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MUNICIPAL SECURITIES AND STATE SECURITIES LAWS: A NEW LOOK

Michael Newman†

The Uniform Securities Act exempts from registration the offerings of municipal or tax exempt securities. Although a number of jurisdictions have adopted the Uniform Act, they have not uniformly applied this exemption. The author examines various state registration schemes with reference to the specific types of municipal securities: general obligation bonds, revenue bonds, and industrial development bonds. He proposes statutory changes that accomplish the purposes for the exemption, yet simplify the offerings of municipal securities.

I. INTRODUCTION

Offerings of municipal or tax exempt securities in the United States have long enjoyed exemptions from the registration requirements of state securities laws. Recent developments in the use of tax exempt securities, however, have led state securities commissioners to reevaluate these exemptions. This reevaluation is reflected in the current diversity of treatment of municipal securities under state securities laws. When the Uniform Securities Act¹ (Uniform Act) was first drafted, the differences among the states, at least with respect to exemptions for municipal securities, were "essentially phraseological,"² and exemptions from registration for all types of municipal securities were common. Now, even among those thirty-nine jurisdictions that have adopted some form of the Uniform Act,³ the substantive differences are

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1. UNIF. SEC. ACT, 7A U.L.A. 567-698 (1958).
2. L. LOSS, COMMENTARY ON THE UNIFORM SECURITIES ACT 109 (1958).
3. ALA. CODE §§ 8-6-1 to -33 (1975 & Supp. 1983); ALASKA STAT. §§ 45.55.010 to -.55.270 (1959 & Supp. 1983); ARK. STAT. ANN. §§ 67-1235 to -1264.14 (1980 & Supp. 1983); COLO. REV. STAT. §§ 11-51-101 to -129 (1973 & Supp. 1983); CONN. GEN. STAT. ANN. §§ 36-470 to -502 (West 1958 & Supp. 1984); DEL. CODE ANN. tit. 6, §§ 7301-28 (1974 & Supp. 1982); D.C. CODE ANN. §§ 22-2601-19 (1981 & Supp. 1983); GUAM GOV'T CODE §§ 45101-420 (1980); HAWAII REV. STAT. §§ 485-1 to -25 (1976 & Supp. 1982); IDAHO CODE §§ 30-1401 to -1462 (1980 & Supp. 1983); IND. CODE ANN. §§ 23-2-1 to 24 (Burns 1984); IOWA CODE ANN. 502.101 to .612 (West Supp. 1983-1984); KAN. STAT. ANN. §§ 17-1252 to -1275 (1981 & Supp. 1983); KY. REV. STAT. ANN. §§ 292.310 to .550, .991 (Baldwin 1981 & Supp. 1983); MD. CORPS. & ASS'NS CODE ANN. §§ 11-101 to -805 (1975 & Supp. 1983); MASS. GEN. LAWS ANN. ch. 110A, §§ 101-417 (West Supp. 1983-1984); MICH. COMP. LAWS ANN. §§ 451.501 to .818 (West 1967 & Supp. 1983-1984); MINN. STAT. ANN. § 80A.01 to .31 (West Supp. 1984); MISS. CODE ANN. §§ 75-71-101 to -735 (Supp. 1983); MO. ANN. STAT. §§ 409.101 to .418 (Vernon

pronounced. These differences directly result from attempts by state securities administrators to deal with the growing use of municipal securities to finance facilities for nongovernmental entities and the adoption of innovative techniques by municipalities to raise funds for capital improvements in the face of severe constitutional and statutory restrictions.

This article discusses the differences among the states with respect to exemptions for municipal securities from registration, and concentrates on the different filing requirements under these state exemptions and on the rationales for these differences. The article concludes with suggested changes in the state regulatory schemes.

II. THE CURRENT STATUS OF MUNICIPAL SECURITIES UNDER STATE SECURITIES LAWS

Registration of securities offerings increases the expense of the offering and creates market problems of timing. Unless an exemption is available, the Uniform Act and most other state statutes require registration of all securities offerings. The Uniform Act exemption for municipal securities offerings is set forth in subsection 402(a)(1), which exempts "any security (including a revenue obligation) issued or guaranteed by the United States, any state, any political subdivision of a state, or any agency or corporate or other instrumentality of one or more of the foregoing."⁴

Thirty-nine jurisdictions have adopted a version of the Uniform Act.⁵ All of the remaining jurisdictions, except for New York, have a form of exemption for municipal securities. New York requires registration of securities if they are sold solely intrastate or are certain types

1979 & Supp. 1984); MONT. CODE ANN. §§ 30-10-101 to -308 (1983); NEB. REV. STAT. §§ 8-1101 to -1124 (1982 & Supp. 1983); NEV. REV. STAT. §§ 90.010 to .205 (1983); N.H. REV. STAT. ANN. §§ 421-B:1 to :34 (1983); N.J. STAT. ANN. §§ 49:3-47 to -76 (West 1970 & Supp. 1983-1984); N.M. STAT. ANN. §§ 58-13-1 to -47 (1978 & Supp. 1983); N.C. GEN. STAT. §§ 78A-1 to -65 (1981 & Supp. 1983); OKLA. STAT. ANN. tit. 71, §§ 101-504 (West 1965 & Supp. 1983-1984); OR. REV. STAT. §§ 59.005 to .445 (1981); 70 PA. CONS. STAT. ANN. §§ 1-101 to -704 (Purdon Supp. 1983-1984); P.R. LAWS ANN. tit. 10, §§ 81-895 (1963); S.C. CODE ANN. §§ 35-1-10 to -1590 (Law. Co-op. 1976 & Supp. 1983); TENN. CODE ANN. §§ 48-1601-53 (1979 & Supp. 1983); UTAH CODE ANN. §§ 61-1-1 to -30 (1978 & Supp. 1983); VA. CODE §§ 13.1-501 to -527.3 (1978 & Supp. 1983); WASH. REV. CODE ANN. §§ 21.20.005 to .940 (1978 & Supp. 1983-1984); W. VA. CODE 32-1-101 to -4-418 (1982 & Supp. 1983); WIS. STAT. ANN. §§ 551.01 to .67 (West Supp. 1983); WYO. STAT. §§ 17-4-101 to -129 (1977 & Supp. 1983).

The Blue Sky Law Reporter states that 39 jurisdictions have adopted the Uniform Act, or have substantially adopted it with modifications. 1 BLUE SKY L. REP. (CCH) ¶ 5501, at 1503 (1982). Uniform Laws Annotated, however, lists only 37 jurisdictions "wherein the Uniform Act has been adopted." It excludes Guam and Tennessee. UNIF. SEC. ACT prefatory notes, 7A U.L.A. 335 (Supp. 1984).

4. UNIF. SEC. ACT, 7A U.L.A. 638 (1958).

5. See *supra* note 3 (listing of Uniform Act jurisdictions).

of real estate securities.⁶ Of the Uniform Act jurisdictions, eight⁷ except from the exemption certain types of industrial development bonds⁸ (IDBs) and one, New Jersey, excepts certain municipal obligations that may be classified as real estate securities.⁹ Four jurisdictions that have not adopted the Uniform Act have narrowed broader exemptions formerly provided by statute and now require a filing prior to the sale of some municipal securities.¹⁰ New York, by virtue of its real estate syndication law, requires a filing with respect to any municipal security that could be considered a real estate security within the definition of that law.¹¹ The lack of uniformity among jurisdictions is further complicated by staff interpretations, often not embodied in formal regulations, that vary from state to state despite identical statutory text.¹²

6. N.Y. GEN. BUS. LAW §§ 352-e, 359-ff (McKinney 1968 & Supp. 1983-1984). A municipal security may also be exempt from the requirement of these provisions, but a filing must be made to obtain the exemption. *Id.*

7. IND. CODE ANN. § 23-2-1-2 (Burns 1984); IOWA CODE ANN. § 502.202.1 (West Supp. 1983-1984); MICH. COMP. LAWS ANN. § 51.802 (1967 & Supp. 1983-1984); MINN. STAT. ANN. §§ 80A.14.8, .15.1(a) (West Supp. 1984); MONT. CODE ANN. § 30-10-104(1) (1983); N.H. REV. STAT. ANN. §§ 421-B:2.VII, :17(a) (1983); WASH. REV. CODE ANN. § 21.20.310(1) (1978 & Supp. 1983-1984); WIS. STAT. ANN. § 551.22(1) (West Supp. 1983).

Pennsylvania, a Uniform Act jurisdiction, has a regulation that deems an industrial development bond (IDB) (as defined in I.R.C. § 103(b)(2) (1982)) as exempt under 70 PA. CONS. STAT. ANN. § 1-202(a) (Purdon Supp. 1983-1984), provided the issuer satisfies two general conditions. First, the issuer must obtain a ruling from the Internal Revenue Service (IRS) that the interest on the security is exempt from income taxation under the Internal Revenue Code of 1954 (the Code), or an opinion of counsel to the same effect. Second, the issuer must obtain a no-action letter from the Securities and Exchange Commission (SEC) that the sale of the security does not need to be registered under section 5 of the Securities Act of 1933, 15 U.S.C. § 77e (1976 & Supp. II 1978), or an opinion of counsel to the same effect. Because few municipal obligations are issued without either a ruling or opinion on the tax exemption and a no-action letter or opinion on the federal registration question, Pennsylvania effectively does not require filings with respect to sales of most municipal obligations.

Two Uniform Act jurisdictions, Colorado and Nevada, do not require filings with respect to securities not sold solely intrastate. Colorado requires a filing after securities are actually sold, but securities exempt from federal registration and other federal filing requirements are exempt from this requirement. COLO. REV. STAT. §§ 11-51-107(2), -51-113(4) (Supp. 1983). The District of Columbia imposes no filing requirements for the sale of securities.

8. IDBs are securities backed generally by a loan, lease, or sale agreement of a third party obligor that is not a governmental or tax-exempt entity. For a discussion of IDBs, see *infra* notes 30-42 and accompanying text.
9. N.J. REV. STAT. ANN. § 49:3-29 (West 1970). This statute does not necessarily require registration of tax exempt securities, but a letter confirming an exemption from this law must be sought.
10. ARIZ. REV. STAT. ANN. §§ 44-1843(1), 1843.01 (1967 & Supp. 1983); N.D. CENT. CODE § 10-04-05(1) (1976 & Supp. 1983); OHIO REV. CODE ANN. § 1707.02(B) (Page 1978 & Supp. 1982); TEX. REV. CIV. STAT. ANN. art. 581-5M (Vernon 1964 & Supp. 1982-1983).
11. N.Y. GEN. BUS. LAW § 352-e (McKinney 1968 & Supp. 1983).
12. For example, Kentucky and North Carolina, both Uniform Act states, interpret their versions of § 402(a)(1) differently with respect to single family mortgage rev-

Analysis of this diverse set of regulatory schemes requires a discussion of the types of municipal securities.¹³ The first part of this discussion focuses on securities backed by municipal credit, i.e., securities secured by the full faith and credit of the municipality, by revenues generated by a municipal enterprise, or from lease obligations for which the municipality is bound to supply the payments for the bonds and for which no nongovernmental entity is liable. The second part of this discussion analyzes securities that are ultimately paid by a nongovernmental source, such as a private corporation. These are securities that must be issued by a municipality for the tax exemption to apply but the proceeds of which are used in the trade or business of a nongovernmental entity. They include IDBs and bonds issued for tax exempt corporations that, although not technically IDBs under the Internal Revenue Code of 1954 (Code),¹⁴ are included in this category for purposes of this discussion.¹⁵

A. Securities Backed by Municipal Credit

There are many types of municipal bonds,¹⁶ but this discussion is confined to general obligation bonds and revenue bonds. Three types of revenue bonds are discussed: (1) bonds for which revenues are generated by a municipal enterprise, such as an electric utility, and are pledged to pay indebtedness on the bonds; (2) lease revenue bonds, for which revenues are generated under a lease with another governmental entity or a quasi-governmental entity, whose purpose is to issue securities on behalf of a municipality; and (3) certificates of participation, which generally are interests in a municipal lease or sale obligation.

1. General Obligation Bonds

General obligations of a municipality are those that are backed by its full faith and credit. These obligations are secured by the taxing power of the municipality, so that if the municipality has insufficient

enue bonds issued by municipalities. Kentucky does not require registration, while North Carolina generally does, although exemptions are granted on a case-by-case basis. See SUBCOMMITTEE ON MUNICIPAL, BANKING, NONPROFIT, AND OTHER EXEMPT SECURITIES, STATE REGULATION OF SECURITIES COMMITTEE, SECTION ON CORPORATION BANKING AND BUSINESS LAW OF THE AMERICAN BAR ASSOCIATION, SURVEY REGARDING APPLICABILITY OF STATE SECURITIES LAWS TAX-EXEMPT SECURITIES 14 (Jan. 1, 1982) (unpublished survey on file at the ABA offices in Chicago) [hereinafter cited as ABA SURVEY].

13. This discussion will be limited to those securities on which the interest is exempt from taxation under I.R.C. § 103(b)(2) (1982).

14. *Id.*

15. For a definition of IDBs, see *supra* note 8. For a discussion of the significance of an obligation being characterized as an IDB, see *infra* notes 30-42 and accompanying text.

16. See generally J. DALEY, A GUIDE TO MUNICIPAL OFFICIAL STATEMENTS 35-42.22 (1980 & Supp. 1983); 15 E. MCQUILLIN, THE LAW OF MUNICIPAL CORPORATIONS §§ 43.05-.12 (3d ed. 1970) (discussing various types of municipal bonds).

revenues to pay principal and interest on the bonds, the entity can raise taxes to make up the deficiency.¹⁷ All states exempt general obligation bonds from registration requirements, although Wisconsin requires registration of sales to the public of general obligation bonds if the issuer's financial statements are not in accordance with generally accepted accounting principles.¹⁸

2. Revenue Bonds

Revenue bonds usually receive the same treatment under state securities laws as general obligation bonds when the proceeds are used directly by a municipality and are payable from revenues generated from a municipal enterprise, such as a sewer system or other municipal utility.¹⁹ New Hampshire takes the position, however, that any bond not paid out of the general revenues (as opposed to specified revenues) of a municipality must be registered.²⁰ Ohio requires a filing to obtain the exemption.²¹ Filings also must be made in New Jersey and New York under their real estate syndication laws if the revenue bond comes within the definition of real estate security.²²

Lease revenue bonds have received diverse statutory and regulatory treatment by the states, primarily because of the nature of many of the issuers of this category of bonds. Lease revenue bonds to finance a capital improvement for a municipality are frequently issued by a joint powers authority, another municipality, or a nonprofit corporation that has complied with the requirements of Internal Revenue Service (IRS) Revenue Ruling 63-20.²³ Issuances by a joint powers authority or another municipality are generally treated as revenue bonds and are exempt from registration. Some state securities commissions, however, have found it difficult to categorize obligations of nonprofit corpora-

17. J. DALEY, *supra* note 16, at 387.

18. WIS. STAT. ANN. 551.22(1) (West Supp. 1983); WIS. ADMIN. CODE § 7.06 (1982); see BLUE SKY L. REP. (CCH) ¶ 64,614, at 56,548 (Dec. 1983). This requirement applies to fiscal years commencing on or after January 1, 1982.

19. ABA SURVEY, *supra* note 12, at 6.

20. N.H. REV. STAT. ANN. § 421-B:17(a) (1983).

21. OHIO REV. CODE ANN. § 1707.02(B)(3) (Page 1978 & Supp. 1982).

22. See N.J. STAT. ANN. §§ 49:3-27, -29 (West 1970); N.Y. GEN. BUS. LAW § 352-e (McKinney 1968 & Supp. 1983-1984).

23. Rev. Rul. 63-20, 1963-1 C.B. 24. Under guidelines specified in this ruling, the IRS will consider indebtedness issued by a nonprofit corporation on behalf of a municipality as bearing interest excludable from gross income under I.R.C. § 103(a)(1) (1982). These guidelines require, among other things, that the nonprofit corporation engage in certain public activities; that its income not inure to the benefit of any private person; that the municipality have a beneficial interest in the facilities being financed while the indebtedness is outstanding and receive full legal title after the retirement of the indebtedness; and that the municipality have approved the organization of the corporation and the issuance of the indebtedness. See also Rev. Proc. 82-26, 1982-1 C.B. 476 (delineating the circumstances under which the IRS will issue an advance ruling that obligations issued by a corporation organized under the general nonprofit corporation law of a state will be considered obligations of a state under section 103(a)(1) of the Code).

tions as exempt under subsection 402(a)(1) or any analogue thereto, despite the analysis of the IRS holding the bonds tax exempt. These differences in treatment do not result from any variations in statutory language; rather, they stem from different interpretations of similar statutes. For example, although Iowa and Texas require a filing for tax exempt issues of nonprofit corporations, they do not mandate filing for revenue bonds issued by a municipality.²⁴ In addition, certain states, such as California, Indiana, and North Dakota, do not necessarily require registration of indebtedness issued by nonprofit corporations. These jurisdictions recommend either application for an interpretive response to determine whether an exemption is permissible because the corporation is an instrumentality of a political subdivision, or application for an exemption under the state exemption for securities issued by a nonprofit corporation.²⁵ Other states, such as New Hampshire, treat this obligation in the same way as any other type of revenue bond.²⁶

For over a decade certificates of participation have been used to finance municipal indebtedness.²⁷ They have become a prominent form of municipal security, however, only within recent years. Accordingly, many state securities administrators do not have significant experience with certificates of participation. A typical structure requires a municipality to enter into a lease or sale obligation for a capital improvement with a third party, such as a bank or a nonprofit corporation, which then assigns its rights in the lease to a trustee. The trustee takes the lease obligation, issues certificates of participation in the lease payments, and uses the proceeds of the certificates to acquire, construct, or install the improvements so leased. As in lease revenue financings, the lease payment is designed to pay debt service on the certificates of participation. The certificates avoid state law provisions that prohibit or restrict municipalities from issuing indebtedness, whether by reason of statutory restrictions (such as competitive bidding), constitutional debt limitations, or voting requirements. Other types of certificate of participation structures involve issuing participation certificates in a number of lease obligations of one or more municipalities.²⁸ The analysis that follows, however, focuses only on certificates involving a sin-

24. ABA SURVEY, *supra* note 12, at 13.

25. *Id.* The interpretive problems faced by state securities administrators in analyzing the exempt securities issued by nonprofit corporations are well documented in J. LONG, 1984 BLUE SKY LAWS HANDBOOK, DEVELOPMENTS IN STATE SECURITIES REGULATION 4-16 to -27 (1984).

26. ABA SURVEY, *supra* note 12, at 13.

27. SEC No-Action Letter, Lakeland School Constr. Co., [1971-72 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 78,595, at 81,273 (Dec. 3, 1971). For a discussion of the structure of a certificates of participation transaction, see SEC No-Action Letter, Smith, Barney, Harris, Upham & Co., [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,953, at 87,505 (Dec. 6, 1976).

28. *Cf.* SEC No-Action Letter, Gem Savings Ass'n, [Current] FED. SEC. L. REP. (CCH) ¶ 77,528, at 78,697 (July 14, 1983).

gle lease to a municipality of capital improvements by a third party or a bank trustee, where the trustee has only ministerial duties and the holders of the certificates have a direct right against the municipality in the event of default.

As an obligation of the municipality, the lease obligation in a certificate of participation transaction ought to be treated as any other municipal obligation under state securities laws. Because the lease typically is not backed by the taxing power of the governmental entity, it should be analyzed as a lease revenue obligation. A difficulty arises, however, if the certificate of participation itself is considered a security separate from the underlying municipal lease obligation; such a separate security is not eligible for the subsection 402(a)(1) exemption of the Uniform Act and should be registered, unless it is eligible for another exemption, to be sold publicly in a state. The better analysis is that only one security, an exempt municipal obligation under subsection 402(a)(1), is involved. A certificate trustee, if performing only ministerial duties, is acting very much like a bond trustee. Specifically, the trustee assumes the responsibilities of administering funds, representing the interests of security holders, and maintaining registration books. A determination that a separate security is present is understandable only if the transaction is structured to enable or require the trustee to do more than pass on the rights it has against the municipality under the lease to the certificate holders, such that the certificate possesses a substance of its own and does more than represent a mere right of participation in the lease obligation. Jurisdictions such as Arkansas, Connecticut, and North Dakota have indicated, however, that they may require registration of the certificates as separate securities regardless of the nature of the trustee's duties or obligations.²⁹

B. Securities Backed by Nongovernmental Credit

Industrial development bonds, although ultimately backed by payments made by a nongovernmental entity such as a private corporation or nonprofit private hospital, are a type of revenue bond of the issuing entity. The issuing entity is typically obligated to pay the principal of and interest on the bonds, but *only* from the revenues it receives under

29. The SEC takes a no-action position on the question of registration of a certificate of participation if there is a right of action by event of default. SEC No-Action Letter, Smith, Barney, Harris, Upham & Co., [1976-77 Transfer Binder] FED. SEC. L. REP. (CCH) ¶ 80,953, at 87,505 (Dec. 6, 1976). *But see* SEC No-Action Letter, Buffalo Savings Bank (available Oct. 25, 1982, on LEXIS, Fedsec library, No act file) (SEC refused to take a no-action position); Letter from Arkansas Securities Commission to O'Melveny & Myers (Apr. 14, 1983) (copy on file at the University of Baltimore Law Review office); Letter from Office of the Banking Commissioner of the State of Connecticut to O'Melveny & Myers (May 2, 1983) (copy on file at the University of Baltimore Law Review office); Letters from the North Dakota Securities Commissioner to O'Melveny & Myers (Mar. 23, 1983, May 18, 1983) (copy on file at the University of Baltimore Law Review office).

a lease, sale, or loan arrangement with the nongovernmental entity. When, as in most cases, the issuing entity is a political subdivision, the obligations are exempt from registration under the language of the Uniform Act. A special legislative response is thus necessary to regulate these bonds in a manner different from other tax exempt securities. In many instances these responses require a filing. Before discussing the legislative responses to the regulation of IDBs, it is useful to consider the federal tax treatment of some of the different kinds of obligations.

Section 103 of the Code provides that gross income for purposes of income taxation does not include interest on bonds issued by states and their political subdivisions.³⁰ Section 103, however, generally disallows this interest exemption for bonds the proceeds of which are used in the trade or business of a nonexempt person (i.e., a nongovernmental entity whose income is subject to income taxation under the Code) and which are payable from moneys derived from payments by a nonexempt user.³¹ Despite this disallowance of the exemption under section 103, certain of these types of obligations are eligible for the exemption if they fall into one of two categories. The first category includes bonds issued to provide certain facilities listed in section 103, such as pollution control equipment, docks and wharves, airport facilities, and housing.³² The second category consists of bonds issued to acquire, construct, or improve land or depreciable property, if they do not exceed \$1,000,000 (\$10,000,000 in some cases) in principal amount and do not provide certain facilities set forth in section 103, such as entertainment facilities.³³ Other types of indebtedness, exemplified by hospital revenue bonds or bonds issued for a nonprofit educational institution, are not technically IDBs because they are not issued to provide a facility used in the trade or business of a nonexempt person, since a non-

30. I.R.C. § 103(a)(1) (1982).

31. IDBs are bonds defined in the Code as obligations, "all or a major portion of the proceeds of which are to be used" in the "trade or business" of "a person who is not an exempt person" and the payment of the principal or interest on these bonds is wholly or partially "secured by any interest in property used or to be used in a trade or business or in payments in respect of such property, or . . . to be derived from the payments in respect of property, or borrowed money, used or to be used in a trade or business." I.R.C. § 103(b)(2) (1982). *See generally supra* note 8 (general definition of IDB).

Any exempt person, under subsection 103(b)(3), is "a governmental unit, or . . . an organization described in subsection 501(c)(3) and exempt from tax under subsection 501(a)." Thus bonds, the proceeds of which are used in the trade or business of a charitable corporation such as a nonprofit hospital, and which are to be repaid by the corporation, are not IDBs unless the proceeds would also be used in the trade or business of another nonexempt entity that would also secure or pay on the bonds.

32. *See* I.R.C. § 103(b)(4)-(5) (1983).

33. *See id.* § 103(b)(6). Congress recently enacted legislation that restricts the purposes for which IDBs can be issued and disallows financing of acquisitions of land or existing facilities. Deficit Reduction Act of 1984, Pub. L. No. 98-369, 98 Stat. 928-31.

profit hospital or university would be an exempt person. There is no need, however, to distinguish for purposes of this analysis a revenue bond issued for an exempt person from an IDB because the source of payments in both cases is a nongovernmental entity.

The diverse legislative responses to the regulation of IDBs by jurisdictions that have adopted the Uniform Act,³⁴ as well as those that have not adopted it,³⁵ complicate the issuance of this type of revenue bond. In some instances, the purpose for issuance of the bond may determine whether registration is required. For example, while Indiana does not require registration of bonds issued to provide pollution control equipment for a nonexempt person under subsection 103(b)(4) of the Code, it requires registration of issues to provide residential housing.³⁶ Texas does not require registration of hospital revenue bonds, but does require registration of most IDBs.³⁷ Michigan requires only that a notice be filed,³⁸ but North Dakota requires a complete registration of the underlying lease, sale, or loan agreement, which is deemed a separate security, the bonds themselves being exempt.³⁹

The North Dakota treatment of IDBs embodies an analysis discussed in connection with certificates of participation⁴⁰ that has also been applied by several jurisdictions in cases of guaranties of payments on bonds by nongovernmental entities. In many instances, guaranties by the ultimate obligor of the bonds or other obligations are deemed desirable so as to market the issue, particularly if a lease is involved. If the municipality defaults on the bonds, bondholders have recourse directly on the guaranty to the ultimate obligor and need not be concerned with the enforceability of the lease under the federal bankruptcy law.⁴¹ Because guaranties fall within the definition of security under many state laws, states such as Arizona, California, and Virginia have required registration of guaranties of municipal obligations by nongovernmental entities prior to the public sale of bonds backed by guaranties.⁴²

III. THE RATIONALE BEHIND THE EXEMPTION

A. *Municipal Debt*

The exemption from registration requirements for securities issued

34. *See supra* note 7.

35. *See supra* note 10.

36. IND. CODE ANN. § 23-2-1-2 (Burns 1984).

37. ABA SURVEY, *supra* note 12, at 8; Letter from Texas State Securities Board to O'Melveny & Myers (May 18, 1983) (copy on file at the University of Baltimore Law Review office).

38. MICH. COMP. LAWS ANN. § 451.802(a)(1) (West 1967 & Supp. 1983-1984).

39. N.D. CENT. CODE § 10-04-05(1) (1976 & Supp. 1983).

40. *See supra* notes 27-29 and accompanying text.

41. Trustees in bankruptcy have the power to reject unexpired leases. *See* 11 U.S.C. App. § 365 (1976 & Supp. V 1981).

42. *See* ABA SURVEY, *supra* note 12, at 9.

by municipalities has existed for many years. Reasons for the long continuance of this exemption are obvious. Municipalities are generally quite conservative about incurring indebtedness.⁴³ This conservatism is structural: in all states, statutory and constitutional provisions prevent or severely limit the incurrence of indebtedness without an electoral vote. Moreover, politicians usually are unwilling to incur obligations absent a source of repayment. Most issuances of municipal indebtedness are exposed to some form of a hearing process that can focus public attention on the wisdom of incurring the indebtedness.⁴⁴ Added to these significant checks are the threats of a voters' referendum if a particular transaction is controversial, or a taxpayer's suit questioning the legality of an act of the legislative body.

Further support for the Uniform Act exemption for municipal obligations derives from the quality of the security underlying a municipal obligation. This rationale is strongest with respect to general obligation bonds, which are backed by the taxing power of a municipality. It may be less evident with respect to revenue bonds that are not generally supported by the taxing power of a municipality. In the case of a revenue bond payable from a municipal enterprise, however, the municipality may increase rates to pay principal and interest on debt. With respect to certificates of participation and lease revenue obligations, the bonds may be backed only by the municipality's promise to pay.

The treatment of municipal obligations under federal law reinforces the rationale for exemption from registration. The Code's tax exemption of interest on municipal obligations continues traditional federal policy dating back to an early federal income tax statute.⁴⁵ Furthermore, the municipal exemption in state securities laws parallels in substance that contained in subsection 3(a)(2) of the Securities Act of 1933.⁴⁶ The federal exemption is an outgrowth of the basic relationship between the federal government and the states, with which states *inter se* need not concern themselves. Nevertheless, a problem of comity arises when a state regulates sales of securities of other states and their political subdivisions, particularly because a registration requirement for sales of municipal debt increases the issuance expenses, thereby further burdening taxpayers or ratepayers.

43. See generally E. MCQUILLIN, *supra* note 16, at § 39.17 (3d ed. 1970 & Supp. 1983) (discussing power of municipalities to incur indebtedness).

44. If the indebtedness is not subject to an electoral vote it will of necessity be exposed to approval by the municipal body issuing the debt, which generally must hold its meetings in public with due notice. See E. MCQUILLIN, *supra* note 16, at § 39.33 (3d ed. 1970 & Supp. 1983); cf. CAL. GOV'T CODE §§ 54950-61 (West 1983) (mandating that all meetings of public bodies be open and public); MD. ANN. CODE art. 41, § 14 (1978) (mandating that all meetings of public bodies be open to the public except executive sessions, but that no ordinance, resolution, rule, or regulation may be finally adopted at an executive session).

45. Revenue Act of 1913, ch. 16, 38 Stat. 168 (1913).

46. 15 U.S.C. § 77c(a)(2) (1977 & Supp. V 1981).

Perhaps the most compelling justification for the state municipal securities exemption has been the historical lack of any need for registration. Municipalities have experienced relatively few defaults on their indebtedness, possibly because of the structural conservatism and the quality of the security for the bonds. There have, of course, been significant exceptions. For instance, in the nineteenth century, before any federal or state securities regulation, there were numerous municipal defaults.⁴⁷ These defaults, which sometimes were accompanied by a finding that the indebtedness had not been authorized by the municipality in accordance with law and thus were not legally binding on the municipality, led to the employment of independent counsel (in the present day known as bond counsel) to examine the proceedings relating to the issuance of the debt to ensure its legality.⁴⁸ This development has added to the inherent conservatism of municipal finance.

Later, during the Great Depression, the incidence of default by municipal issuers increased.⁴⁹ The New Deal responded to the perceived manipulations of the securities markets in the decades prior to the Depression by enacting the Securities Act of 1933 and later the Securities Exchange Act of 1934, which established the Securities and Exchange Commission (SEC).⁵⁰ The municipal defaults, however, did not result from fraud or lack of disclosure but rather from the complete inability of a municipality, even through the exercise of its taxing power, to provide revenues to pay on the indebtedness.⁵¹

Following the Great Depression, and until the City of New York defaulted in the mid-1970's, very few municipalities defaulted on their indebtedness, and many of these were probably technical or temporary.⁵² Two recent defaults seem to run counter to this trend. The failure of the City of New York to meet its obligations was a major shock

47. SECURITIES AND EXCHANGE COMMISSION STAFF REPORT ON TRANSACTIONS IN SECURITIES OF THE CITY OF NEW YORK, 95th Cong., 1st Sess. ch. 6, at 1 (1977) [hereinafter cited as STAFF REPORT]; see also ADVISORY COMMISSION ON INTER-GOVERNMENTAL RELATIONS, CITY FINANCIAL EMERGENCIES: THE INTERGOVERNMENTAL DIMENSION 9-11 (July 1973) (discussing incidence and causes of defaults in the nineteenth century) [hereinafter cited as FINANCIAL EMERGENCIES]

48. This experience also led jurisdictions to introduce or enhance the constitutional and statutory restrictions on issuing municipal indebtedness. See *supra* notes 16-27 and accompanying text.

49. A 1973 survey found that 77% of all defaults on municipal obligations occurred during the decade ending in 1939. FINANCIAL EMERGENCIES, *supra* note 47, at 11-13.

50. See generally I L. LOSS, SECURITIES REGULATION 119-21 (2d ed. 1961) (briefly discussing the international trend toward corporate law reform that preceded the adoption of 1933 and 1934 Acts); J. SELIGMAN, THE TRANSFORMATION OF WALL STREET: A HISTORY OF THE SECURITIES AND EXCHANGE COMMISSION AND CORPORATE FINANCE 1-100 (1982) (discussing the events in the United States that culminated in the adoption of the 1933 and 1934 Acts).

51. FINANCIAL EMERGENCIES, *supra* note 47, at 14-15.

52. *Id.* at 16.

to the market for municipal securities.⁵³ The New York experience and the recent default by the Washington Public Power Supply System (WPPSS),⁵⁴ however, are of a different category than prior recent defaults. The conservatism inherent in municipal finance, including the practical reliance upon independent bond counsel, apparently failed to prevent the issuance of debt for which insufficient revenues existed for payment. In New York, indebtedness was issued despite growing undisclosed deficits that were masked behind "unsound accounting and reporting practices."⁵⁵ Furthermore, the City's management and bond counsel, together with other professionals involved, were taken to task by the SEC for failing to halt issuance of the securities when there was evidence of an inability to make payments.⁵⁶ In the WPPSS situation, the underlying contracts that purportedly guaranteed the security of the bonds were found illegal, despite the opinions of reputable counsel to the contrary.⁵⁷ The municipal finance self-policing mechanism, which in Washington involved ninety different public entities with citizen boards and in New York the administration of the nation's largest city, apparently faltered.⁵⁸ This problem was compounded, at least in New York, by a lack of disclosure of material information.⁵⁹

When these experiences are viewed against the tremendous volume of municipal securities issued each year, their aberrational character becomes clear. Municipal securities backed by a municipality — municipal debt — tend to be paid; this fact remains the strongest argument against state securities regulation of these instruments.

The requirement by some states that issuances of tax exempt bonds by nonprofit corporations under Revenue Ruling 63-20 be registered or receive a letter confirming the quasi-governmental status of the issuing corporation does not seem consistent with these rationales. The current attitudes of certain state securities administrators with respect to registration of sales or certificates of participation also seems misplaced. If the indebtedness issued by these entities is exempt from taxation under the Code so that the bondholder receives the benefit of tax exempt interest and the indebtedness is backed by a municipal credit (as opposed to nongovernmental credit, in which case the analysis should be that with respect to IDBs), the nature of the issuer should be of no concern to state securities administrators. Of course, if it could be

53. STAFF REPORT, *supra* note 47, Introduction and Summary.

54. 15 SEC. REG. & L. REP. (BNA) 1448 (July 29, 1983).

55. STAFF REPORT, *supra* note 47, Introduction and Summary at 7.

56. *Id.* at 10-11.

57. *Chemical Bank v. Washington Public Power Supply Sys.*, 99 Wash. 2d 772, 666 P.2d 329 (1983); *see also* Mayer, *The Firm That WPPSS Built*, AM. LAW. 37 (Jan. 1984) (concerning the possible suit against a law firm by its oldest and most important client, WPPSS).

58. *Chemical Bank v. Washington Public Power Supply Sys.*, 99 Wash. 2d 772, 666 P.2d 329 (1983); STAFF REPORT, *supra* note 47.

59. STAFF REPORT, *supra* note 47, Introduction and Summary at 10-11.

shown that more defaults occur with certificates of participation or 63-20 transactions because the municipality's obligation is backed by a promise to pay, registration might be worthwhile. Nevertheless, emphasis on the nature of the issuing entity, rather than on its credit, once it is determined that the entity can issue tax exempt indebtedness under the Code, seems misplaced.

B. Industrial Development Bonds

The rationale for state securities law exemptions for municipal debt backed by nongovernmental credit — IDBs — is somewhat more difficult to ascertain. The explanation may be that since IDBs are securities issued by municipalities, they are exempt under the Uniform Act because the Act looks to the issuer and not the ultimate obligor, regardless of what credit stands behind them. This explanation by itself is an unsatisfactory basis for exemption.

There are, however, valid reasons for exempting this kind of indebtedness in some cases. For example, a municipality issuing bonds on behalf of nongovernmental entities may institute a rigorous screening process.⁶⁰ At least one such authority requires involvement of the office of the state securities administrator.⁶¹ Thus the conservatism inherent in municipal debt issues can be built into the issuance of IDBs. This type of screening process may also occur less formally. A long standing policy of the California Pollution Control Financing Authority requires bonds issued by it to bear a rating in one of the three highest rating categories of a major rating agency, or to be placed with sophisticated investors capable of making their own credit analysis and able to understand and bear the risk of default.⁶²

Furthermore, a state securities administrator should not require any kind of filing with respect to indebtedness issued on behalf of an entity when those securities, if issued directly by the entity, would otherwise be exempt. For example, if a New York Stock Exchange listed company may sell securities in the state without registration,⁶³ bonds issued on behalf of that company should not be subject to registration. Moreover, transactional exemptions, such as those afforded by the Uniform Act for private placements or sales to sophisticated institutions, should also apply to such issues.⁶⁴ Registration of a sale of an IDB should not be required if payment on the bond is fully backed by

60. See CAL. GOV'T CODE § 91550-74 (West Supp. 1984), which establishes the California Industrial Development Financing Advisory Commission (Commission). The Commission must find that the issue will be "fair, just and equitable to a purchaser" and that the method of issuance will not "work a fraud upon the purchaser." *Id.* § 91571(b).

61. *Id.* § 91550.

62. Telephone interview with a member of the staff of the California Pollution Control Financing Authority (Sept. 30, 1983) (confirming policy).

63. UNIF. SEC. ACT § 402(a)(8), 7A U.L.A. 638-39 (1958).

64. *Id.* § 402(b)(8)-(9), 7A U.L.A. 640-41 (1958).

a letter of credit, guaranty, or insurance provided by an entity that, if it were issuing a security directly in the state, would not be required to register.

If, however, the transaction does not comply with any of the foregoing, there seems to be no reason for exempting sales of IDBs from registration requirements. This assertion may be best understood in light of the Uniform Act's exemptive scheme. If requiring registration of sales of securities issued by a private corporation is valid, municipal bonds backed solely by the credit of the same entity should not be exempted unless the municipal issuer has performed a screening function and received some assurances of payment. A good argument for exempting municipal indebtedness from registration is the historically low rate of default; if the municipality does nothing to assure payment, but acts as a mere conduit, it is not expected that the same low rate of default will be experienced with respect to IDBs.

The regulation of sales of IDBs by requiring registration of guaranties of municipal obligations by nongovernmental entities, however, is a totally inadequate method of handling this problem. Not all transactions use guaranties, although they usually are present when a lease arrangement is involved,⁶⁵ or when a subsidiary of a corporation is the underlying obligor on the bonds and a promise of the parent to pay debt service is desired. Accordingly, filings in those states that require registration of guaranties but do not otherwise require filings with respect to bonds issued on behalf of nongovernmental entities serve no rational policy. Indeed, a policy of registering only guaranties of IDBs and not the bonds themselves is arguably counterproductive, because transactions with a stronger security (i.e., the guaranty plus the underlying lease, sale, or loan obligation) are being regulated while sales of bonds with weaker security (i.e., a nonguaranteed lease, sale, or loan obligation or an obligation of a subsidiary without a parent guarantee) are not required to be registered. If the sale of IDBs should be regulated, it should not be on such a haphazard basis.

IV. SUGGESTIONS FOR CHANGE

The diverse treatment of municipal securities under state securities laws is justifiable. Assuming that the goal of a state securities law is to protect investors, then those jurisdictions that review the merits of an offering should reexamine their policy toward the exemption for municipal securities when the traditional safeguards associated with the issuance of municipal securities do not exist. This is not to suggest that the exemptions ought to be eliminated. The reasons for exempting municipal securities from registration are still valid; however, they may

65. Because a lease could be disallowed by a trustee in bankruptcy, bondholders could be left without a claim. See *supra* note 41.

not apply to the entire spectrum of the securities now entitled to fall within the exemption.

The exemption should remain for securities backed by municipal credit; with a few significant recent exceptions, the history of municipal defaults has not demonstrated a need for regulation. Furthermore, if a municipal credit is involved and in the opinion of bond counsel or under private letter ruling obtained from the IRS, the obligation bears tax exempt interest, the identity of the issuer should not dictate whether the obligation is exempt from registration. Thus, issuance of bonds by a Revenue Ruling 63-20 corporation should not be subjected to the level of investigation some states now assert. The degree of municipal control required to gain the tax exemption and the underlying municipal obligation should be sufficient to entitle a municipality to the exemption. Municipal securities backed by nongovernmental credit may, however, demand somewhat more investigation. Bases for an exemption of these securities exist but not with respect to every issue.

To implement these suggestions, some statutory or regulatory changes would be required. With respect to municipal credit, the easiest method would be to tie the municipal exemption to the Code. Specifically, any security of a municipality should be exempted, and the term "municipality" would include any entity whose interest on indebtedness is exempt from taxation under the Code.

A statutory change would be appropriate in many jurisdictions to require registration with respect to the issuance of IDBs since the Uniform Act exempts all issuances by governmental issuers. Making references to the Code for this purpose, however, is probably not the best solution. Not all bonds backed by a nongovernmental entity's credit are classified as IDBs under the Code.⁶⁶ A better change, which has been adopted by some states,⁶⁷ would be to regulate the sale of those revenue obligations that are payable from payments in respect of property or money used under a lease, sale, or loan agreement for a nongovernmental industrial or commercial enterprise. This approach would use the second part of the test employed under the Code for determining whether a bond is an IDB,⁶⁸ but it would distinguish between governmental and nongovernmental entities as opposed to the exempt and nonexempt entities, as set forth in subsection 103(b) of the Code. An exception should be added if the issuer has determined that the nongovernmental entity has sufficient resources to assure payment on the bonds.

66. See *supra* note 31.

67. Michigan requires the filing of a notice prior to sale of any bond payable from a lease, sale, or loan agreement when a nongovernmental enterprise is the obligor. MICH. COMP. LAWS ANN. §§ 451.802(a)(1) (West 1967 & Supp. 1983-1984). While the North Dakota statute exempts obligations of municipalities, it requires registration of the underlying lease, sale, or loan agreement. ABA SURVEY, *supra* note 12, at 5.

68. I.R.C. § 103(b)(2)(B) (1982).

An additional statutory change might also be necessary to delete requirements for registration with state securities administrators of bonds issued for, guaranteed, or otherwise backed by any entity that otherwise would be able to issue indebtedness in the jurisdiction without registration. Finally, in states where the statute has been interpreted to require registration of guaranties, a statutory change would be necessary to delete this requirement or rationalize it with existing law. Alternatively, a regulation interpreting the existing statute not to require separate registration of guaranties may be sufficient.⁶⁹

V. CONCLUSION

Many types of municipal securities in the current marketplace present challenges for state securities administrators. Statutory or regulatory changes may be necessary to fulfill the intent of the Uniform Act in rationalizing and harmonizing securities regulation throughout the country with respect to tax exempt securities. This pattern of regulation is decidedly nonuniform at the present time. The value of the municipal exemption, while demonstrated in the past, may not always be clear in the future, particularly with respect to securities backed by a nongovernmental credit where the issuer acts only as a conduit for the tax exemption and has no standards concerning the obligor's ability to pay its lease, sale, or loan obligation. Any statutory initiative should, in determining the desirable scope of the exemption, take into account the reasoning behind the municipal exemption and the types of securities that now qualify for this exemption.

69. See MO. ADMIN. CODE § 30-54.020(2) (Vernon 1979); see BLUE SKY L. REP. (CCH) ¶ 35,502, at 30,548 (May 1980) (providing for this interpretation).