen Park, Michigan, "controlled" the city of Allen Park at the time it issued $28 million in revenue bonds and that he was therefore liable for the city's fraudulent misrepresentations in connection with those bonds.[121] The SEC based its theory of lia-

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114 Id at *3.

115 Id at *2.

116 See, for example, *Anderson v Creighton*, 483 US 635, 638 (1987) (observing that "permitting damages suits against government officials can entail substantial social costs").

117 See Petition for Writ of Certiorari, *Boudreaux v Securities and Exchange Commission*, Docket No 14-1142, *1 (US filed Mar 17, 2015) ("*Boudreaux* Petition").

118 Id at *i.

119 *Boudreaux v Securities and Exchange Commission*, 135 S Ct 2890, 2890 (2015).

120 Glazier, *SEC's Top Cop* (cited in note 83).

121 Complaint, *Securities and Exchange Commission v Burtka*, Civil Action No 14-14278, *2 (ED Mich filed Nov 6, 2014) ("*Burtka* Complaint"). See also generally Order Instituting Cease-and-Desist Proceedings pursuant to Section 8A of the Securities Act of 1933 and Section 21C of the Securities Exchange Act of 1934, Making Findings, and Imposing a Cease-and-Desist Order, *In the Matter of City of Allen Park, Michigan*, Securities Act of 1933 Release No 9677, SEC Administrative Proceeding No 3-16259 (Nov 6, 2014) (available on Westlaw at 2014 WL 5764984) ("*Allen Park* Order").

bility on § 20(a) of the Exchange Act,[122] which provides that "[e]very person who, directly or indirectly, controls any person" proved to be liable under the antifraud provisions "shall also be liable jointly and severally with and to the same extent as such controlled person."[123] Without addressing the SEC's § 20(a) theory, a judge for the United States District Court for the Eastern District of Michigan approved a settlement between the SEC and Burtka in January 2015.[124] Under the terms of the settlement, Burtka agreed both to permanently refrain from participating in any municipal securities offerings and to pay a monetary penalty of $10,000.[125] Although the settlement order is not clear on this point, Burtka's lifetime injunction from participating in municipal bond offerings will likely preclude him from serving in any public role that relates to local economic development or financial planning. A fraud charge against a municipal official based solely on § 20(a) is another first-of-its-kind SEC enforcement.[126] It is not clear how far this liability can or should extend in the context of municipal government.

D. Framing the New Frontier

To emphasize an obvious point, this new, multifaceted enforcement regime pointedly targets the act of disclosure. There is a practical reason for this: As discussed in Part I.B, the SEC's authority with respect to municipal issuers is limited to enforcing the antifraud provisions of the securities laws.[127] Policing fraudulent disclosures is, therefore, as close as the SEC can come to regulating issuers themselves. But while the SEC's tools may be limited, its policy objectives are broad. According to the SEC's description of its recent initiatives, the purpose of heightened enforcement is to demand greater accountability from local officials by increasing the threat of liability.[128] The SEC reasons

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[122] See *Burtka* Complaint at *2 (cited in note 121).

[123] 15 USC § 78t(a).

[124] Final Judgment as to Defendant Gary J. Burtka, *Securities and Exchange Commission v Burtka*, Civil Action No 14-14278, *3 (ED Mich filed Jan 28, 2015) ("*Burtka* Final Judgment").

[125] Id at *2.

[126] See *SEC Charges Allen Park, Mich. and Two Former City Leaders* (cited in note 103).

[127] See text accompanying notes 60–62.

[128] The SEC has repeatedly articulated this goal in public statements announcing its recent enforcement efforts. For example, the current chief of the SEC's Division of Enforcement's municipal securities unit recently remarked that the Division "won't hesitate to use every legal avenue available to [the SEC] in order to hold [ ] officials accountable." *SEC Charges Allen Park, Mich. and Two Former City Leaders* (cited in note 103).

that this will deter issuer fraud, which will in turn "make our municipal securities market fairer and more transparent" on multiple fronts.[129]

While most would agree that both greater government transparency and market fairness are unobjectionable regulatory goals, it is worthwhile to pause and take a more disciplined look at the means and the rhetoric that the SEC has employed in pursuit of these goals. This Section contrasts the SEC's rhetoric—which is pointedly focused on the need to protect individual investors from issuer fraud—with the reality of financial distress that has recently plagued cities and towns across the country. A closer analysis reveals that there is a mismatch between the goals that the SEC has articulated and the core problems that many local governments and citizens currently face.

1. The SEC's investor-protection rhetoric.

The SEC consistently cites the need to protect retail investors from disclosure fraud as the core justification for aggressive enforcement action against government issuers and their officers. In a 2009 speech calling for greater regulatory oversight of the municipal market, former SEC Commissioner Elisse Walter argued that "[i]nvestors in municipal securities are . . . afforded 'second-class treatment' under current law."[130] Commissioner Luis Aguilar has reiterated the view that individual investors have been significantly disadvantaged by a lack of market transparency in his February 2015 speech on the SEC's recent efforts.[131] Furthermore, former SEC Chairman Levitt's assertion that retail investors in this market "need the SEC's full protection"[132] echoes throughout the SEC's 2012 *Report on the Municipal Securities Market* and more-recent SEC statements regard-

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[129] Aguilar, *Statement on Making the Municipal Securities Market More Transparent* (cited in note 50) (emphasizing that lack of transparency and other features of the municipal securities market "place[ ] individual investors at a distinct disadvantage").

[130] Walter, *Regulation of the Municipal Securities Market* (cited in note 3).

[131] Aguilar, *Statement on Making the Municipal Securities Market More Transparent* (cited in note 50).

[132] Levitt, *Muni Bonds Need Better Oversight* (cited in note 2). See also Leslie Norwood, *With Renewed Focus, the Spotlight Shines on Municipal Bonds* (SIFMA, Nov 26, 2014), archived at http://perma.cc/E7AY-FAKZ (paraphrasing remarks by Ceresney, director of the SEC's Division of Enforcement, to the effect that "a lack of regulation can create substantial risk" in this market because "retail investors are the primary holders of these securities").

ing enhanced enforcement efforts.[133] Academic discussion of the flaws in the municipal securities market has further confirmed that the existing regulatory regime is "investor-centric."[134] The SEC's argument, of course, is that greater transparency regarding the financial health of municipal issuers will allow investors to identify investments that match their risk preferences and to "know what they own," which will theoretically prevent investment losses due to information asymmetries.[135] In theory, this rationale is straightforward and compelling, and it may be a plausible justification for the SEC's new enforcement approaches.

The SEC's narrow rhetoric does not, however, address the full scope of interests at stake in municipal disclosure. Strikingly absent from the SEC's published statements—including its comprehensive 2012 report, which drives the current enforcement approach[136]—is a straightforward acknowledgement of the core, underlying problem that stakeholders in this market face: widespread and sometimes-catastrophic fiscal mismanagement at the local level.[137] Only once in its 165-page *Report on the Municipal Securities Market* does the SEC note that, in addition to "provid[ing] investors with critical information" to guide investment decisions, robust financial disclosures by municipal issuers are "important to other stakeholders, such as . . . taxpay-

133 See, for example, SEC, *Report on the Municipal Securities Market* at *2 (cited in note 1) ("The mission of the SEC is to protect investors—including investors in municipal securities."); Aguilar, *Statement on Making the Municipal Securities Market More Transparent* (cited in note 50) ("The Commission can and must do better for individual investors."). The language of a 2008 press release announcing the creation of EMMA and related rule changes also demonstrates the SEC's pointed investor centrism: "[T]he disclosure and transparency of the municipal markets have never been more critical. Municipal securities investors need to know what they own." *SEC, MSRB: New Measures to Provide More Transparency Than Ever Before for Municipal Bond Investors* (SEC, Dec 9, 2008), archived at http://perma.cc/N4DH-E3QV.

134 Chung, 34 Cardozo L Rev at 1500 (cited in note 1) (arguing that "the governing regulatory regime is investor-centric and default-centric in its approach to risk").

135 *SEC, MSRB: New Measures* (cited in note 133) (explaining that the creation of EMMA "will improve the flow of information in the municipal market and enable more informed investors").

136 See Glazier, *Gaunt* (cited in note 88) (citing the chief of the SEC's municipal securities–enforcement unit as saying that the unit's enforcement priorities are driven by the 2012 report).

137 There is no shortage of commentary on the recent surge in municipal bankruptcies and the broader insolvency problems that many cities have faced since the 2008 financial crisis. Most recently, Professor Michelle Wilde Anderson paints a sweeping and insightful picture of the current state of municipal distress and the harm it imposes on low-income residents. See generally Michelle Wilde Anderson, *The New Minimal Cities*, 123 Yale L J 1118 (2014).

ers."[138] The SEC's failure to fully and thoughtfully consider the role of taxpayers in this unique market is problematic, because—as the following Section discusses—the functioning of the municipal bond market can have deep impacts on the financial health of municipalities and the well-being of their residents.

2. The reality of local fiscal distress.

The development of the SEC's new enforcement frontier coincides with an unprecedented surge in fiscal distress among American municipalities. Between the years of 2008 and 2013, twenty-eight cities filed bankruptcy or entered state receivership in response to fiscal insolvency.[139] Five of the six largest municipal bankruptcies in American history have taken place in the years since 2008.[140] An even greater number of municipalities face budget crises or are teetering on the edge of fiscal failure.[141] In several cases, state governments have appointed emergency managers to take control of failing cities' finances and implement stopgap measures against insolvency.[142] As Anderson documents in her detailed study of "American cities that have gone broke," there is a widespread "austerity experiment" underway in distressed cities.[143] Local governments are "engaging in slash-and-burn budgeting to address falling revenues, rising expenses, and mounting debt."[144] Crime rates have risen dramatically in localities that have been forced to cut police resources.[145] Funding for other categories of municipal services—including maintenance of parks, street lighting, public libraries, education, and public transportation—has been reduced or eliminated

[138] SEC, *Report on the Municipal Securities Market* at *69, 143 (cited in note 1).

[139] Anderson, 123 Yale L J at 1120, 1130 (cited in note 137).

[140] Id at 1120.

[141] Anderson's 2014 article is perhaps the most comprehensive academic account of the recent dilemma of fiscal distress. Anderson, 123 Yale L J at 1124–25 (cited in note 137). For a more succinct overview of the financial challenges facing local governments across the country, see generally Liz Gross, et al, *The Local Squeeze: Falling Revenues and Growing Demand for Services Challenge Cities, Counties, and School Districts* (The Pew Charitable Trusts, June 2012), archived at http://perma.cc/B3LH-DW7H ("Many [cities, counties, and school districts] are in a fiscal vise, squeezed on one side by reduced state aid and property tax income—which together make up more than half of local revenues—and growing demand for services on the other.").

[142] See *The State Role in Local Government Financial Distress* *7 (The Pew Charitable Trusts, July 2013), archived at http://perma.cc/2BDJ-E33M (analyzing recent instances of state intervention to prevent local insolvency).

[143] Anderson, 123 Yale L J at 1129 (cited in note 137).

[144] Id at 1120.

[145] Id at 1160–63 (documenting a rise in crime rates in several failing cities).

entirely.[146] In an increasing number of localities, Anderson has observed, "[d]ecisionmakers must evaluate . . . whether a [failing] city could cut still more deeply into spending on current residents to pay off creditors, or whether it is creditors, rather than residents, who have to bear the next round of cuts."[147]

The underlying causes of local fiscal distress are diverse. The 2008 financial crisis strained all areas of the American economy, but the associated spike in unemployment, decline in the housing market, and rise in poverty rates hit local revenues particularly hard.[148] More recently, unmanageable pension debt has proved a problematic and controversial local liability.[149] In many cases, poor financial planning and outright mismanagement by local officials have exacerbated the impact of these external pressures.[150]

For example, the financial troubles currently facing the city of Allen Park, Michigan—which plays a central role in this Comment's analysis—are the result of unsophisticated local decisionmaking and a disastrous misuse of the municipal securities market. The city hastily issued $28 million in revenue bonds to finance the construction of a film studio that was supposed to bring thousands of new jobs to the struggling city, but the plans collapsed; the ensuing budget crisis prompted an emergency city manager to impose a regime of fiscal austerity.[151] Residents across the city consequently faced service reductions in many areas of public life.[152] Allen Park's story is troubling, but it is not

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146 See id at 1164–67 (cataloguing budget cuts in several ailing urban municipalities); Gross, et al, *The Local Squeeze* at *13–17 (cited in note 141).

147 Anderson, 123 Yale L J at 1122 (cited in note 137).

148 See id at 1130, 1137. See also Robert Slavin, *Why So Many Big Bankruptcies?* (Bond Buyer, Jan 14, 2015), archived at http://perma.cc/BX5C-XEYL (explaining that even "[w]hen the broader economy started to pick up, recovery never came to these municipalities, leaving revenues depressed").

149 See Anderson, 123 Yale L J at 1146–49 (cited in note 137) (identifying the recent rise in unfunded-pension liabilities and their impact on local fiscal distress). The debate surrounding the treatment of pension obligations in Detroit's bankruptcy plan is a notable recent example. See, for example, Chris Christoff, *Detroit Pension Cuts from Bankruptcy Prompt Cries of Betrayal* (Bloomberg, Feb 4, 2015), archived at http://perma.cc/JU7K-LY8N.

150 See Anderson, 123 Yale L J at 1150–51 (cited in note 137) (highlighting recent instances of misguided local-development projects).

151 *Allen Park* Order at *5–6 (cited in note 121).

152 See, for example, Leverage Academy, *Detroit Is Bankrupt, Allen Park, Michigan Sends Layoff Notices to Entire Fire Department* (Business Insider, Feb 24, 2011), archived at http://perma.cc/J723-LRPK. Allen Park is among the twenty-eight cities that Anderson studied as part of her investigation into what she terms the local "austerity experiment." Anderson, 123 Yale L J at 1129–32, 1224–27 (cited in note 137). For further

anomalous. Indeed, the problems of local governance—weak oversight, lack of sophistication, and agency problems, to name a few—are deeply intertwined with the nationwide dilemma of fiscal distress.[153]

* * *

This Comment serves in part to contextualize the SEC's new enforcement frontier within this broader national dilemma. Consistent with its mandate to "protect investors" and "maintain fair, orderly, and efficient markets,"[154] the SEC has focused myopically on the structure of the municipal securities market and the role of investors within it. But the SEC does not act in a vacuum: the monetary penalties and backdoor disclosure requirements that the SEC has aggressively pursued will have deep and lasting impacts on cities facing financial hardship. Indeed, many of the cities that have been the subjects of the SEC's most novel theories of liability are already facing severe financial stress.[155]

Moreover, financial disclosure in the bond market is not as isolated an issue as it might seem. In several of the SEC's recent enforcement cases, the disclosure failures at issue have stemmed from flawed governance structures, unsophisticated decisionmaking, and attempts by local officials to conceal deeper systemic financial issues facing the cities. The SEC's suit

detail on Allen Park's financial troubles and the resulting reduction in citywide services, see Part II.B.

[153] This Comment does not examine theories of local governance in great depth, but there is no shortage of scholarly discussion on this important aspect of public finance. Professors Clayton P. Gillette and Richard C. Schragger, for instance, have written extensively on the design of local institutions and the governance problems that contribute to financial instability. Their work informs some of this Comment's analysis and is a valuable starting point for further inquiry. See, for example, Clayton P. Gillette, *Can Municipal Political Structure Improve Fiscal Performance?*, 33 Rev Bank & Fin L 571, 572 (2014) (arguing that "immediate sources of municipal fiscal distress" are "attributable to problems of institutional design, problems that fail to discourage local officials from pursuing self-interested objectives that deviate from policies that would enhance the fiscal health of the localities that they govern"); Richard C. Schragger, *Democracy and Debt*, 121 Yale L J 860, 863 (2012) (disputing the prevailing notion that "profligacy is [the] central problem" of failing municipalities and that externally imposed discipline on local officials is the solution). See also generally Clayton P. Gillette, *Bondholders and Financially Stressed Municipalities*, 39 Fordham Urban L J 639 (2012); Schragger, 39 Fordham Urban L J 787 (cited in note 18).

[154] *The Investor's Advocate: How the SEC Protects Investors, Maintains Market Integrity, and Facilitates Capital Formation* (SEC, June 10, 2013), archived at http://perma.cc/7SJ5-X6CT.

[155] See, for example, Part II.B.

against Boudreaux, former Miami budget director, is a useful example: Under the loose supervision of other local decisionmakers, Boudreaux executed several questionable capital transfers to cover shortfalls in the city's general budget.[156] He then allegedly concealed the transfers from local investors and Miami residents by making glaring misrepresentations in various public documents relating to the city's finances.[157]

Government opacity and fiscal distress have appeared in equal measure at the state level, as well. The SEC's action against Illinois, for example, centered on the state's failure to disclose to bond investors the magnitude of its unfunded-pension liability[158]—one of the many financial pressures that continues to plague the state.[159] Highlighting the linkages between opacity, fiscal distress, and problems of local governance, the SEC noted in its cease and desist order against the state that the misleading disclosures "resulted from, among other things, various institutional failures," including the failure to "train personnel involved in the disclosure process adequately."[160] A similar story can be told about Allen Park, Michigan, where city officials' decision to incur $28 million of debt *despite* the disintegration of their planned development project bespoke severely flawed financial planning, if not outright incompetence.

In many ways, these cases are not solely about the lies that issuers tell; they also signal that opacity in local government decisionmaking can be a symptom of poor local governance, which itself contributes to local fiscal hardship. Whether or not the SEC acknowledges it, the new frontier in municipal securities enforcement is as much about imposing discipline on poorly managed local governments as it is about policing fraud. And every effort that the SEC makes to penalize mismanagement will impose some form of social or monetary cost on local governments and the residents who rely on them for basic services. Any analysis of the SEC's new frontier must, therefore, pay

156 See *Securities and Exchange Commission v City of Miami*, 988 F Supp 2d 1343, 1346–51 (SD Fla 2013).

157 See id.

158 See *Illinois* Order at *5–8 (cited in note 93).

159 See, for example, Richard Dye, Nancy Hudspeth, and Andrew Crosby, *Apocalypse Now? The Consequences of Pay-Later Budgeting in Illinois: Updated Projections from IGPA's Fiscal Futures Model* *1, 4 (The Fiscal Futures Project, Jan 19, 2015), archived at http://perma.cc/KJA5-DKL7 (noting that Illinois's current fiscal crisis is rooted in the state's "long-established practice of pay-later budgeting") (emphasis omitted).

160 *Illinois* Order at *8 (cited in note 93).

careful attention to the ways in which the SEC's activity impacts and interacts with the broader dilemma of local fiscal distress.

To that end, the following Parts investigate how the SEC's investor-protection rhetoric and common intuitions about the virtues of transparency are likely to be experienced on the ground by two key stakeholder groups: bondholders and taxpayers.[161] Parts II and III identify some of the more troubling practical and doctrinal implications of the SEC's new enforcement regime and provide a rubric for further scrutiny of the SEC's changing role in this market. The Conclusion explains that, while sunlight may theoretically be the best disinfectant, the SEC's doctrine-bending theories of municipal liability, expressed through an aggressive punitive enforcement regime, will be relatively ineffective in achieving healthier communication between local governments and their various stakeholders. Indeed, there is good reason to believe that these theories could cause harm to already-ailing local communities without meaningfully improving municipal governance. The problem of local fiscal mismanagement is in need of a solution, but the SEC's current attempts may well cause more harm than they remedy.

II. The Promise and Peril of a Disclosure-Forcing Regime

The first step in critiquing the SEC's new enforcement frontier is to consider whether the penalties it imposes are likely to achieve their intended aim—that is, to protect "disadvantaged" investors by enhancing market transparency.[162] It is natural to assume, as the SEC does, that poor disclosure practices in a securities market harm investors by obscuring the true risk of investment.[163] But as this Part demonstrates, the unique nature of municipal bonds makes it more likely that taxpayers, rather than bondholders, lose when local projects fail—regardless of

[161] Most often, there is no significant overlap between bondholders and taxpayers in a given municipality, and the academic literature treats these groups as conceptually distinct. See, for example, Schragger, 39 Fordham Urban L J at 797 (cited in note 18); Gillette, 39 Fordham Urban L J at 641 (cited in note 153) (describing the "competing claims by bondholders and residents"). This Comment does the same, and Part II.A further examines the distinction between the two groups.

[162] As discussed in Part I.D.1, the SEC has repeatedly emphasized that the aim of its various ongoing initiatives, including its increased enforcement activity, is to "make our municipal securities market fairer and more transparent" in the interest of "disadvantage[d]" individual investors. Aguilar, *Statement on Making the Municipal Securities Market More Transparent* (cited in note 50).

[163] See Part I.D.1.

whether disclosures were accurate or robust. As a result, punitive enforcement mechanisms are likely to impose short- and long-term costs on cities without providing clear offsetting benefits to investors.

Part II.A describes precisely what is at stake for bondholders and taxpayers when issuers borrow. It establishes that, while bondholders have legal and economic means of quantifying and securing their investments, "[r]esidents, by contrast, have no such legal instruments with which to monetize their share of a city's revenues."[164] This results in an inherent imbalance of risks between these stakeholder groups. Part II.B examines how instances of issuer fraud can further exacerbate this imbalance. Part II.C argues that the burdens of SEC enforcement impose significant and potentially far-reaching social costs on localities already facing financial stress without providing offsetting benefits. Finally, Part II.D posits that investors may not be willing to bear an increase in the cost of municipal securities as a result of more-burdensome regulatory oversight. A chilling of investor interest in municipal bonds could limit local governments' access to capital in undesirable ways. The policy arguments set forth in this Part are not exhaustive, but they are a starting point for a critical analysis of the SEC's new frontier. More importantly, they serve as a guide to any future judicial analysis of the emerging legal questions that are outlined in Part III.

A. The Difference between Taxpayers and Bondholders

Central to this Comment's analysis of the SEC's new enforcement activity is a clear understanding of the inherent tensions that exist between the primary stakeholder groups implicated in public borrowing: local citizens, whose tax money and services are on the line when their governments borrow, and bondholders, whose investments' integrity hinges on the success of local government operations and projects.[165] There are certainly

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[164] Anderson, 123 Yale L J at 1122 (cited in note 137).

[165] This Comment uses the terms "taxpayers," "residents," and "citizens" interchangeably, as does the academic literature. See generally, for example, Anderson, 123 Yale L J 1118 (cited in note 137). The terms collectively and simultaneously refer to the individual subgroups of the American population that rely on the institutions of local governance to organize civic life. Indeed, the terms are valuable in highlighting the distinct vectors on which these subgroups engage with local government. Taxpayers are a city's primary source of revenue and thus have a direct financial stake in local fiscal management. Residents entrust local officials to provide fundamental services and en-

ways in which the interests of taxpayers and bondholders align. Both groups have meaningful incentives to monitor local financial decisionmaking, and both are invested to varying degrees in the municipalities' successful operation. As discussed in Part I.D.2, residents often suffer when their representatives fail to manage local finances effectively, giving residents good reasons to monitor and discipline poor decisionmaking through the political process. Bondholders may be less concerned with the ongoing vitality of the local governments whose bonds they hold, but they do have an interest in protecting their investments and are thus incentivized to detect and deter local misconduct.[166] In the abstract, then, residents and bondholders have a joint interest in promoting better local governance. But in times of distress, competing claims to dwindling local resources complicate the relationship between citizens and bondholders, making the two parties distinct in ways that are important to any analysis of local governance.[167]

The most striking difference between the two groups lies in the relative flexibility of their investments in municipal operations. To put it simply, bondholders have greater choice in and greater control over the investments they make, while citizens—especially those with low incomes—are in many ways anchored to the cities and towns in which they live.[168] There is a significant body of literature on the question of citizen mobility as an expression of preference; the classic theory is that, in a world free of transaction costs, any given citizen can make an informed choice about which municipality to "invest" in and is free

sure basic public safety in exchange for tax dollars. And citizens mediate this exchange by participating in local political processes.

166 The question whether local residents or bondholders are superior monitors of local decisionmaking is complex and interesting. Professors Gillette and Schragger have both considered the issue in depth. See Gillette, 39 Fordham Urban L J at 657 (cited in note 153) (arguing that "[a]ssigning priority to residents in the event of fiscal distress [ ] would induce bondholders to ensure that [third parties] involved in the bond issuance process would exploit their monitoring capacity to avoid bondholder losses"); Schragger, 39 Fordham Urban L J at 788 (cited in note 18) ("Gillette's article has convinced me that neither bondholders nor citizens are particularly good monitors of local fiscal probity.").

167 See, for example, Gillette, 39 Fordham Urban L J at 641 (cited in note 153) (describing "a contest that threatens to become all too familiar as the current fiscal crisis continues to engulf municipal budgets: the effort to resolve competing claims by bondholders and residents to a limited municipal treasury"); Schragger, 39 Fordham Urban L J at 788, 797 (cited in note 18) (considering the implications of legal rules that favor bondholders over citizens when local governments face fiscal stress).

168 Gillette, 39 Fordham Urban L J at 658 & n 104 (cited in note 153) (explaining that "even relatively mobile residents cannot exit costlessly").

to exit her investment by relocating to a different taxing jurisdiction whenever local officials fail to satisfy her preferences.[169] But outside such a "highly stylized world,"[170] practical constraints on mobility—including discovery costs, expenses of relocation, geographic preferences, and employment opportunities—often prevent taxpayers from freely entering and exiting municipalities. At the same time, the realities of local politics, such as the divergent sizes and organizational skills of various unaligned local interest groups, can diminish the effectiveness of the traditional voting process in reflecting individual preferences.[171] The reality of immobility is even starker for low-income residents, who typically have no realistic exit options and therefore often bear the brunt of their cities' fiscal distress.[172]

Bondholders, on the other hand, are likely to be less socioeconomically diverse, are better able to manage the risks of default by diversifying their investments, and face greater choice and more exit options when making investments in local government. To start with, investors have thousands of distinct bond issuances to choose from and can engage in substantial ex ante information gathering—with the help of credit rating agencies[173]—as they make investment choices. Investors are also empowered to mitigate the risk of default (however minimal) on a single bond by including it within a diversified portfolio of in-

[169] See, for example, Charles M. Tiebout, *A Pure Theory of Local Expenditures*, 64 J Polit Econ 416, 419–20 (1956) ("Consumer-voters are fully mobile and will move to that community where their preference patterns, which are set, are best satisfied."). See also, for example, Clayton P. Gillette, *Dictatorships for Democracy: Takeovers of Financially Failed Cities*, 114 Colum L Rev 1373, 1402 (2014) ("[I]n the idealized Tieboutian world of perfect mobility, the threat of exit would fully constrain local officials from offering bundles of goods and services or tax prices inconsistent with residents' preferences.").

[170] Gillette, 114 Colum L Rev at 1402–05 (cited in note 169).

[171] See id.

[172] See Anderson, 123 Yale L J at 1198–99 & n 312 (cited in note 137).

[173] Credit rating agencies are not immune to the information asymmetries that poor issuer disclosure practices can create, but they are nonetheless a useful and important tool available to bondholders in making investment decisions. See Annette Thau, *The Bond Book* 42 (McGraw-Hill 3d ed 2011) (noting that, despite "criticism" and "skepticism" of credit ratings after the 2008 financial crisis, "no viable alternative has taken [their] place" and that "[m]any, if not most, investors, continue to rely on [credit] ratings to evaluate the credit quality of bonds"); Fischer, *Investing in Municipal Bonds* at 7–10 (cited in note 13) (advising uninformed investors to buy rated bonds and pointing out that municipal bonds have historically had more-dependable ratings than taxable bonds).

vestments with differing risk-return profiles.[174] The local citizen can live in only one locality at a time, making her highly sensitive to the risks of municipal distress: when fiscal woes arise, she either endures the associated service cuts and tax increases or she pursues a costly relocation. The municipal investor, on the other hand, can hold a stake in a number of localities—as well as in corporate entities, foreign sovereigns, and the US government—at any given moment. In a well-diversified portfolio, the costs of fiscal distress in any given locality are offset by gains that are generated by the other assets the investor holds. Investors can thus manage municipal risk with greater precision and foresight than the average citizen. And, as noted above, the low-income citizen—who relies more heavily on local services but is generally less mobile—is even less capable than the average citizen of hedging against the risk of local financial failures.

It is useful to note that individual municipal investors are also more likely to be wealthy than the average citizen, as the federal tax savings associated with municipal bonds are most beneficial to those who fall within higher federal tax brackets. That is, an investor who faces a high marginal tax rate may achieve a higher net yield from tax-exempt municipal bonds than from taxable bonds (or from other securities that do not carry tax advantages), despite the fact that tax-exempt municipal bonds generally offer lower interest rates than their taxable counterparts.[175] As a general principle, investors structure their

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[174] See Gillette, 39 Fordham Urban L J at 665 (cited in note 153). See also Fischer, *Investing in Municipal Bonds* at 205–18 (cited in note 13) (explaining methods by which to diversify one's portfolio in order to minimize risk).

[175] The ratio used to compare prospective returns on tax-exempt versus taxable bonds is $R = (r_t - r_e) / r_t$, in which R is the yield advantage of taxable bonds compared to municipal bonds, r_t is the yield on the taxable bond, and r_e is the yield on the tax-exempt bond. As long as R exceeds a taxpayer's marginal tax rate, the municipal bond will have a higher after-tax yield, whereas if R is below the marginal tax rate, the opposite is true. For example: If an investor's marginal tax rate is 33 percent and she has the option to invest in a tax-exempt bond with a 5 percent yield, she will benefit from switching her investment to a taxable bond only if that bond offers a minimum interest rate of 7.46 percent. An investor with a marginal tax rate of 15 percent, on the other hand, would switch to any taxable instrument that offers a yield greater than 5.88 percent. This simplified scenario demonstrates that, because of the tax exemption, higher-income individuals will prefer tax-exempt bonds to taxable bonds more frequently than lower-income individuals will, even though interest rates on tax-exempt bonds are lower. See Harvey Galper, et al, *Who Benefits from Tax-Exempt Bonds? An Application of the Theory of Tax Incidence*, 35 Mun Fin J 53, 58 (2014). For a straightforward description of the investment choice between tax-exempt bonds and taxable bonds, see Jason Van Bergen, *Weighing the Tax Benefits of Municipal Securities* (Investopedia), archived at http://perma.cc/JXX7-L7DR.

portfolios to achieve the highest after-tax rates of return; as a result, the existence of the tax exemption induces higher-income taxpayers to shift their holdings away from taxable securities and toward municipal debt.[176] In theory, high earners thus hold a greater proportion of municipal debt.[177]

The empirical literature reflects these theoretical principles. A 2014 study published in the *Municipal Finance Journal* employed a new methodology to demonstrate that the tax exemption on municipal bonds "provides a disproportionate benefit to high-income taxpayers,"[178] and an older but more comprehensive study of federal income tax returns found that more than three-quarters of tax-exempt bonds held by households were held by individuals with marginal income tax rates of 28 percent or higher.[179] This figure is significant given the makeup of the municipal bond–investor pool: as recently as 2011, individual households held 37 percent of all outstanding municipal debt in the United States, while mutual funds and money market funds—common investment mechanisms for individuals—held another 18 and 11 percent of the market, respectively.[180] Indeed, politicians on both sides of the aisle have criticized the tax exemption of municipal bonds as "a subsidy for the rich."[181] This characterization is controversial, but it illustrates the straight-

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176 See Galper, et al, 35 Mun Fin J at 61–62 (cited in note 175). See also James M. Poterba and Arturo Ramírez Verdugo, *Portfolio Substitution and the Revenue Cost of the Federal Income Tax Exemption for State and Local Government Bonds*, 64 Natl Tax J 591, 596 (2011) (noting that "investors tend to invest in the asset classes for which they have a comparative tax advantage" and that, if the tax exemption were eliminated, "there would be a substantial shift in the set of investors with a comparative tax advantage for holding these bonds"). As an additional empirical example of portfolio shifting in the municipal market, a 1994 study found that taxpayers in higher-income categories decreased their holdings of tax-exempt bonds from 1983 to 1989, a period during which the Tax Reform Act of 1986 reduced marginal tax rates for high earners. See generally John Karl Scholz, *Tax Progressivity and Household Portfolios: Descriptive Evidence from the Survey of Consumer Finances*, in Joel Slemrod, ed, *Tax Progressivity and Income Inequality* 219 (Cambridge 1994).

177 Galper, et al, 35 Mun Fin J at 66–67 (cited in note 175).

178 Id at 66. See also Galper, et al, 67 Natl Tax J at 901–02, 922 (cited in note 15) (expanding on the previous study and concluding that, although higher-income households receive most of the benefit of the tax exemption on municipal bonds, "tax-exempt municipal debt is also shown to [ ] benefit low-income households with children by reducing the cost of public education").

179 Daniel R. Feenberg and James M. Poterba, *Which Households Own Municipal Bonds? Evidence from Tax Returns*, 44 Natl Tax J 93, 93 (1991).

180 Tracy Gordon, *Buy and Hold (On Tight): The Recent Muni Bond Rollercoaster and What It Means for Cities* *3 (Brookings Institution, Sept 19, 2011), archived at http://perma.cc/44BP-2KJ8.

181 Aikman, et al, 33 Mun Fin J at 16 (cited in note 15).

forward fact that the individual investors whom the SEC's new frontier aims to protect are likely to have higher incomes than the average American taxpayer. Such investors may be better positioned than local citizens to manage their investment risks and to weather fiscal declines in the local governments in which they hold a stake.

It is also useful to identify the various mechanisms that investors may rely on to hedge against risk in municipal investments and to protect against the effects of default. First and foremost, a bond investment creates a contractual obligation: The terms of the instrument—including maturity date, coupon rate, and purpose of the funds to be raised—are set out in an indenture or other formal offering statement that provides each bondholder with a contractual remedy in the event that the issuer fails to meet its obligations.[182] The indenture identifies which of the issuer's acts or omissions will constitute a default on the bond and what remedies will flow from an uncured event of default.[183] Moreover, bondholders are not individually responsible for policing the issuer's performance; the indenture typically appoints a trustee to safeguard investors' interests and act on their behalf if legal action is required.[184] Thus, a bondholder's first line of defense against a loss is the contract by which his bond is governed. Purchasers can also seek out bonds that are priced to provide additional safeguards against default, like bond insurance.[185]

Risks of loss are also constrained in the event of municipal insolvency or Chapter 9 bankruptcy, in which immediate contractual remedies may be unavailable.[186] Revenue bonds, which are secured by specific anticipated revenue streams, are considered to be among the safer municipal investments: they are given priority over unsecured general obligation bonds and there-

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[182] See Zipf, *How Municipal Bonds Work* at 1–25, 47–48 (cited in note 26).

[183] See id at 3–4.

[184] See id at 3.

[185] Municipal bond insurers were deeply impacted by the financial crisis, such that insured bonds are no longer the norm in the municipal market, but investors still have the option to seek out bonds with this and other protective mechanisms. See Thau, *The Bond Book* at 136–42 (cited in note 173).

[186] The filing of a Chapter 9 bankruptcy petition triggers the automatic stay provision of § 362 of the Bankruptcy Code. 11 USC § 901(a). The automatic stay halts all litigation and debt-collection activities against the municipality (including contractual claims by creditors), thereby giving the municipality an opportunity to develop a thorough restructuring plan. See James A. Coniglio and M. David Gelfand, 2 *State & Local Government Debt Financing* § 14:13 (Thomson Reuters 2d ed 2014).

fore are paid ahead of those bonds in a municipal bankruptcy.[187] The priority of general obligation bonds in Chapter 9 bankruptcy is somewhat uncertain and often depends on state law.[188] But Chapter 9 bankruptcy is still fairly rare, especially in light of the possibility of state bailouts and emergency receiverships that help struggling cities weather financial downturns.[189] Indeed, in a few high-profile instances, bondholders have "survived [municipal] bankruptcy relatively unscathed."[190]

Investor losses are even less frequent outside the rare event of bankruptcy. Schragger recently noted the irony in his observation that "[d]uring the present economic crisis, . . . the rhetoric (if not practice) of bondholder inviolability seems . . . robust," while rates of municipal default have remained markedly low.[191] In fact, recent reports indicate that the rate of municipal defaults has steadily declined over 2013 and 2014. According to a December 2014 study, 57 issuers defaulted for the first time in 2014, as compared to 69 defaults in 2013 and 140 in 2010.[192] These numbers are striking when viewed in light of the SEC's estimate that, in 2012, there were approximately forty-four thousand distinct municipal issuers with outstanding debt.[193] Of those fifty-seven recent defaulters, most were government agencies and sublocal districts, as opposed to state or municipal governments, and 82 percent were unrated.[194]

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187 See Fischer, *Investing in Municipal Bonds* at 15 (cited in note 13).

188 See *General Obligation Bonds: State Law, Bankruptcy and Disclosure Considerations* *i (National Association of Bond Lawyers, Aug 2014), archived at http://perma.cc/5242-HKLL.

189 See id at *13. See also generally Gillette, 114 Colum L Rev 1373 (cited in note 169) (arguing for takeover boards as a useful alternative option available for struggling cities).

190 Chung, 34 Cardozo L Rev at 1496 & n 203 (cited in note 1) (discussing Vallejo, California, and a school district in San Jose, California, both of which paid bondholders "in full and on time" despite seeking municipal-bankruptcy protection).

191 Schragger, 39 Fordham Urban L J at 797 (cited in note 18). See also Larry G. Locke and Virginia R. Locke, *Who's Afraid of Municipal Defaults?*, 5 Intl J Bus, Accounting & Fin 129, 134–35 (2011) (explaining that bondholders' confidence in municipal debt in the face of local fiscal distress stems from the historical rarity of municipal default and the probability of intervention by the state government to prevent it).

192 See Romy Varghese, *Municipal Defaulters Decline amid Improving Economy: Muni Credit* (Bloomberg, Dec 31, 2014), archived at http://perma.cc/TM6Y-RBMA.

193 SEC, *Report on the Municipal Securities Market* at *1 (cited in note 1). Precise calculations regarding the current number of municipal issuers with outstanding debt appear to be unavailable.

194 See Varghese, *Municipal Defaulters Decline* (cited in note 192). Note that rating agencies such as Moody's or Standard & Poor's provide municipal credit ratings for many, but not all, municipal-debt issuances. Such ratings take into account the relative

One straightforward explanation for the dearth of defaults is the ability of municipal entities to simply raise taxes or receive state bailouts to cover shortfalls.[195] Even in cases of financial distress, cities may be more willing to cut services or raise taxes than to default on municipal bonds. Like any borrower, municipal issuers fear that default could increase borrowing costs or jeopardize their (or surrounding municipalities') access to credit markets altogether.[196] Schragger additionally posits that the preference to not default may be explained by political "hostility to redistributional spending"—for many municipalities, "[i]t may be that repaying bonds that primarily pay for local infrastructure is more palatable than keeping the municipality's pension commitments or providing social services."[197] Once again, defining the distinction between citizens and bondholders is paramount to understanding the asymmetrical allocation of benefits and risks in this market.

B. Who Loses When Issuers Lie?

In the municipal bond market as it currently stands, the average individual investor is far better positioned than the average local citizen to make careful investment selections that balance her unique preferences for risk and return. But what happens to the best-laid municipal investment plans when issuers commit fraud? The question is crucial to investigating the SEC's new frontier. The answer is that very little happens. Two recent, representative case studies help illuminate this point.

In late 2009 and 2010, the city of Allen Park, Michigan, issued over $30 million in so-called double-barreled general obligation bonds. The bonds specified that principal and interest would be paid out of revenues generated from the project being financed, but they also included a pledge of the municipality's full faith and credit—that is, a commitment by Allen Park to draw on local tax revenues—if the designated project failed to

default risk of a given issuer. See *Municipal Bond Credit Report: Third Quarter 2014* *13–15 (SIFMA, 2014), archived at http://perma.cc/7QZZ-5N9B.

[195] For a thorough overview of the role that states have (or have not) played in aiding local governments in distress, see generally *The State Role* (cited in note 142). See also Locke and Locke, 5 Intl J Bus, Accounting & Fin at 134–35 (cited in note 191) ("[A]s local governments have experienced the occasional default or near default, state governments have imposed legal regimes upon them to increase their economic stability.").

[196] See Schragger, 39 Fordham Urban L J at 799 (cited in note 18).

[197] Id at 801.

yield sufficient income to meet ongoing debt obligations.[198] In Allen Park, the designated project was the construction of a movie studio by a California-based film and production company.[199] The city formed a public-private partnership with both the production company and a third-party developer, and the city pledged to use proceeds from the bond issuance to buy land that it would then donate to the partnership for development.[200] The partnership collapsed, however, when the city was advised by bond counsel that it was not permitted to donate assets purchased with bond proceeds to the partnership.[201] Once it became clear that the city was unable to make the requisite contribution, the developer walked away—along with the $20 million it had pledged to finance the project's first phase—and the production company significantly reduced its commitment.[202] The city nonetheless proceeded to issue over $28 million in double-barreled bonds in late 2009 and another $2.7 million in 2010, all the while keeping silent about the deteriorating prospects of the project.[203]

The failure to disclose the status of the project in its bond-offering documents was the subject of a 2014 cease and desist proceeding against the city for violations of each of the federal antifraud provisions.[204] As discussed in Part I.C.4, the SEC also charged the city's mayor, Burtka, alleging derivative control person liability under § 20(a) of the Exchange Act. A district judge in the Eastern District of Michigan approved a settlement between the SEC and Burtka in January 2015; in it, Burtka agreed to permanently refrain from participating in any municipal securities offerings and to pay a penalty of $10,000 to the SEC.[205]

The failed project, compounded with other financial pressures and a budget deficit, thrust the city into financial distress.[206] Michigan state officials appointed an emergency manager in October 2012, who implemented various budgetary cutbacks to ac-

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[198] See *Allen Park* Order at *2 (cited in note 121). See also Part I.A (discussing the nature of the full faith and credit pledge with respect to general obligation bonds); Fippinger, *The Securities Law of Public Finance* at § 1:6.1 (cited in note 17) (same).

[199] *Allen Park* Order at *2 (cited in note 121).

[200] Id.

[201] Id at *3.

[202] Id.

[203] *Allen Park* Order at *2 (cited in note 121).

[204] Id at *7.

[205] See generally *Burtka* Final Judgment (cited in note 124).

[206] See *Allen Park* Order at *5–6 (cited in note 121).

commodate the city's debt obligations.[207] In fact, instead of immediately defaulting on its debts, the city made a 10 percent reduction in pay to active employees, eliminated vacant positions, consolidated health-care plans, and increased co-pays and deductibles for city employees.[208]

The SEC's cease and desist action imposed an additional monetary and administrative burden on the city. As a condition of the order, the city agreed to implement remedial measures designed to improve the city's disclosure procedures. Under the order, the city must: (1) adopt written policies and procedures, to be drafted by disclosure counsel, to facilitate the city's compliance with federal securities laws; (2) designate an individual to "certify, upon consultation with disclosure counsel, that the offering documents do not contain any untrue statements of material fact" for any new bond issuances in the next two years; and (3) retain disclosure counsel to train "all personnel involved in the City's bond offering and disclosure process."[209] The SEC will play an ongoing monitoring role: the city must provide the SEC with copies of its policies and procedures as well as with certifications that the relevant personnel have been adequately trained.[210] The procedural, training, and reporting requirements seem to apply even if the city refrains from issuing bonds in the foreseeable future.

While citizens suffer service cuts and emergency management, where do the bondholders stand? To start with, the most recent Allen Park budget contemplates debt service through 2016, signaling no intent to default on the fraudulently issued bonds.[211] Further confirming the commitment not to default, local media outlets have reported that the city is in the process of

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207 See Corey Williams, *Allen Park Latest Michigan City to Get Emergency Manager* (Crain's Detroit Business, Oct 26, 2012), archived at http://perma.cc/K5VG-DRPE; *Gov. Rick Snyder: Allen Park Financial Emergency Resolved* (State of Michigan, Sept 25, 2014), archived at http://perma.cc/9FJ6-XBSJ. See also City of Allen Park, *City of Allen Park: Fiscal Years 2014-2015 & 2015-2016 Adopted Budget* *3 (May 13, 2014), archived at http://perma.cc/J7ST-5RDC ("Allen Park Budget") (explaining that the adopted 2015 and 2016 budgets "include[ ] a subsidy made by the General Fund in order to cover the debt service payment totaling $1,200,000" on the "Southfield Lease Properties," the land that was purchased for the failed studio project). The city successfully sold the land for $12 million in August 2014. Jenny Kalish, *Allen Park City Council to Discuss Restructuring Bond Debt from Failed Movie Studio at Closed Meeting Thursday* (The News-Herald, Nov 13, 2014), archived at http://perma.cc/8JJD-JQDL.

208 See *Gov. Rick Snyder* (cited in note 207).

209 *Allen Park* Order at *6 (cited in note 121).

210 Id.

211 See Allen Park Budget at *3 (cited in note 207).

restructuring its debt through a redemption feature built into the terms of the underlying bond contracts: The city reportedly plans to exercise a call option to repurchase the 2009 and 2010 issuances, thereby paying off the bonds' principals in full ahead of their maturity dates and relieving itself of the relatively high interest payments due over the maturity of the bonds.[212] The city also purportedly plans to simultaneously issue a new series of debt at a lower interest rate; this will finance the call and reduce the city's future interest payments.[213] The details of the refinancing plan are currently unclear, but the effect of a call option is straightforward: bondholders get their money back in full (and possibly at a premium, if the indenture so provides).[214] They can then reinvest it however they would like. Moreover, because the call option was an element of the bond contract, it is an eventuality for which bondholders bargained when they made their initial investments—no investor in the 2009 and 2010 Allen Park bonds can fairly be surprised by this early redemption or by the loss of future interest payments from this particular issuer.

It should be noted that it is possible, though unlikely, that some holders of the 2009 and 2010 Allen Park bonds suffered a financial loss in the secondary market as a result of the fraud. Theoretically, revelation of the failure of a project designed to finance principal and interest payments, compounded with revelation of the issuer's misstatements about that project, could have depressed the prices of those bonds if they were being traded in the secondary market. If a hypothetical purchaser of those bonds at their primary issuance sought to sell in the secondary market after these revelations came to light (but before news of the refinancing was reported), she might end up selling at a loss.

It is unclear, however, if this is how the market would respond in practice. As Part II.A discusses, the various mechanisms currently in place to protect bondholders against actual default—including cities' general unwillingness to default in the first place—may make secondary investors relatively unresponsive to news of local financial mismanagement or even fraud. This may be especially true when the bond is backed, as were the Allen Park bonds, with the issuer's pledge to draw on tax revenues in order to meet principal and interest payments. Ad-

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[212] See Caitlin Devitt, *Allen Park, Mich., to Refinance Bonds Targeted by SEC* (Bond Buyer, Nov 7, 2014), archived at http://perma.cc/4A9Y-FZHK.

[213] Id.

[214] See Zipf, *How Municipal Bonds Work* at 33–40 (cited in note 26).

ditionally, the predominance in this market of buy-and-hold activity as opposed to robust secondary trading decreases the likelihood that the individual investors that the SEC aims to protect have suffered from their investments in the Allen Park movie studio.

Note, too, that even if some subset of Allen Park bondholders has suffered cognizable losses as a direct result of the city's misstatements, private recovery is available under § 10(b) of the Exchange Act and Rule 10b-5, as well as under applicable state securities laws.[215] While opacity of the secondary trading market makes it hard to test the theory that Allen Park investors as a whole have emerged from the fraud unscathed, the fact that no contractual or fraud claims appear to have been brought in state or federal court on behalf of Allen Park investors bolsters the theory that losses, if any, have been minimal.

A second case study suggests that, in some instances, mandated disclosure is unnecessary because material information is readily available to investors through other publicly available channels. In its settlement with the state of Kansas in 2014, the SEC alleged that offering documents associated with eight of Kansas's recent bond offerings failed to disclose the risky underfunding of the state's pension program.[216] But in almost the same breath, the SEC noted that, "[f]rom 2004 on, the underfunding . . . was repeatedly discussed in various local newspapers, and by credit rating agencies."[217] It is hard to credibly argue that investors in Kansas bonds were harmed by scanty bond-offering documents when robust and decision-critical information was already publicly available through popular media and bond rating materials.[218] It is true that the SEC has elsewhere held that "[p]ublication of a few articles in local newspapers with limited circulation" is not sufficiently "available" to na-

[215] See Part I.B.2. See also *Sonnenfeld v City and County of Denver*, 100 F3d 744, 745, 747 (10th Cir 1996) (establishing that there is an implied private right of action against municipal issuers under § 10(b) and Rule 10b-5).

[216] The *Kansas* Order notes that the significant underfunding of the pension program created a "risk of non-appropriation of debt service payments by the State Legislature." *Kansas* Order at *2, 4 (cited in note 93). Such a nonappropriation would have been tantamount to a default and would accordingly have made the Kansas bonds riskier for individual investors.

[217] Id at *4.

[218] Indeed, the SEC acknowledged in the 2012 report that retail investors tend to rely on credit ratings more readily than institutional investors do. SEC, *Report on the Municipal Securities Market* at *53 & n 302 (cited in note 1).

tionwide investors to inform their investment decisions.[219] But there is little doubt that investors in local governments have adequate notice that local media are likely to be the best sources of current information on city operations. Practically speaking, impaired disclosure does not necessarily lead to investor losses in this unique market, in which the media and communication from public officials have the capacity to fill the informational gap that investors often face in the corporate market.

As the Allen Park and Kansas settlements demonstrate, the SEC's current investor-protection rhetoric rings hollow. Whether issuers disclose freely or incompletely, and whether they are honest or they instead shield the truth of their financial conditions, bondholders are largely indifferent because, quite simply, they rarely lose. Even in the face of fiscal mismanagement, the security of municipal bond investments seems to come at the expense of local citizens—especially the less mobile and less savvy among them.

C. Who Pays When the SEC Settles?

One principal argument in favor of the SEC's newly aggressive punitive regime is that it resolves what might be called a problem of recurring misses: when bondholders fail to suffer a cognizable loss (and therefore do not sue), and when citizens are unable to monitor and discipline local officials through the political process (a problem exacerbated by the frictions of exit), action by the SEC ensures that local officials who lie—and the administrations that aid them—are held accountable for the losses that they imposed on their constituencies. The argument is compelling, but a deeper consideration of the costs of SEC enforcement suggests that it is not as elegant a solution to local mismanagement as it first appears.

To begin, there are obvious and nonobvious predictions to be made about the costs that the SEC's novel enforcement measures will impose on cities and taxpayers. The SEC's belief that liability through monetary penalties is "the most effective de-

[219] Opinion of the Commission, *In the Matter of Dolphin and Bradbury, Inc and Robert J. Bradbury*, Securities Act of 1933 Release No 8721, SEC Administrative Proceeding No 3-11465, *16 (July 13, 2006) ("*Bradbury* Opinion"). This opinion upheld an SEC cease and desist order against the underwriter of a municipal issuance by a local authority in Harrisburg, Pennsylvania. The SEC charged the underwriter with violations of §§ 17(a) and 10(b) of the federal securities laws. Id at *1–3.

terrent"[220] seems facially plausible: increasing the stakes of producing false or misleading statements may well induce local officers to take a more measured approach to financial disclosures.[221]

But the other, perhaps more likely eventuality is that targeted personal liability, in addition to the broader risk of penalties imposed directly on municipalities themselves, will deter involvement in local government altogether. In combination, the SEC's recent first-of-their-kind enforcement methods make it increasingly riskier for private individuals to assume roles of authority in local government, and, moreover, these enforcement methods fail to define the potential scope and magnitude of those risks.

The Supreme Court has expressed precisely the same concerns in rejecting the notion that individual officers should be liable for damages in private suits brought under 42 USC § 1983.[222] In *Anderson v Creighton*,[223] the Court observed that "permitting damages suits against government officials can entail substantial social costs, including the risk that fear of personal monetary liability and harassing litigation will unduly inhibit officials in the discharge of their duties."[224] The Court reiterated this view more recently in *Filarsky v Delia*,[225] confirming that immunity from personal monetary liability "protect[s] government's ability to perform its traditional functions . . . by helping to avoid unwarranted timidity in performance of public duties, ensuring that talented candidates are not deterred from public service, and preventing the harmful distractions from carrying out the work of government that can often accompany damages suits."[226] Immunity from the threat of damages further "gives government officials breathing room to make reasonable but mistaken judgments" about their obligations under the law.[227]

Some empirical research has already begun to identify personnel problems as an obstacle to effective local governance. A

220 Glazier, *SEC's Top Cop* (cited in note 83) (quoting remarks by Ceresney).

221 On the other hand, "there is little evidence of [monetary penalties'] effectiveness in deterring securities law violations." Steinway, Comment, 124 Yale L J at 222 (cited in note 80).

222 As further discussed in Part III.B, the Supreme Court has not yet considered the propriety of individual monetary liability in the context of other federal statutes, including the federal securities laws.

223 483 US 635 (1987).

224 Id at 638.

225 132 S Ct 1657 (2012).

226 Id at 1665 (quotation marks omitted).

227 *Ashcroft v al-Kidd*, 131 S Ct 2074, 2085 (2011).

detailed study of four distressed suburbs of industrial cities recently cited "high turnover among city professional staff due to poor working environments and low wages" as a factor in local financial struggles.[228] The study concludes that "when cities cannot offer competitive wages and potential municipal employees don't see a career track because of political instability, they experience high staff turnover," exacerbating existing management and governance issues.[229] This research is troubling in light of the Supreme Court's prediction that the threat of individual financial liability would deter "talented candidates . . . from entering public service."[230]

In fact, an increase in personnel upheavals or a further shrinking of the pool of willing candidates for public service would only further complicate the SEC's goal of improving internal disclosure processes. Recall that the Allen Park cease and desist order—like several of the orders that came before it—required the city to designate counsel to train all personnel involved in the city's bond-offering and disclosure processes.[231] Recall, too, that the SEC's action against Allen Park resulted in severe sanctions against the city's mayor, Burtka, who agreed—under a theory of derivative control person liability—to pay a $10,000 penalty and to permanently refrain from participating in any future municipal bond offering.[232] Functionally, this provision is likely to act as a bar on the former mayor's ability to assume a position of leadership in local government except in a limited, nonfinancial role, even though he was not found to be a principal violator of the federal securities laws. The stigma of an SEC fraud settlement is certain to make him a weaker candidate for elected office in any capacity. More precisely, any city that contemplates electing or hiring the former mayor would have to take great pains to segregate his duties and responsibilities from any debt financing activities. Given how commonly local governments and agencies—including school districts and public

[228] Kathryn W. Hexter, et al, *Revitalizing Distressed Older Suburbs* *18 (Cleveland State University, Nov 2011), archived at http://perma.cc/9T8D-3D3P.

[229] Id at *22–23.

[230] *Filarsky*, 132 S Ct at 1665.

[231] *Allen Park* Order at *6 (cited in note 121).

[232] Under the terms of the settlement, Burtka "is permanently barred from participating in an offering of municipal securities . . . including engaging in activities with a broker, dealer, or issuer for purposes of issuing, trading, or inducing or attempting to induce the purchase or sale of any municipal security." *Burtka* Final Judgment at *2 (cited in note 124).

utilities—use the public debt market to raise capital,[233] such segregation may be impracticable in all but a few isolated cases. It is, of course, difficult to discern precisely how the SEC sanctions will impact the political career of an individual like Burtka, but it is fair to conclude that he is now a far less compelling candidate for local government service. If political instability and low wages led to problematic staff turnover in four closely studied American localities, then legal uncertainty and heightened risks of liability for higher-level public service positions will surely pose unprecedented personnel challenges for this troubled Detroit suburb. To be sure, a city that cannot attract talented candidates for finance-related roles will have a difficult time developing and implementing a comprehensive and functional financial-disclosure system.

It is an obvious argument, but one worth making: imposing heightened scrutiny and possible monetary penalties on local governments and public officials while simultaneously lowering the legal barriers (indeed, demolishing some preexisting barriers) to individual liability will be costly to local governments. It will make it more difficult for issuers to hire or elect professionals with the right level and scope of expertise—as well as the right level of risk aversion—to fill financial and higher-level government roles. An inability to employ well-qualified decisionmakers will lead to tighter local budgets, less sophistication in local decisionmaking, and potentially riskier investment and financing decisions. And greater volatility of risk at the local level naturally implicates state governments, who often step in to bail out failing municipalities that are unable to raise and manage capital of their own.[234] This is especially true if local governments remain reluctant to default.

To be sure, the costs of legal uncertainty and of direct SEC penalties will ultimately be felt by local budgets and the taxpayers who fund them. Penalties exacted against a municipal government will most likely draw from the city's operating funds; so, too, will monetary penalties secured against local of-

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[233] As the SEC has explained, the municipal securities market is crucial to local development, and numerous local entities regularly access the market "to finance a wide variety of public projects, to provide for cash flow and other governmental needs, and to finance non-governmental private projects." SEC, *Report on the Municipal Securities Market* at *i (cited in note 1). For an indication of the diversity of local entities that rely on public debt financing, see Appendix.

[234] See, for example, *The State Role* at *20 (cited in note 142) (analyzing recent instances of state intervention to prevent local insolvency).

ficers be drawn indirectly from the local fisc, as professionals considering any role of financial responsibility within a municipality will likely seek higher compensation or another form of assurance against the threat of liability.[235] The Supreme Court itself is sensitive to the problem of pass-through in the municipal context; the Court has reasoned that "*municipal liability for punitive damages awards would punish innocent taxpayers, not actual wrongdoers*, and therefore considerations of public policy militate[ ] against expanding punitive damages liability to encompass municipalities."[236] Even in the recent cases in which the SEC has not imposed direct penalties on local governments or officials, the burdens, risks, and uncertainties that accompany SEC enforcement will ultimately make local governance and municipal borrowing more costly for local citizens in the long term.

D. Transparency and the Risk of Overexposure

Of course, not all costs are undesirable, especially if those costs incentivize issuers to reform their disclosure practices in socially beneficial ways. Indeed, economic theory and financial research establish that improvements in primary market transparency can work to reduce transaction costs for market participants in both the corporate and the municipal contexts.[237]

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[235] The issue of public sector compensation is complex and varies across jurisdictions. Empirical work in this area is also relatively undeveloped. According to one recent study by economists at the Bureau of Labor Statistics, "data suggest that public sector workers, especially local government ones, on average, receive greater remuneration than observably similar private sector workers." Maury Gittleman and Brooks Pierce, *Compensation for State and Local Government Workers*, 26 J Econ Persp 217, 218 (2011). They note that the forces driving this public/private differential are unclear and could involve a combination of agency considerations, political interests, bargaining, and legal constraints on local expenditures, all of which have varying impacts on pay structures for public employees. Id at 239. The key point here is that compensation at the local level is not fixed and can be influenced by a variety of social and political factors. The increased legal risks of assuming a position of authority in local government could, as a theoretical matter, have a significant impact on the wage and benefit structures that individuals may seek in assuming public office. And if, as a hypothetical matter, financially stressed municipalities are unable to raise compensation to account for heightened risks in assuming public office, some candidates—especially those with transferable finance and accounting skills, such as candidates for budget-management-type positions—may be incentivized to switch to the private sector, in which slightly lower compensation levels could be offset by lower risks of personal liability. This is an area worthy of further investigation in light of the SEC's increasing focus on individual monetary penalties.

[236] *Walters v City of Atlanta*, 803 F2d 1135, 1148 (11th Cir 1986), citing *City of Newport v Fact Concerts, Inc*, 453 US 247, 259–66 (1981) (emphasis added).

[237] For further discussion of such theories, see Frank H. Easterbrook and Daniel R. Fischel, *The Economic Structure of Corporate Law* 280–85 (Harvard 1996) (arguing that

Recent studies of the municipal bond market have documented that, in defined markets, structured disclosure practices and more-uniform accounting methods have allowed issuers to offer lower interest rates to investors, which in turn allows issuers to access the capital markets more cheaply.[238] Investors in local governments that have, for example, made key financial data—like budget reports and cash flow projections—readily available online will theoretically be willing to accept less favorable repayment terms in exchange for the greater investment certainty that online disclosures provide.[239]

Improvements in market transparency can also generate "information spillover"—positive externalities that result when local citizens gain greater access to reliable data on the financial health of their localities as a result of better investor communication.[240] A more informed electorate is undoubtedly an added safeguard against mismanagement and fraud.

As a baseline rule, then, transparency has concrete value for issuers, investors, and citizens alike.[241] But there are (at least)

antifraud rules have the effect of lowering borrowing costs for firms by incentivizing more-accurate disclosure practices). For empirical studies of disclosure practices in the municipal securities market, see Tiankai Wang, Patricia Shields, and Yangmei Wang, *The Effects of Fiscal Transparency on Municipal Bond Issuances*, 35 Mun Fin J 25, 26, 42 (2014) (observing that "accessibility of fiscal information disclosure, such as online budget reports, can decrease issuers' borrowing costs," but finding that there are "limits to the value of transparency"); Lisa M. Fairchild and Timothy W. Koch, *The Impact of State Disclosure Requirements on Municipal Yields*, 51 Natl Tax J 733, 740, 750 (1998) (studying the impact of state disclosure requirements on interest rates).

238 See Fairchild and Koch, 51 Natl Tax J at 750 (cited in note 237) (finding that net interest cost—the cost that issuers must pay to borrow—is, on average, lower for comparable issues in states that impose direct disclosure requirements on municipal issuers); William R. Baber and Angela K. Gore, *Consequences of GAAP Disclosure Regulation: Evidence from Municipal Debt Issues*, 83 Accounting Rev 565, 568 (2008) (finding that "state-imposed requirements on municipalities to use GAAP accounting are associated with lower municipal debt costs").

239 See Wang, Shields, and Wang, 35 Mun Fin J at 26 (cited in note 237). See also Mark Robbins and Bill Simonsen, *The Quality and Relevance of Municipal Bond Disclosure: What Bond Analysts Think*, 31 Mun Fin J 1, 9–16 (2011) (finding that professional bond analysts would value easier access to documents such as budget projections, cash flow statements, and capital improvement plans).

240 Baber and Gore, 83 Accounting Rev at 570 (cited in note 238) (explaining the liquidity benefits that accrue to lenders when there is increased market transparency).

241 Recent efforts to overhaul and improve disclosure processes in Massachusetts are strong evidence that issuers can benefit from becoming more transparent. Among other things, the state has launched a website, Massbondholder.com, to provide investors with comprehensive data and real-time updates on the state's finances. See Jeffrey Burger, et al, *Municipal Industry Roundtable: Trends and Developments*, 34 Mun Fin J 51, 51, 54–57 (2014) (describing the initiatives that Colin MacNaught, the assistant treasurer for Massachusetts, has helped develop in the state). Note, however, that Massachusetts is

two caveats to this baseline rule in the municipal context, and the SEC's disclosure-forcing efforts fail to take these caveats into account.

1. The costs and benefits of transparency.

The first caveat is that disclosure—whether voluntary or mandated by state or federal regulation—makes economic sense only if the savings and other nonmonetary benefits it generates exceed the costs of implementation. Recent empirical work has only just begun to investigate this trade-off. Consider, for instance, a 2008 study of borrowing costs for municipalities required by state law to use generally accepted accounting principles (GAAP) in bond disclosures.[242] Researchers found, consistent with the baseline rule, that debt financing costs—that is, interest that cities pay to borrow from the public—were lower in GAAP states than in states with unregulated disclosures.[243] These researchers note, however, that their findings "should be interpreted cautiously, [ ] as [they] do not consider the costs of disclosure regulation, *which potentially exceed benefits realized in debt markets*."[244] They further note that disclosure costs are "likely to be more substantial" for smaller municipalities.[245] The study is a useful starting point for understanding the value of transparency in the primary debt market, but more research is needed to clarify the interplay between borrowing costs, disclosure costs, and regulation, as well as to define how such costs might impact localities of different sizes with varying financial profiles.

In a recent, slightly more theoretical study of issuer disclosure, researchers confirmed that there is an optimal level of transparency beyond which the costs exceed the benefits.[246] The analysis demonstrated that a moderate level of fiscal transparency provides the lowest borrowing costs for issuers, while both high and low levels of transparency yield higher borrowing costs.[247] In

among the top five wealthiest states in the nation and ranks sixth in the nation in taxes paid per capita. See Richie Bernardo, *2014's Richest and Poorest States* (WalletHub), archived at http://perma.cc/5WA4-WLDZ (compiling data from the US Census Bureau, the US Bureau of Economic Analysis, and the IRS).

242 See generally Baber and Gore, 83 Accounting Rev 565 (cited in note 238).

243 Id at 589.

244 Id at 568 (emphasis added).

245 Id.

246 Wang, Shields, and Wang, 35 Mun Fin J at 36–37 (cited in note 237).

247 Id at 42.

other words, there is a "sunlight/overexposure *tradeoff*" in fiscal disclosure: some transparency is profitable, but too much can leave local governments worse off.[248] The authors of this study emphasize that the empirical study of fiscal transparency at the local level is "inchoate in both theory and practice" and call for further investigation.[249]

The question of information spillover—that is, the possibility that citizens will benefit from better financial transparency within their localities—also demands additional thought. Consider the case of Kansas.[250] The subject of the SEC's cease and desist order with the state was its failure to disclose to investors, through formal bond-offering documents, the fact that the state pension system was grossly underfunded.[251] But even if one concedes that investors may have suffered from this omission, the "repeated[ ]" discussion of the underfunding in "various local newspapers"[252] would likely have provided local citizens with sufficient notice of the problem to correct it through the political process. The governance failures that led to the pension crisis in Kansas cannot necessarily be attributed to citizens' lack of awareness. As a result, the formalized disclosure systems that the SEC has sought to impose on local issuers[253] will not always provide incremental transparency benefits to citizens. If improved disclosure also fails to provide net monetary savings in the bond market, it lacks a policy justification altogether.

[248] Id.

[249] Id. There is, of course, substantial writing on disclosure practices and costs of regulatory compliance in the corporate context, but researchers in this area caution that "important differences between the public and private sectors" counsel against "importing results from publicly traded companies into the context of municipal debt." Baber and Gore, 83 Accounting Rev at 570 (cited in note 238). This Comment does not engage in such comparisons, but other scholarship has. See, for example, Chung, 34 Cardozo L Rev at 1520–24 (cited in note 1) (arguing that municipalities should be subject to the same fiduciary principles that apply in the corporate context); Gabaldon, 34 J Corp L at 761 (cited in note 43) (positing that the only reason to regulate public issuers differently than private issuers is to avoid the mistakes that have been made in the private sector). This is an area that is ripe for further investigation.

[250] See Part II.B.

[251] *Kansas* Order at *6 (cited in note 93).

[252] Id at *4.

[253] Recall that the SEC's cease and desist orders by and large require issuers to adopt more-formal disclosure policies and to provide training to the personnel involved in bond issuances. See Part II.B.

2. Elasticity of demand for municipal bonds.

The second caveat is that, at a certain point, a decrease in interest rates could have a chilling effect on investor demand for municipal bonds. As Part II.A discusses, municipal bonds are appealing to individual investors because of their tax advantages and their low rates of default. These features allow municipal issuers to keep interest rates lower than those on comparable taxable bonds; in exchange for the tax exemption and low default risk, investors accept lower yields. As the financial literature discussed above suggests, in many cases issuers are able to lower interest rates in order to offset the cost of enhanced disclosure practices without driving investors to other instruments. In other words, transparency has value, and many investors will value it enough to accept still-lower yields on municipal bonds.

But naturally, there is a limit to this inelasticity. In theory, if interest rates on municipal bonds fall low enough, investors will begin to substitute away from municipal bonds and pursue other investment sources that offer comparable or more-favorable returns. If an issuer's interest rate falls below the level that investors are willing to accept in exchange for the bundle of benefits that municipal bonds provide, investors will simply switch to the bonds of another municipal issuer, to taxable bonds, or to other asset classes altogether. In other words, there is a point at which demand for municipal bonds becomes highly sensitive to interest rates, because investors can easily find substitute investments that will better maximize their returns.[254] As with the costs and benefits of disclosure, research into the nature of portfolio shifting in the municipal bond market is underdeveloped.[255] It is therefore imperative for decisionmakers and courts to carefully consider how the SEC's recent activity might impact investor behavior going forward.

As a starting point, it is useful to conduct a closer analysis of the costs of the SEC's new frontier. As the recent cease and desist orders tend to show, there are two distinct categories of costs that flow from the SEC's new enforcement regime. Most

[254] See, for example, Poterba and Verdugo, 64 Natl Tax J at 595–98 (cited in note 176) (discussing the various ways in which individual investors can adjust their portfolios in response to changes in the municipal bond market).

[255] Id at 595 ("[R]elatively little empirical work informs the set of portfolio adjustments that may result from a change in the tax treatment of state and local government bonds.").

immediately, local issuers facing SEC sanctions incur what might be termed "enforcement costs": the monetary and non-monetary burdens that flow directly from SEC enforcement actions. These costs include (but are not limited to) the direct monetary penalties that the SEC has imposed in some cases, as well as the costs of legal defense, possible reputational harm, and general uncertainty resulting from the SEC's novel theories of liability.

The second category, which involves what might be termed "transparency costs," captures the expenditures these cities must make to comply with the SEC's new disclosure demands. As a condition of its deal with Allen Park, for example, the SEC has required that the city engage disclosure counsel to develop more-robust internal accounting procedures and to train personnel in financial-reporting processes and best practices.[256] There is little doubt that the plan will be costly and administratively challenging, especially given the city's current state of financial distress. But if investors believe that the plan can be implemented effectively and that it would add value to their investments, they may be willing to accept lower rates to compensate Allen Park for the costs of implementation.

Investors are much less likely, however, to accept still less favorable rates in order to compensate issuers for the enforcement costs resulting from SEC intervention. This may prove especially true in places like Allen Park, where the city has gone to great lengths to avoid default and ensure that investors are repaid under the terms of the bond contract, as well as in places like Kansas, where any vigilant bondholder was already in a position to stay abreast of the financial condition of the city by monitoring local media. The market may be willing to bear transparency costs up to a certain point, but the added input of enforcement costs may make municipal bonds as a whole—or the individual bonds hit hardest by SEC scrutiny—less attractive than other classes of securities. In the end, SEC intervention could prove costly enough to dampen investor interest altogether. This would have the unwanted effect of impairing local governments' access to capital—a consequence that would be especially problematic at a time when responsible, well-planned public borrowing could provide a much-needed source of liquidity and funding for suffering cities and towns.

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[256] See Part II.B.

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The ultimate point of this analysis is that the SEC is doing in two steps something that could be done in one. From a policy perspective, it is fair to say that local governments should be able to invest in affordable levels of transparency without significantly hindering their ability to borrow; transparency will benefit bondholders by providing better grounds for risk analysis, and it has the potential to empower citizens to act as more-effective monitors of local decisionmaking. But the SEC's efforts to incentivize better transparency through a costly, opaque punitive regime adds an additional layer of short- and long-term burdens that do not significantly benefit any stakeholders in this market and may, in the most extreme cases, deter bond investment altogether.

Luckily, there are less costly ways to achieve greater transparency. Before examining these alternatives, it is important to first situate the SEC's new frontier within the existing legal regime. In so doing, it will become apparent that the SEC's new enforcement frontier is not only a costly means of achieving fiscal transparency but a legally unsound one as well.

III. DOCTRINAL NOVELTY THROUGH THE REGULATORY BACK DOOR

While the SEC has not technically acted outside its authority in pursuing issuer fraud with greater intensity and coordination, it has pushed the limits of individual and entity liability into uncharted territory. Indeed, the novelty of the SEC's theories of liability has not gone unnoticed by the broader legal community. In March 2015, Dean Erwin Chemerinsky filed a petition for a writ of certiorari before the Supreme Court on behalf of the city of Miami's former budget director, who lost his appeal for a qualified immunity defense in the Eleventh Circuit.[257] The *Boudreaux* petition challenged the Eleventh Circuit's denial of the immunity defense and broadly questioned the propriety of SEC suits for monetary penalties against individual officers,[258] as discussed further in Part III.B. This petition and the doctrinal questions it raises are ample evidence of the legal complexity of the SEC's new enforcement strategies.

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[257] See generally *Boudreaux* Petition (cited in note 117). See also Part I.C.3.

[258] *Boudreaux* Petition at *i (cited in note 117).

This Part investigates the doctrinal underpinnings of the SEC's enforcement frontier and provides a framework for further examination. Part III.A addresses the text and history of the Tower Amendment, which signal a congressional intent to limit the SEC's role in local fiscal decisionmaking. Part III.B revisits the distinct theories of liability that the SEC has recently pursued and flags the doctrinal problems that those theories pose. Finally, Part III.C discusses the implications of the SEC's preference for administrative action, which limits potential legal challenges to its novel enforcement tactics.

A. The Looming Tower Amendment

If not for the Tower Amendment, the SEC's new frontier in municipal securities enforcement would look quite different. By prohibiting the SEC and MSRB from "directly or indirectly" requiring any issuer of municipal securities to file any disclosure documents in connection with primary bond issuances,[259] Congress expressed an intent not to subject municipal issuers to a formal, federally administered disclosure regime akin to that imposed in the corporate sphere. Nonetheless, neither the language nor the legislative history of the Amendment makes clear whether Congress intended to allow the SEC to induce such disclosure through its antifraud enforcement powers. As this Section highlights, any court considering a challenge to the SEC's aggressive theories of liability—or weighing the propriety of monetary penalties against public officials—must ground its analysis in an interpretation of the Tower Amendment.

1. The text.

The text of the Tower Amendment does not expressly prohibit the SEC from using its enforcement power under the federal antifraud regime to induce or otherwise incentivize issuers to provide accurate and timely disclosures to investors. Recall the language of the Amendment:

> Neither the Commission nor the Board is authorized under this chapter, by rule or regulation, to require any issuer of municipal securities, *directly or indirectly* through a purchaser or prospective purchaser of securities from the issuer, to file with the Commission or the Board prior to the sale

[259] 15 USC § 78o-4(d)(1).

> of such securities . . . any application, report, or document in connection with the issuance, sale, or distribution of such securities.[260]

A plain language reading of this provision suggests that the SEC does not overstep its authority when it uses fraud sanctions to alter issuer disclosure behavior. First, the Amendment applies only to attempts by the SEC to mandate disclosure "by rule or regulation"—it does not expressly prohibit the use of "softer" methods of inducement, like a penalty regime designed to incentivize better disclosure practices. The Amendment's ban on indirect regulations is also narrowly defined: it applies only to regulation that might be imposed on "a purchaser . . . of securities from the issuer." This clause most plausibly implicates third-party underwriters, who facilitate a debt offering by purchasing the securities from the issuing entity and reselling them to primary investors. SEC enforcement activity—even activity that is designed to induce issuer disclosure—does not appear to be the sort of indirect regulation that the Tower Amendment prohibits by its terms.

Furthermore, the restriction technically applies only to rules or regulations that would require issuers to file pre-issuance "application[s], report[s], or document[s]" directly with the SEC or MSRB.[261] It does not, by its express language, prohibit the SEC from creating any disclosure regime whatsoever—it only limits the SEC's ability to demand access to specified documents prior to an issuance of debt. At a bare minimum, the language of the Tower Amendment does not foreclose an argument that the SEC is empowered to induce issuer disclosure by means of a punitive enforcement regime.

While the language of the Amendment is narrowly drafted, the SEC has interpreted it to impose broad restrictions on its ability to regulate the municipal securities market. This complicates any attempt to apply the Tower Amendment to the SEC's new enforcement frontier. Most straightforwardly, the SEC maintains that, by prohibiting it from requiring issuers to file disclosure documents directly with the SEC, the Amendment prevents it from reviewing the content of those disclosures before securities are offered to the public.[262] This presumably lim-

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[260] 15 USC § 78o-4(d)(1) (emphasis added).

[261] 15 USC § 78o-4(d)(1).

[262] See Aguilar, *Statement on Making the Municipal Securities Market More Transparent* (cited in note 50) (explaining that "[r]epealing the Tower Amendment would allow

its the SEC's ability to identify and flag misrepresentations before they impact investment decisions. Reading the provision in conjunction with the other filing exemptions applicable to the municipal securities market,[263] the SEC has further concluded that the Tower Amendment denies the SEC authority to "establish mandatory disclosure requirements for municipal offerings" and to require issuers "to follow a uniform accounting standard"[264] on an ongoing basis.

Strictly speaking, the Tower Amendment's language does not unequivocally compel these conclusions. The SEC's interpretation is tenable considering the broader regulatory framework within which it operates, but the courts have not substantively analyzed how far the SEC's regulatory authority extends in this context; nor have they considered whether the SEC's view deserves deference in light of a fairly straightforward statutory text.[265] Because the Amendment's text is susceptible to both a broad and a narrow reading, uncertainties remain regarding how the SEC's novel enforcement frontier interacts with Congress's underlying intent. Because there appears to be uncertainty regarding the proper interpretation of the Tower Amendment's express and implied prohibitions, it is instructive

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the Commission and the MSRB to require issuers of municipal securities to file disclosure materials for review before offering securities to investors").

[263] In general, municipal securities are exempt from the registration requirements of the Securities Act and the reporting regime of the Exchange Act. See Part I.B.1. The Tower Amendment complements these exemptions with a more direct prohibition on direct SEC oversight, as this Section and Part III.A.2 make clear.

[264] Aguilar, *Statement on Making the Municipal Securities Market More Transparent* (cited in note 50).

[265] Under *Chevron U.S.A. Inc v Natural Resources Defense Council, Inc*, 467 US 837 (1984), courts will defer to agency interpretations of statutory authority when congressional intent is unclear and the agency's approach is "based on a permissible construction of the statute." Id at 842–43. But it is not clear how or whether *Chevron* deference would be triggered in this context. Because the SEC's enforcement activity and the penalties it has imposed are not, by themselves, founded on any questionable interpretation of the SEC's clear antifraud enforcement authority, a challenge to the SEC's broader enforcement regime would have to allege that the regime as a whole—or, perhaps, the disclosure-related terms of the SEC's recent cease and desist orders—functions as de facto regulation of issuer disclosure practices in contravention of the Tower Amendment. Such a challenge seems unlikely, since the SEC is unambiguously empowered to impose monetary penalties on issuers and local officials through antifraud actions and since respondents are free to challenge and reject the terms of proposed cease and desist orders. It is interesting, however, that the SEC's own interpretation of the Tower Amendment has been narrow and restrictive. If a local issuer were able and willing to bring a substantive challenge to an SEC penalty as an impermissible "regulation" of issuer disclosure, the SEC's narrow reading of the Tower Amendment could work in the challenger's favor.

to consider the intentions expressed by the members of Congress who originally advocated for the Amendment's passage.

2. The legislative history.

While the Tower Amendment's text may not expressly impede the SEC's use of enforcement tools to induce disclosure, its legislative history makes clear that, when it comes to subjecting state and local actors to federal control, restraint is paramount. Senator Harrison Williams, in introducing the amendment on the Senate floor, stated that the provision was designed to "make clear that the Municipal Securities Rulemaking Board . . . would not have authority to require State and local governments to make disclosures about their operations," and he emphasized that "the bill [was] not intended to tamper in any way with prerogatives of State and local governments in their sale of securities."[266] As Williams explained, "The amendment thus states that the Municipal Securities Rulemaking Board may not impose on issuers, directly or indirectly, disclosure requirements. Surely there can be no argument with that result."[267]

As the record further reveals, "that result" seemed sound to Congress for two distinct reasons. First, Senator John Tower was confident that "[m]uch of [the] information" pertinent to local government operations—that is, the information most relevant to prospective investors—"will undoubtedly be made available [to the market] in any case."[268] He further observed that the SEC and MSRB can easily "obtain such information from municipal securities brokers and dealers, who already supply such information to investors" when they market and sell new debt issues.[269] Since private financial intermediaries have access to pertinent issuer information and are already subject to regulation, there was no practical need, in Tower's view, to impose disclosure requirements directly on issuers themselves.[270]

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[266] Securities Acts Amendments of 1975, S 249, 94th Cong, 1st Sess, in 121 Cong Rec 10736 (Apr 17, 1975).

[267] Id.

[268] Id at 10737. Tower did not explain precisely how relevant information "will [ ] be made available in any case," but the implication is that prospective investors can gain information about a new issue from the private parties that act as intermediaries in the issuance process. Id.

[269] Id. Recall that the SEC retains the authority to impose regulations on private parties involved in the municipal securities market—only issuers are exempt from disclosure regulation. See Part I.B.1.

[270] 121 Cong Rec at 10737 (cited in note 266).

Second, and more importantly, Congress was clearly skittish about opening the door to federal intervention in state and local financial affairs. Under the unequivocal heading "Regulation of Municipal Securities Professionals—Not Issuers," a 1975 Senate committee report on the amendments states that, "[a]part from the general antifraud provision, municipal securities are exempt from all substantive requirements. . . . The bill does not in any way change this pattern, for *the Committee is not aware of any abuses which would justify such a radical incursion on states' prerogatives*."[271]

The report does not articulate any concrete theory under which federal intervention in local-bond issuances would violate the Constitution or softer principles of intergovernmental comity;[272] nor does it precisely define its understanding of states' prerogatives in accessing capital markets. The report also fails to specify the type or magnitude of abuses that would, in Congress's view, warrant a "radical incursion" on those prerogatives. The historical context of the Amendment does, however, provide some insight: the 1975 Amendments were drafted in response to New York City's catastrophic near default on $600 billion of municipal bonds in that same year.[273] Apparently, a bond crisis of this magnitude—resulting in a concerted bailout effort by the state and federal governments—was not, in Congress's eyes, sufficiently troubling to warrant a "radical incursion" on state sovereignty in financial affairs.[274] The bar to federal intervention in disclosure practices thus seemed, in the view of the drafters of the Tower Amendment, quite high.

A restrictive interpretation of the text of the Tower Amendment—with its prohibition of both direct and indirect attempts to impose disclosure requirements on issuers—would be reasonable, especially given the high threshold that Congress

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271 S Rep No 94-75 at 44 (cited in note 45) (emphasis added).

272 The most straightforward constitutional concern would be posed by the Tenth Amendment, which reserves to the states any powers not expressly delegated to the federal government. However, this concern has been dismissed as overly simplistic. See, for example, Gabaldon, 34 J Corp L at 753–54 (cited in note 43). See also *Woods v Homes and Structures of Pittsburg, Kansas, Inc*, 489 F Supp 1270, 1296 (D Kan 1980) (holding that the Tenth Amendment did not prevent the federal government from interfering with a local government's issuance of industrial-development bonds, because the Tenth Amendment only protects the states' ability to carry out "traditional governmental function[s]").

273 See Gabaldon, 34 J Corp L at 742 (cited in note 43); Chung, 34 Cardozo L Rev at 1502–03 & n 230 (cited in note 1).

274 Chung, 34 Cardozo L Rev at 1502 n 230 (cited in note 1).

seems to have intended to set on federal intervention.[275] If one views the SEC's new enforcement frontier in the way that this Comment has framed it—as a second-best, backdoor disclosure-forcing regime, or as a coordinated program designed to induce certain ex ante disclosure practices through systematic ex post punishment—it appears to violate the underlying intent, if not the text, of the Tower Amendment's proscription.

It remains true that municipal securities, as a class of instruments traded in interstate commerce, are subject to federal oversight through the antifraud provisions of the securities laws. And despite some initial debate,[276] federal courts agree that local issuers (though not states themselves[277]) are subject to private rights of action for violations of § 10(b) and Rule 10b-5 of the securities laws,[278] which by implication makes them proper subjects of SEC enforcement actions. Moreover, states themselves are not immune from suit by agencies of the federal government,[279] making the SEC's settlements with New Jersey, Illinois, and Kansas legally sound (though still entirely novel). But the federal securities laws "must be understood against the backdrop of what Congress was attempting to accomplish,"[280] and in passing the Tower Amendment, Congress was far more concerned with exempting state and local issuers from SEC oversight than it was intent on ensuring that they be subject to direct civil or SEC liability. In light of this legislative history, it is reasonable to conclude that the SEC's exercise of its implied right to enforce the antifraud provisions against government issuers has begun to overstep the limits that Congress intended to

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[275] One scholar interpreting the applicability of the antifraud provisions to municipal issuers under the Tower Amendment has even insisted that a consideration of legislative history is essential to a proper reading of securities laws. See Margaret V. Sachs, *Are Local Governments Liable under Rule 10b-5? Textualism and Its Limits*, 70 Wash U L Q 19, 26–33 (1992).

[276] Id at 25.

[277] The Eleventh Amendment continues to shield states and "arm[s] of the state" from private suits under the antifraud provisions of the federal securities laws. *Sonnenfeld v City and County of Denver*, 100 F3d 744, 749–50 (10th Cir 1996) (concluding that Denver was not an arm of the state entitled to Eleventh Amendment immunity because it had significant autonomy in local affairs, had the power to levy taxes and issue bonds, and had not shown that a judgment against it would be paid out of the state treasury).

[278] See id at 746–47.

[279] See *Alden v Maine*, 527 US 706, 755–56 (1999). It is also well settled that state governments are included in the definition of "person" as applied to §§ 17(a) and 10(b). See Part I.B.2.

[280] *Reves v Ernst & Young*, 494 US 56, 63 (1990).

impose on the federal role in municipal finance. This alone is reason to question the legal propriety of the new frontier.

As if to confirm that its recent activity fits uneasily within the framework of the Tower Amendment, the SEC has repeatedly urged its repeal, as well as the elimination of municipal securities' exemption from the registration and filing requirements of the securities laws.[281] Some federal agencies and scholars have agreed that removing the Tower Amendment's restrictions and allowing the SEC to create and enforce a comprehensive disclosure program would make good sense in terms of policy.[282] Other key stakeholders—including the Council of State Governments—disagree and forcefully oppose repeal of the Tower Amendment.[283] But until Congress makes a choice between the competing legal and political considerations weighing on both sides of the question, the SEC is constrained by the design of existing law.

B. The Unsettled Scope of Issuer and Officer Liability

If there is reason to be uncomfortable with the legal footing of the SEC's coordinated program—given its aim to induce more-robust disclosure practices through the Tower Amendment's back door—then there is equal reason to be concerned about the means that the SEC has used to construct this coordinated program. Recall the four doctrinal novelties that have thus far characterized the SEC's new frontier: (1) For the first time ever, the SEC has pursued enforcement actions against state governments. (2) The SEC has expanded the basis for fraud violations to include any public statements made by municipal governments or officials, even outside the context of securities disclosures. (3) Monetary penalties against government entities and officials were unheard of until 2010 but are now a central focus

[281] See Aguilar, *Statement on Making the Municipal Securities Market More Transparent* (cited in note 50).

[282] See, for example, State Budget Crisis Task Force, *Report of the State Budget Crisis Task Force* *5 (Jan 2014), archived at http://perma.cc/BD63-XR4W; *Municipal Securities* at *23–25 (cited in note 83); Gabaldon, 34 J Corp L at 769 (cited in note 43); Spencer T. Bachus, *Federal Policy Responses to the Predicament of Municipal Finance*, 40 Cumb L Rev 759, 793 (2010).

[283] See generally Council of State Governments, *Resolution on Rating Agency Reform and Preserving the Tower Amendment* (Nov 2009), archived at http://perma.cc/A3PQ-2H8R. See also, for example, National Association of State Treasurers, *Resolution: Opposing Amendment or Repeal of the Tower Amendment* (Oct 7, 2013), archived at http://perma.cc/47MK-78FP.

of the SEC enforcement program. Furthermore, on an issue of first impression, the Eleventh Circuit held that public officials are not entitled to qualified immunity in federal enforcement actions for monetary penalties, bolstering the SEC's enforcement efforts. (4) The SEC has, for the first time, invoked control person liability to bring charges against a city official.

Very little case law has arisen from these doctrinal firsts, due mostly to the fact that the majority of the SEC's enforcement actions have concluded in administrative orders without formal adjudication.[284] There is, however, considerable room for debate about each of these distinct issues, and it is likely that courts will face more-frequent challenges as the SEC's enforcement activity intensifies. The remainder of this Section highlights the lingering legal uncertainties surrounding the SEC's new frontier and provides a starting point for deeper analysis.

1. The SEC has pursued enforcement actions against state governments.

As a threshold point, it is not doctrinally troubling that the SEC has pursued actions against state governments: while states are protected from private suits under the Eleventh Amendment,[285] the Supreme Court has definitively established that states are not immune from legal actions by federal enforcement agencies.[286] Still, the sheer novelty of the SEC's actions against states is ripe for potential legal challenges and could be a site of controversy if the SEC's activity in this area becomes more aggressive.

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[284] See Part III.C.

[285] US Const Amend XI ("The judicial power of the United States shall not be construed to extend to any suit in law or equity, commenced or prosecuted against one of the United States by citizens of another state, or by citizens or subjects of any foreign state."). See also *Hans v Louisiana*, 134 US 1, 15, 21 (1890) (holding that the Eleventh Amendment's protection of states from suits by individuals extends to the state's own citizens as well as to citizens of other states or foreign countries).

[286] See *Alden*, 527 US at 755–56 (holding that "[s]overeign immunity [ ] does not bar all judicial review of state compliance with the Constitution and valid federal law" and pointing to an exception for suits "commenced and prosecuted against a State in the name of the United States by those who are entrusted with the constitutional duty to 'take Care that the Laws be faithfully executed'").

2. The SEC has expanded the basis for fraud violations to include any public statements made by municipal governments or officials, even outside the context of securities disclosures.

The question of the scope of the public statements that may form the basis of a fraud charge is thornier. In determining whether corporate defendants have made "any untrue statement of a material fact" warranting liability under Rule 10b-5, courts look beyond representations made in SEC-mandated disclosures and consider information included in press releases, public statements by managers, court filings involving the company, and information disseminated through general media channels.[287] This means, in turn, that statements made outside formal SEC disclosures can form the basis of a fraud claim against corporate issuers. The SEC directly imported this approach into the municipal context in its 2013 settlement with Harrisburg, Pennsylvania, in which it based fraud allegations on statements made in the city's budget report and in the mayor's State of the City address.[288] Again, there is no federal judicial precedent to support the assertion that the full range of communications by government officials to local stakeholders fits within the judicially created notion of the "total mix of information" under the federal securities laws.

Indeed, there may be good arguments in favor of the SEC's view: in the case of Harrisburg, for example, the city had failed to make any formal disclosures relating to its bond issuance at all, supporting the inference that bondholders may have relied on the public statements of city officials in making investment decisions.[289] Nonetheless, the standard that the SEC announced in its 2013 press release on the Harrisburg settlement—that all public statements are part of and may impact "the total mix of information available to the market" and that they can therefore form the basis of fraud liability—is in dire need of a limiting principle.[290] Marc Steinberg, an early commentator hailing from the SEC's Office of the General Counsel, considered the question to be "controversial" six years after the Tower Amendment became

[287] See Hazen, 4 *Treatise on the Law of Securities Regulation* at § 12.9 (cited in note 68).

[288] See Part I.C.2.

[289] See Part I.C.2.

[290] SEC, *Report of Investigation* (cited in note 99).

law.[291] And, as Steinberg has highlighted, the United States District Court for the Southern District of New York was sensitive to this question in considering investor claims arising from the New York City bond crisis: "In my opinion," Judge Richard Owen wrote, "interjection of the federal securities laws into clearly political affairs of local government would represent an unwarranted intrusion into the political life of the community."[292]

The normative intuition that certain elements of local government communication should be shielded from federal scrutiny—muddy as that intuition may be—comports with Congress's intent to prevent federal "incursion[s] on states' prerogatives."[293] In some cases, it may be easy for a court to distinguish between purely political speech and public statements that are likely to affect outside investment decisions. But as Part III.C discusses in greater detail, the likelihood of courts reviewing this gray area in the near future is relatively low, which places the line-drawing discretion squarely with the SEC.

Furthermore, the SEC's only formal interpretation of the "total mix" standard in the context of a municipal bond issuance creates more confusion than clarity.[294] Acting in its judicial capacity,[295] the SEC concluded in *In the Matter of Dolphin and Bradbury, Inc and Robert J. Bradbury*[296] that disclosure of pertinent information through the "[p]ublication of a few articles in local newspapers with limited circulation" and through "discussion at [local government] meetings" was not effective in making such information "reasonably available" to potentially far-flung investors.[297] Because regional newspaper stories and government hearings were too local to have reliably reached investors, any disclosures made through those channels would not enter the total mix of information applicable to investment decisions.[298] They would therefore not be sufficient to counteract the

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[291] Marc I. Steinberg, *Municipal Issuer Liability under the Federal Securities Laws*, 6 J Corp L 277, 281–82 (1981).

[292] *In re New York City Municipal Securities Litigation*, 507 F Supp 169, 186 (SDNY 1980).

[293] S Rep No 94-75 at 44 (cited in note 45). See also Part III.A.2.

[294] *Bradbury* Opinion at *16 (cited in note 219).

[295] In issuing the *Bradbury* Opinion, the judicial arm of the SEC was reviewing a challenge to a cease and desist order imposed by an ALJ through the administrative hearing process. See id at *2–3. See also Part I.B.

[296] Opinion of the Commission, Securities Act of 1933 Release No 8721, SEC Administrative Proceeding No 3-11465 (July 13, 2006).

[297] Id at *16.

[298] Id.

effects of material omissions or misstatements made in formal disclosure documents. This approach generally comports with the SEC's case against Kansas, which relied on the principle that local newspapers—which had extensively discussed the underfunded state of the pension system, even though formal disclosure documents failed to mention it—were not sufficiently accessible to investors to have qualified as sources of disclosure.[299] But this construction directly contradicts the result in the Harrisburg case, in which the SEC's theory of liability hinged on the presumption that a local speech by the city's mayor and other political communications *were* sufficiently available to investors to have impacted their investment decisions. The lack of clarity in the SEC's approach signals the need for a more principled standard by which to evaluate the potential impact of various types of local public communications.

3. Monetary penalties against government entities and officials are now a central—and controversial—focus of the SEC's enforcement program.

The novel question of local officials' and governments' liability for SEC monetary penalties (rather than mere injunctions) is equally thorny. The United States District Court for the Southern District of Florida addressed the question squarely in *Securities and Exchange Commission v City of Miami*[300] in December 2013.[301] The court summarily rejected the city's challenge to the claim for monetary penalties with a straightforward—though not entirely unobjectionable—statutory argument: the federal securities laws allow the SEC to seek penalties against any "person" who violates those laws;[302] "person" is statutorily defined to include a "government, or political subdivision, agency, or instrumentality of a government";[303] and therefore, the SEC can seek penalties against municipal entities.[304]

The city's defense hinged on an analogy between SEC monetary penalties and punitive damages in civil suits: it argued that the Supreme Court has long held that municipalities are

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[299] For a discussion of the Kansas case, see Part II.B.
[300] 988 F Supp 2d 1343 (SD Fla 2013).
[301] Id at 1347–51. See also Part I.C.3.
[302] *City of Miami*, 988 F Supp 2d at 1361. See also 15 USC § 78u(d)(3)(A).
[303] 15 USC § 78c(a)(9).
[304] *City of Miami*, 988 F Supp 2d at 1361.

immune from punitive damages,[305] that civil monetary penalties will punish taxpayers without meaningfully deterring local officials from wrongdoing, and that SEC penalties imposed on the city are therefore improper.[306] Without citing pertinent legal authority, the district court dismissed this analogy wholesale, writing that "a civil penalty does not serve the same punishment goals of punitive damages, but instead is meant to provide disincentives to securities law violations."[307]

On appeal, the Eleventh Circuit later held that public officers are not entitled to qualified immunity in SEC suits for monetary penalties, similarly reasoning that penalties serve a purpose fundamentally different from that of civil damages.[308] And yet, the Supreme Court itself seems somewhat undecided on the proper characterization of these penalties. SEC penalties, the Court wrote in its 2013 decision in *Gabelli v Securities and Exchange Commission*,[309] "*are intended to punish*, and label defendants wrongdoers."[310] The petition for certiorari filed by Chemerinsky on behalf of Boudreaux, Miami's former budget director, argues forcefully that there is little logical reason—and no legal reason—to draw a distinction between monetary *penalties* and monetary *damages*. The petition notes that the "Court has been clear that the label used for the relief is not determinative when it comes to immunity; it is the financial effect on the defendant."[311] In fact, as the *Boudreaux* petition highlights, much of the Court's reasoning in upholding qualified immunity against punitive damages has focused on the same downstream social costs discussed in Part II.C of this Comment.

In *Filarsky*, for example, the Court noted that immunity from civil damages "help[s] to avoid 'unwarranted timidity' in performance of public duties" and ensures "that talented candidates [are] not deterred by the threat of damages suits from

[305] See, for example, *City of Newport v Fact Concerts, Inc*, 453 US 247, 271 (1981) (stating that "considerations of history and policy do not support exposing a municipality to punitive damages for the bad-faith actions of its officials").

[306] Defendant City of Miami's Reply in Support of Motion to Dismiss and Memorandum of Law in Support Thereof, *Securities and Exchange Commission v City of Miami*, Civil Action No 13-226600, *12–14 (SD Fla filed Nov 25, 2013) (available on Westlaw at 2013 WL 6823900).

[307] *City of Miami*, 988 F Supp 2d at 1361.

[308] *City of Miami*, 2014 WL 4377831 at *2–3.

[309] 133 S Ct 1216 (2013).

[310] Id at 1223 (emphasis added).

[311] *Boudreaux* Petition at *10 (cited in note 117), citing *Edelman v Jordan*, 415 US 651, 668 (1974).

entering public service."[312] Such precedent calls into question the Eleventh Circuit's strained distinction between private damages and public penalties, and it counsels against eliminating immunity in SEC enforcement actions. Because the Court has declined to consider the issue, there remains room for contrary decisions at the district and appellate court levels.[313] Any court considering this issue will necessarily face the same policy questions considered in Part II of this Comment. More importantly, courts will also have to contend with the Supreme Court's straightforward views on the social implications of direct monetary liability, which seem to militate against the imposition of penalties in these cases.

4. The SEC has invoked control person liability to bring charges against a city official.

The scope of control person liability under § 20(a) of the Exchange Act is unsettled in both the municipal and the corporate contexts, making the SEC's use of the provision against the former mayor of Allen Park especially striking.[314] Most notably, the standard that the SEC must meet to bring such a claim in the corporate-securities context is the subject of a circuit split on which much has already been written.[315] According to one recent media source, the SEC may have made strategic use of the split in its case against the former mayor of Allen Park. Interpreting remarks by an SEC enforcement official during a panel discussion

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[312] *Filarsky*, 132 S Ct at 1665.

[313] In fact, there already exists a circuit split regarding whether the qualified immunity defense is available under federal statutes aside from § 1983, under which a vast majority of immunity cases arise. The *Boudreaux* Petition sought resolution of this split. *Boudreaux* Petition at *11–15 (cited in note 117).

[314] The SEC's action against Allen Park and its former mayor, Burtka, is discussed in depth in Parts I.C.4, II.B.

[315] See, for example, Brianna L. Gates, Note, *The SEC on a Forum Shopping Spree: SEC Enforcement Power and Control Person Liability after Dodd–Frank*, 99 Iowa L Rev 393, 396–97 (2013) (arguing that the Supreme Court should strengthen SEC enforcement power and end potentially harmful forum-shopping by rejecting the strict "culpable participation" standard for control person liability adopted by some courts); Michael A. Bednarz, Comment, *Let's Be Frank: The Future Direction of Controlling Person Liability Remains Uncertain*, 46 Suffolk U L Rev 551, 551–53, 567–69 (2013) (tracing the history of inconsistent standards for control person liability before and after Dodd-Frank and anticipating a loosening by the Supreme Court); Brian A. Melhus, Note, *Control Person Liability: A Repudiation of Culpable Participation*, 37 J Corp L 929, 949–50 (2012) (calling on either Congress or the Supreme Court to banish the "culpable participation" standard so as to create incentives for control persons to exercise the oversight needed for sound financial markets).

on the state of the municipal securities market, the *National Law Review* recently reported that the SEC seems to have pursued its § 20(a) claim against the former mayor because the Sixth Circuit provides a "somewhat more flexible standard" for proving such a claim.[316] The authors of the article further wrote that, "[r]eading between the lines, it appears as if the SEC believed they had proof that Allen Park's mayor was complicit in the alleged fraud," and the SEC thus seized "an opportunity to use control person liability in a way that would . . . [deter] municipal officials around the country."[317]

The claims against the former mayor were never litigated, making it virtually impossible for outsiders to gauge just how "complicit" he may have been in the alleged misconduct. The lack of a factual record also precludes a more thorough analysis of how, precisely, control person liability can and should be applied to municipal government fact patterns. Perhaps what is more troubling is the fact that the disparate views among federal appellate courts regarding the bounds of § 20(a) liability—and the possibility that the SEC will use the legal rules applicable to one region of the country to influence behavior in others—complicates local governments' abilities to predict and plan for the risks of liability for higher-level officials.

As with each of the four doctrinal novelties that this Section has considered, there are policy and doctrinal reasons to look closely and skeptically at the SEC's new frontier. The question remains how many of these novel cases will ultimately come before the federal courts for more-thorough judicial consideration.

C. The Problem of Procedural Opacity

Ironically, many of the SEC's efforts to eliminate informational disadvantages and induce market-wide transparency have been procedurally opaque. Between 1977 and 2014, the SEC has brought a total of thirty enforcement actions against governmental entities for fraudulent municipal securities disclo-

[316] John R. Regier and Breton Leone-Quick, *Current and Former SEC Officials Speak about Enforcement Issues concerning Municipal Securities* (National Law Review, Mar 13, 2015), archived at http://perma.cc/2JP7-D7MY (interpreting remarks by SEC enforcement officials and noting that, "[f]rom [the SEC's] presentation, it appeared as if one of the reasons why the SEC chose to assert a Section 20(a) claim in the Allen Park case was the somewhat more flexible standard for proving control person liability that exists in the Sixth Circuit").

[317] Id.

sures.[318] Of those thirty actions, only eight were pursued in federal court; the remainder concluded in swift administrative settlements.[319] Of the eight federal suits, four were settled shortly after charges were filed, and settlement agreements have been filed in two.[320]

Market participants and academics alike have highlighted the many reasons to be troubled by the SEC's increasing preference for intra-agency settlement of charges under federal securities laws.[321] Most prominently, administrative proceedings bypass the federal judiciary, follow a swifter timeline than federal proceedings, and do not provide defendants a right to discovery.[322] When a would-be defendant chooses to settle with the SEC through administrative channels—as has happened in 73 percent of municipal securities cases as of June 2015[323]—settlement agreements are both nonprecedential and vague as to the nature and theory of liability.[324]

Issuers and other stakeholders in the municipal securities market have recently raised concerns about their inability to determine precisely how to comply with the SEC's as-yet-undefined disclosure expectations from these vague settlement releases.[325] The SEC has offered little guidance: The leader of the Division of Enforcement's municipal securities unit recently responded to an issuer's concerns by broadly stating, "Don't lie, cheat or steal. That's the rule."[326] The SEC's recent self-reporting program itself, with its vague promise of leniency for any issuers who come forward with possible violations of the antifraud statutes, effectively endows the SEC with the power to define how and with what level of intensity to pursue penalties against local issuers. This is a strange policy to maintain in pursuing an ini-

318 See Appendix.

319 See Appendix.

320 See Appendix.

321 See, for example, Steinway, Comment, 124 Yale L J at 226–30 (cited in note 80).

322 See id at 226. See also Part I.B.2 (discussing the nature of SEC administrative proceedings and the opportunity for judicial review).

323 See Appendix.

324 For an example of ambiguity in SEC settlement agreements, see text accompanying notes 94–96. See also note 96 (discussing the vague liability language contained in the cease and desist orders against the states).

325 See, for example, Glazier, *Gaunt* (cited in note 88) (noting that bond lawyers have expressed frustration over the vagueness of a recent settlement with the Kings Canyon Joint Unified School District).

326 Id.

tiative whose driving goal is to improve and clarify channels of communication among key stakeholders in a unique market.

Of course, it could be contended that, as a general rule, the nature and direction of any new enforcement regime will be unclear to market participants at the outset of its implementation. It is not, therefore, wholly troubling that there is confusion on the ground while the SEC considers and defines its priorities going forward. What is troubling, however, is the exceedingly low likelihood that a municipal issuer with a fraught relationship to the municipal bond market—a city like Allen Park, for example, whose financial woes led to two years of state-mandated control by an emergency manager—would decline to settle and would choose instead to litigate fraud charges. Litigation is risky for any corporate entity, and accepting a neither-admit-nor-deny order is likely to appear to most municipal issuers as the lowest-risk option in the face of SEC scrutiny. It also may be more politically salient than a lengthy, publicized suit with the SEC. These facts are convenient to a regulator seeking to bare its enforcement teeth without judicial involvement.

CONCLUSION: FISCAL DISCIPLINE AND ITS ALTERNATIVES

This Comment identifies two key problems currently facing legal and political decisionmakers in the field of municipal finance. The first problem is familiar, but it remains complex and unresolved: In the wake of the Great Recession, numerous cities and towns have faced crippling financial distress, insolvency, and even bankruptcy. And in many cases, the crisis was the direct result of poor governance and inadequate monitoring of local decisionmaking.[327] Scholars, regulators, and stakeholders have agreed that greater fiscal transparency at the local level would be a valuable first step toward better governance and would carry with it the additional benefit of making the municipal bond market—a valuable tool in local development—function more effectively for everyone concerned.

The second problem is one of design: What are the most effective means by which the goal of better governance through greater transparency may be achieved? The SEC's new frontier in antifraud enforcement represents a strategy of "fiscal discipline," founded on the notion that local decisionmakers can be induced to exercise good fiscal judgment through the infliction of

[327] See generally Anderson, 123 Yale L J 1118 (cited in note 137).

pain in the right places.[328] As Professor Schragger has observed, "[e]fforts to discipline states and local governments assume that profligacy is their central problem and that some external coercive force is necessary to restrain them."[329] But scholars considering theoretical variants of the fiscal-discipline approach have rejected it as misguided in the municipal context.[330] Notably, Professor Anderson, in her comprehensive analysis of the causes and outcomes of municipal distress, has concluded that "[i]nsolvent cities need a safety net, not punishment."[331] Schragger has similarly argued that fiscal discipline—in the form of top-down controls on local government spending—is misguided and ineffective in preventing local fiscal crises.[332]

The foregoing analysis of the SEC's new frontier confirms these scholars' concerns. As Part II demonstrates, the SEC's disciplinary approach introduces costs into the municipal-borrowing system that are likely to exceed the benefits that it provides. And as discussed in Part III, the legal framework within which the SEC operates—especially the telling legislative history of the Tower Amendment—is inhospitable to the SEC's attempts to redefine itself as a disclosure-forcing watchdog. At the same time, the aggressive theories of liability that the SEC has pursued in the name of local discipline have raised doctrinal red flags and will have significant negative policy implications.

There are, however, alternatives to the SEC's recently aggressive brand of fiscal discipline that will obviate the need for a repeal of the Tower Amendment and avoid the enforcement costs of the SEC's regime while encouraging better financial practices and more-open governance. Several academics have already proposed approaches that involve cooperative efforts between state and local governments, including opportunities for state agencies to help counsel better fiscal decisionmaking at the local level.[333] Finance scholars have considered similarly cooperative approaches; one recent article has proposed the creation of an interstate, nonprofit advisory firm, termed "CommonMuni," that would facilitate the exchange of information among issuers and investors and provide local issuers with much-needed invest-

328 Schragger, 39 Fordham Urban L J at 793, 803 (cited in note 18).

329 Schragger, 121 Yale L J at 863 (cited in note 153).

330 See, for example, Schragger, 39 Fordham Urban L J at 795 (cited in note 18).

331 Anderson, 123 Yale L J at 1217 (cited in note 137).

332 See generally Schragger, 121 Yale L J 860 (cited in note 153).

333 See, for example, Shanske, 33 Rev Bank & Fin L at 802–03 (cited in note 59).

ment guidance.[334] Most recently, a group of philanthropic and academic organizations—including the Government Performance Lab at the Harvard Kennedy School of Government, the Center for Government Excellence at Johns Hopkins University, and the Sunlight Foundation—have come together to launch a nationwide transparency initiative called "What Works Cities."[335] The program will provide funding and support for the development of open data-management systems for one hundred midsize towns and cities in the United States. The systems will be designed to "elevate and accelerate cities' use of data and evidence to engage citizens, make government more effective, and improve people's lives."[336] Outside this new initiative, a few larger cities and towns have already begun to develop their own data-driven mechanisms for improving financial transparency in order to benefit their residents.[337]

Such initiatives are not costless to coordinate, but they promise to provide constructive, ongoing benefits and long-term savings that one-off SEC penalties (or looming threats of such penalties) do not provide. Furthermore, and especially in the case of the What Works Cities initiative, they focus pointedly on the government-citizen relationship: by improving communication between decisionmakers and the people they govern, these programs promise to empower citizens to become more effective, well-informed monitors of local decisionmaking. By contrast, the SEC is concerned narrowly with establishing a disclosure regime that will "protect" the interests of individual bond investors, without regard to whether investor-centric disclosures would be effective or efficient in promoting local transparency and accountability more broadly. Troublingly, the undefined but looming threat of fraud liability that the SEC's new frontier has constructed could make local governments and their officials think twice about joining initiatives like What Works Cities or about developing protransparency programs of their own. If a financially strapped local government fears that a seemingly minor disclosure misstep or miscommunication (or the bad behavior of an unsophisticated city employee) could result in fraud charges,

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[334] See Andrew Ang and Richard C. Green, *Lowering Borrowing Costs for States and Municipalities through CommonMuni*, 34 Mun Fin J 43, 57–64 (2013).

[335] See *Partners* (Bloomberg), archived at http://perma.cc/WB3S-64HD.

[336] *What Works Cities* (Bloomberg), archived at http://perma.cc/J2YS-F5UM.

[337] See Tod Newcombe, *The Payoffs of Financial Transparency* (Governing, Apr 16, 2015), archived at http://perma.cc/F28W-K6JT.

it will be hesitant to pursue a wide-ranging transparency initiative that would only increase its exposure to liability.

It is also important to note that it is not, as a general rule, socially desirable to deter local governments from accessing the public debt markets altogether. An increase in enforcement activity may help curtail blatantly fraudulent practices and outright deception by local issuers, but the undefined threat of potential liability for a wide range of government communications is a blunt tool that could push local governments to avoid the public debt markets and make greater use of private financing—which does not require public financial disclosure—in order to raise the cash necessary to resolve local liquidity problems and recover from economic downturns.[338] Because local governments' demands for capital are not abating, a regulatory regime that discourages the use of public markets could have the undesirable result of further impeding progress toward better financial transparency.

Regardless of how it is designed, the regulatory regime applicable to the municipal securities market should not—as a normative, policy, or legal matter—have the effect of impeding the organic, market-driven movement toward greater transparency that seems to already be in motion.

Going forward, the choice-of-means question may hinge in large part on the courts' treatment of the SEC's new frontier. Because administrative settlements reduce the likelihood of judicial review, courts will have limited but powerful opportunities to send strong messages about the SEC's approach, especially as more enforcement actions are brought in the coming years. Effective judicial review of the SEC's program will require a deeper and more holistic analysis than the SEC has provided thus far. When viewed on a case-by-case basis, it may seem appropriate to lay penalties for wrongdoing at the feet of the wrongdoers—as the Eleventh Circuit and the United States District Court for the Southern District of Florida did in *City of Miami*. But in taking a broader view of the SEC's new enforcement program, it becomes clear that a program of punitive enforcement will do more harm to taxpayers than good to bondholders, all the while defying Congress's clear preference for precluding federal regulators from direct involvement in local borrowing. In future cases,

[338] For a discussion of the costs of disclosure in public versus private debt markets and local governments' abilities to choose between the two, see Baber and Gore, 83 Accounting Rev at 570 (cited in note 238).

judges considering the novel liability theories that the SEC has put forward in this market should think carefully about the systemic consequences of those theories, starting with the Supreme Court's own realization that "municipal liability for punitive damages awards would punish innocent taxpayers."[339] Now that light has been shed on the misbehavior of various local government officials, stakeholders are in a position to make meaningful changes to improve the market. Thoughtfully considered judicial rejection of the SEC's new frontier would open up the landscape for more comprehensive, cooperative, and efficient means of improving local decisionmaking, benefiting bondholders and taxpayers alike.

[339] *Walters v City of Atlanta*, 803 F2d 1135, 1148 (11th Cir 1986), citing *City of Newport v Fact Concerts, Inc*, 453 US 247, 259–66 (1981).

APPENDIX. SEC ENFORCEMENT ACTIONS AGAINST STATE AND MUNICIPAL ISSUERS AND PUBLIC OFFICIALS[340]

Action against	Filing Date	Nature of Proceeding	Status as of June 2015
Allen Park, Michigan, and two former city officials	11/6/2014	Administrative proceeding against city Suit filed against city officials (ED Mich)	Respondents consented to cease and desist order as to city and lower-level official; $10,000 fine imposed on town's mayor (first-ever charges against a municipal official under a federal statute that provides for control person liability (§ 20(a) of the Exchange Act)).
Kansas	8/11/2014	Administrative	Respondent consented to cease and desist order.
Kings Canyon Joint Unified School District, California	7/8/2014	Administrative	Respondent consented to cease and desist order (first settlement reached under the MCDC self-disclosure program).
Harvey, Illinois, and one city official	6/25/2014	Suit filed (ND Ill)	Settled with city; final judgment against city official for $217,115 and an injunction.
UNO Charter School Network, Inc, United Neighborhood Organization of Chicago, Illinois	6/2/2014	Suit filed (ND Ill)	Settled (consent decree entered on June 2, 2014, substantially the same as an administrative cease and desist order).
The Greater Wenatchee Regional Events Center Public Facilities District and one city official, Washington	11/5/2013	Administrative	District consented to cease and desist order plus $20,000 penalty (first-ever monetary penalty imposed on a municipal issuer); official consented to cease and desist order.
Public Health Trust of Miami-Dade County, Florida	9/13/2013	Administrative	Respondent consented to cease and desist order.
West Clark Community Schools, Indiana	7/29/2013	Administrative	Respondent consented to cease and desist order.

[340] Information compiled from *Office of Municipal Securities, Information and Resources, Cases & Materials* (SEC), online at http://www.sec.gov/municipal (visited Oct 23, 2015) (Perma archive unavailable).

Action against	Filing Date	Nature of Proceeding	Status as of June 2015
Miami, Florida, and one city official	7/19/2013	Suit filed (SD Fla)	Currently being litigated (interlocutory appeal involving the city official's qualified immunity defense denied by the Eleventh Circuit on Sept 5, 2014;[341] certiorari denied by the Supreme Court on June 29, 2015[342]).
South Miami, Florida	5/22/2013	Administrative	Respondent consented to cease and desist order.
Harrisburg, Pennsylvania	5/6/2013	Administrative	Respondent consented to cease and desist order (first-ever charges involving public statements made by a city).
Victorville, California, and one city official	4/29/2013	Suit filed (CD Cal)	Currently being litigated.
Illinois	3/11/2013	Administrative	Respondent consented to cease and desist order.
New Jersey	8/18/2010	Administrative	Respondent consented to cease and desist order (first-ever enforcement action against a state).
Four city officials in San Diego, California	4/7/2008	Suit filed (SD Cal)	Respondents consented to cease and desist order plus monetary penalty (first-ever monetary penalty imposed on city officials for bond fraud).
San Diego, California	11/14/2006	Administrative	Respondent consented to cease and desist order.
Dauphin County General Authority, Pennsylvania	4/26/2004	Administrative	Respondent consented to cease and desist order.
Neshannock Township School District, Pennsylvania	4/22/2004	Administrative	Respondent consented to cease and desist order.
Massachusetts Turnpike Authority and one city official	7/31/2003	Administrative	Respondents consented to cease and desist order.
Miami, Florida, and two city officials	6/22/2001	Administrative	ALJ imposed cease and desist order.

[341] *City of Miami*, 2014 WL 4377381 at *3.

[342] *Boudreaux v Securities and Exchange Commission*, 135 S Ct 2890, 2890 (2015).

Action against	Filing Date	Nature of Proceeding	Status as of June 2015
Anaheim, California, and several other entities	9/29/1998	Administrative	Respondents consented to cease and desist order.
Newport-Mesa Unified School District, California	9/29/1998	Administrative	Respondent consented to cease and desist order.
Moorhead, Mississippi	9/24/1998	Administrative	Respondent consented to cease and desist order.
Carthage, Mississippi, and several other entities	7/13/1998	Administrative	Respondents consented to cease and desist order.
County of Nevada, California, and several other entities	2/2/1998	Administrative	Respondents consented to cease and desist order.
Syracuse, New York, and city officials	9/30/1997	Administrative	Respondents consented to cease and desist order.
Maricopa County, Arizona	9/30/1996	Administrative	Respondent consented to cease and desist order.
Orange County, California, and several other entities	1/24/1996	Administrative	Respondents consented to cease and desist order.
San Antonio Municipal Utility District No 1, Texas	11/18/1977	Suit filed (SD Tex)	Respondent consented to cease and desist order.
Whatcom County Water District No 13, Washington	3/7/1977	Suit filed (WD Wash)	Settled (respondent consented to cease and desist order).