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Living in a Material World: Defining "Materiality" in the Municipal Bond Market and Rule 15c2–12

Charlotte W. Rhodes
Washington and Lee University School of Law

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Living in a Material World: Defining "Materiality" in the Municipal Bond Market and Rule 15c2–12

Charlotte W. Rhodes*

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I. Introduction

Predicting large-scale defaults in the municipal bond market,[1] Warren Buffet—one of the nation's shrewdest investors—terminated Berkshire Hathaway's credit default swaps in 2012, which insured $8.25 million in municipal debt.[2] Buffet's move out of the municipal bond market should signal that the once "sleepy"[3] market is no longer as risk-free as it previously has been.[4] Earlier, in 2010, risk analyst Meredith Whitney also forecasted that "50 to 100 sizeable defaults totaling hundreds of billions of dollars" would occur in the municipal bond market.[5] These predictions were not unfounded.[6] Defaults are on

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1. *See* Philip Grommet, *A Call for Action: An Analysis of the Impending Regulatory Crisis in the Municipal Securities Market*, 38 J. LEGIS. 237, 239 (2012) (noting that Warren Buffett warns of municipal debt risk).

2. *See* Gregory J. Wallace, *Could Municipal Bonds Be the Next Financial Titanic?*, FORBES (Sept. 9, 2012, 11:44 AM), http://www.forbes.com/sites/forbesleadershipforum/2012/09/20/could-municipal-bonds-be-the-next-financial-titanic/ (last visited Feb. 11, 2015) (noting that when Warren Buffet "pulls back from a major market, attention must be paid") (on file with the Washington and Lee Law Review).

3. *See* Lisa Anne Hamilton, *Canary in the Coal Mine: Can the Campaign for Mandatory Climate Risk Disclosure Withstand the Municipal Bond Market's Resistance to Regulatory Reform?*, 36 WM. MITCHELL L. REV. 1014, 1019 (2010) ("What was, a century ago, a sleepy backwater market is now a startlingly large municipal bond market . . . .").

4. *See* Wallace, *supra* note 2 (explaining that the municipal bond market has shown signs of stress and providing examples).

5. *See* Grommet, *supra* note 1, at 238–39 (citation and internal quotation marks omitted) (discussing municipal bond analysts prediction of a rise in defaults).

6. *See* Wallace, *supra* note 2 (providing that the Federal Reserve Bank of New York reported 2,366 defaults between 1986 and 2011).

the rise.[7] Municipal bankruptcies, like those in Jefferson County, Alabama, and Detroit, Michigan, have forced the municipal bond market into the headlines.[8] The municipal bond market is no longer the "mom and apple pie of financial markets, wholesome, enduring, and unexciting."[9]

The increase in the perceived risk of municipal securities has led to a corresponding increase in the Securities and Exchange Commission (SEC) regulation of the municipal securities market.[10] For example, West Clark Community Schools (West Clark) made headlines in July 2013 when the SEC charged the school district with falsely claiming that it had been compliant with annual financial disclosures.[11] The West Clark charges represent the SEC's first foray into punishing a municipal issuer for falsely claiming in an official offering statement that the issuer was fully compliant with previous annual disclosures.[12]

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7. *See id.* (discussing how the municipal bond market "has been showing signs of stress").

8. *See* Nathan Bomey, Brent Snavely & Alisa Priddle, *Detroit Becomes Largest U.S. City to Enter Bankruptcy*, USA TODAY (Dec. 3, 2014, 7:53 PM), http://www.usatoday.com/story/news/nation/2013/12/03/detroit-bankruptcy-eligibility/3849833/ (last visited Oct. 22, 2015) (discussing Detroit's Chapter 9 bankruptcy filing and providing that Detroit has "an estimated $18 billion in debt and long-term liabilities") (on file with the Washington and Lee Law Review); William Selway, Martin Braun & Margaret Newkirk, *Alabama County Votes to Declare Biggest Municipal Bankruptcy*, BLOOMBERGBUSINESS (Nov. 9, 2011, 6:49 PM), http://www.bloomberg.com/news/articles/2011-11-09/alabama-s-jefferson-county-votes-for-biggest-municipal-bankruptcy-in-u-s- (last visited Oct. 22, 2015) (discussing Jefferson County's bankruptcy and stating that the county's bankruptcy eclipses Orange County, California's record-setting bankruptcy in 1994) (on file with the Washington and Lee Law Review); SEC, REPORT ON THE MUNICIPAL SECURITIES MARKET 25 (2012), http://www.sec.gov/news/studies/2012/munireport073112.pdf [hereinafter SEC REPORT] (providing a list of high profile municipality bankruptcies).

9. *See* Wallace, *supra* note 2 (discussing how the rise of municipalities facing financial stress could lead the way for more bond defaults).

10. *See* Press Release, SEC, SEC Charges School District and Muni Bond Underwriter in Indiana with Defrauding Investors (July 29, 2013) (discussing the SEC's charge against West Clark Community Schools).

11. *See id.* (noting that the SEC's charge against the school district was for "falsely stating to bond investors that the school district had been properly providing annual financing information and notices required as part of its prior bond offerings").

12. *See id.* ("This is the first time the SEC has charged a municipal issuer with falsely claiming in a bond offering's official statement that it was fully compliant with the annual disclosure obligations it agreed to in prior

According to the SEC, West Clark defrauded investors by leading them to believe it complied with the disclosure requirements for a prior offering; in fact, however, the school district failed to file any annual reports or event notices for its 2005 bond offering.[13]

Access to accurate and adequate information mitigates market risks for investors.[14] Investors use information about securities to evaluate and value the securities' prices and risks.[15] The need for this information raises the question, what information do investors need? Too much information may be cumbersome for investors, but material information allows investors to value securities' prices and risks.[16] In the municipal bond market, Rule 15c2–12[17] establishes the minimum requisite material information for issuers to provide in their continuing disclosure agreements with underwriters.[18]

Even with Rule 15c2–12 in effect, investors still lack access to this information.[19] West Clark's non-compliance does not appear to be a unique event; actually, failure to provide annual reports or continuing disclosures appears commonplace among municipal issuers.[20] In response to the lack of compliance with

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offerings . . . .").

13. *See id.* ("[F]or five years [West Clark Community Schools] failed to submit the required [annual financial] information.").

14. *See* THOMAS LEE HAZEN & DAVID L. RATNER, SECURITIES REGULATION IN A NUTSHELL 38, 111 (9th ed. 2006) (noting that the purposes of the Securities Act of 1933 and the Securities Exchange Act of 1934 are "[assuring] the public availability of adequate information").

15. *See* SEC REPORT, *supra* note 8, at 56 ("To gauge the credit risk of different types of municipal securities, analysts and investors historically have needed information on the type of issuer and credit involved.").

16. *See* 17 C.F.R. § 240.10b–5 (2015) (preventing issuers of securities from omitting material facts when making statements).

17. *See id.* § 240.15c2–12 (governing continuing disclosures for municipal bonds).

18. *Id.*

19. *See* SEC REPORT, *supra* note 8, at 65 ("[I]nvestors and other market participants have emphasized a need for greater and timelier disclosure in several key areas.").

20. *See Municipalities Continuing Disclosure Cooperation Initiative*, SEC, http://www.sec.gov/divisions/enforce/municipalities-continuing-disclosure-cooperation-initiative.shtml (last updated Nov. 13, 2014) (last visited Nov. 22, 2015) [hereinafter *MCDC*] (explaining that noncompliance with continuing disclosures is "potentially widespread" among issuers) (on file with the Washington and Lee Law Review); *see also* NAT'L FED'N OF MUN. ANALYSTS,

Rule 15c2–12, the SEC issued the Municipalities Continuing Disclosure Cooperating Initiative (MCDC Initiative) in March 2014.[21] The MCDC Initiative incentivizes municipal underwriters and issuers to self-report "material" violations of Rule 15c2–12.[22] To comply with the MCDC Initiative, municipal issuers must look back to previous disclosures. Not only do issuers need to know what is material going forward, but they also need to determine what was previously material.[23] Thus, issuers and underwriters must understand the concept of materiality because it is the key to ensuring compliance with the MCDC Initiative.[24] Despite the importance of material disclosures, the SEC has not defined materiality in the context of Rule 15c2–12.[25]

This Note explores materiality's meaning in the context of Rule 15c2–12's continuing disclosure requirements. Within the framework of Rule 15c2–12 and the municipal bond market, this Note argues that the correct meaning of materiality uses a

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NFMA RELEASES RESULTS OF DISCLOSURE SURVEY (2002), http://www.nfma.org/assets/documents/disclosure_survey.pdf [hereinafter NFMA DISCLOSURE SURVEY] (providing data from an informal survey of issuers subject to the continuing disclosure requirements and the completeness or inadequateness of their filed continuing disclosures); PETER J. SCHMITT, DPC DATA, ESTIMATING MUNICIPAL SECURITIES CONTINUING DISCLOSURE COMPLIANCE: A LITMUS TEST APPROACH 4 (2008), http://www.dpcdata.com/research/ [hereinafter SCHMITT, LITMUS TEST APPROACH] (analyzing issuers' compliance with required continuing disclosures under Rule 15c2–12 between 1996 and 2005); PETER J. SCHMITT, DPC DATA, RECENT TRENDS IN MUNICIPAL CONTINUING DISCLOSURE ACTIVITIES 4 (2011), http://www.dpcdata.com/research/ [hereinafter SCHMITT, RECENT TRENDS] (examining recent trends in municipal bond issuers' continuing disclosure activities).

21. *See MCDC*, *supra* note 20 (discussing the MCDC Initiative's background and requirements).

22. *See id.* (discussing how the MCDC Initiative is in response to concern about poor disclosure practices).

23. *See id.* (requiring disclosure of past violations of Rule 15c2–12).

24. *See id.* (explaining that issuers and underwriters should self-report any material violations of prior disclosures within the past five years).

25. *See GFOA Alert: The SEC MCDC Initiative and Issuers*, GOV. FIN. OFFICERS ASS'N (July 7, 2014), http://gfoa.org/gfoa-alert-sec-mcdc-initiative-and-issuers (last visited Sept. 18, 2014) [hereinafter *GFOA Alert*] (noting the SEC will not define "material," instead evaluating material violations on case-by-case basis in the MCDC Initiative) (on file with the Washington and Lee Law Review); *see also* NAT'L FED'N OF MUN. ANALYSTS, WHITE PAPER ON FEDERAL SECURITIES LAW RELATING TO MUNICIPAL SECURITIES 17 (2008) [hereinafter NFMA WHITE PAPER] (discussing that the qualification of event disclosure, if material, "leaves much room for debate").

creditworthiness test, which dictates that a fact, event, or omission is material if it substantially affects the issuer's creditworthiness or ability to meet its obligations to bondholders.[26] Part II provides background information on the current municipal bond regulatory scheme and discusses the MCDC Initiative. Part III explores different meanings of materiality in the securities context. Part IV analyzes these meanings of materiality in the context of the municipal bond market and argues that the correct definition of materiality should depend on creditworthiness. Finally, Part V applies this meaning of materiality in the context of Rule 15c2–12.

II. Current Municipal Bond Regulatory Scheme

A. Municipal Bonds Primer

To provide context for the issue of materiality in the municipal bond continuing disclosures requirements, an introduction to municipal bonds, municipal issuers, and municipal underwriters is necessary. Governmental entities, like states, cities, and counties, issue municipal bonds, or debt securities, to provide funding for capital projects and day-to-day obligations.[27] Essentially, a bond provides a loan to a municipality, and the municipality must pay the principal on that loan when it matures (and interest until it does so).[28] Municipal bonds differ from corporate bonds because they usually involve

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26. *See infra* Part IV.E (arguing that the correct materiality standard should be a creditworthiness test).

27. *See Investor Bulletin: Municipal Bonds*, SEC, http://www.sec.gov/investor/alerts/municipalbonds.htm (last visited Nov. 22, 2015) [hereinafter *SEC Investor Bulletin*] (presenting information on municipal bonds for investor education) (on file with the Washington and Lee Law Review); *see also* SEC REPORT, *supra* note 8, at i (providing that government entities issue bonds to finance private and public projects and to provide cash flow).

28. *See SEC Investor Bulletin*, *supra* note 27 (explaining that investors receive regular interest payments and, at maturity, the original investment); JOEL G. SIEGEL & JAE K. SHIM, INVESTMENTS: A SELF-TEACHING GUIDE 6 (1986) (noting that a bondholder typically receives the interest payments semi-annually).

less risk of default,[29] are exempt from federal income tax,[30] and in the case of default, are more likely to be repaid.[31]

Three types of municipal bonds exist: general obligation bonds,[32] revenue bonds,[33] and short-term debt securities.[34] General obligation bonds are backed by the issuer's "full faith and credit," meaning the issuer can tax residents to provide revenue for repayment of the bonds.[35] Revenue bonds are used to fund specific projects.[36] Unlike general obligation bonds, the specific project's revenue repays the revenue bonds' obligations.[37] Conduit bonds are a special form of revenue bonds, and municipalities issue them on behalf of a third party.[38] As its name indicates, short-term debt securities mature quickly, within thirteen months.[39] These securities provide funds for the gap in "time when expenses occur and when [other] revenues become

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29. *See* TOM LYDON, TRENDS IN FIXED INCOME: INVESTING IN BONDS 17 (2010) (noting that municipal bonds have lower rates of default).

30. *See* 26 U.S.C. § 103(a) (2012) (excluding interest on municipal bonds from gross income); *SEC Investor Bulletin*, *supra* note 27 (discussing that municipal bonds are generally not subject to federal income taxation); SEC REPORT, *supra* note 8, at ii (noting that the bond's interest is usually exempt from federal income taxation and possibly exempt from state income taxation).

31. *See* LYDON, *supra* note 29, at 20 (discussing that municipal bond investors have a higher recovery for defaulted municipal bonds than corporate securities).

32. *See SEC Investor Bulletin*, *supra* note 27 (providing that general obligation bonds "are backed by the 'full faith and credit' of the issuer, which has the power to tax residents to pay bondholders"); *see also* Hamilton, *supra* note 3, at 1017–18 (describing the types of municipal bonds).

33. *See SEC Investor Bulletin*, *supra* note 27 (explaining that revenue bonds are repaid through revenue raised from a specific project, such as highway tolls, and in the event that revenue ceases from the project, purchasers "do not have a claim on the underlying revenue source"); *see also* Hamilton, *supra* note 3, at 1017–18 (describing revenue bonds).

34. *See* JUDY WESALO TEMEL, THE BOND MKT. ASS'N, THE FUNDAMENTALS OF MUNICIPAL BONDS 33–34 (5th ed. 2001) (explaining short-term debt securities).

35. *See SEC Investor Bulletin, supra* note 27 (describing general obligation bonds).

36. *See id.* (explaining revenue bonds).

37. *See id.* (describing the differences between general obligation bonds and revenue bonds).

38. *See* Hamilton, *supra* note 3, at 1017–18 (noting that conduit bonds are "typically used to finance construction or manufacturing for certain industrial-type facilities"). For a discussion on the types of municipal bonds, see *id.*

39. *See* TEMEL, *supra* note 34, at 33–34 (describing short-term securities).

available."[40] General obligation bonds and revenue bonds, however, remain the most common.[41]

Issuers and underwriters are the players involved in the municipal bond process. The issuer—the governmental entity—sells the bonds to the underwriter.[42] Neither the SEC nor the Municipal Securities Rulemaking Board (MSRB) can require municipal bond issuers to file any document in connection with a bond offering.[43] An underwriter functions as the municipal bond dealer by purchasing the municipal bonds from the issuer and selling them to investors.[44] Thus, the underwriter serves as the middleman between the issuer and investors.[45]

B. The Securities Act of 1933, the Securities Exchange Act of 1934, and the Tower Amendment

Despite the municipal bond market's size and necessity, the federal regulatory scheme is limited compared to other U.S. capital markets.[46] The Securities Act of

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40. *See id.* at 33 (discussing the purpose of short-term securities).

41. *See SEC Investor Bulletin*, *supra* note 27 (explaining that the two most common bond types are general obligation bonds and revenue bonds).

42. *See Bonds*, SEC, http://www.sec.gov/answers/bonds.htm (last visited Nov. 14, 2014) (explaining that investors lend money to "a government, municipality, corporation, federal agency or other entity" when they buy bonds) (on file with the Washington and Lee Law Review).

43. *See* 15 U.S.C. § 78o-4(d)(1)–(2) (2012) (prohibiting both the SEC and MSRB from requiring a municipal issuer to file any documents before issuing a bond or providing any documents to the SEC, the MSRB, or a purchaser). The municipal bond market receives exemption from the Securities Act of 1933 and the Securities Exchange Act of 1934 due to constitutional dual-sovereignty issues. *See* Grommet, *supra* note 1, at 245, 247 n.67 (discussing the municipal bond regulatory regime and noting that Congress believed "constitutional dual-sovereignty issues would arise if municipal securities were subjected to federal regulation").

44. *See How the Market Works*, MUN. SECS. RULEMAKING BD., http://www.msrb.org/Municipal-Bond-Market/How-the-Market-Works.aspx (last visited June 25, 2014) (describing the underwriting process) (on file with the Washington and Lee Law Review).

45. *See id.* (explaining that the underwriter buys the bonds from the issuers and then sells the bonds to investors).

46. *See* SEC REPORT, *supra* note 8, at ii–iii (discussing the lack of statutory authority in the Securities Act of 1933, the Securities Exchange Act of 1934, and the Tower Amendment to promulgate disclosure standards for municipal

1933[47] (Securities Act) and the Securities Exchange Act of 1934[48] (Exchange Act) exempt municipal bonds from regulation.[49] These Acts originally exempted municipal bonds based on the belief that municipal bonds involved low risk and "little opportunity for creative fraud."[50] Nevertheless, antifraud provisions of Section 17(a)[51] of the Securities Act and Section 10(b)[52] of the Exchange Act apply to municipal bonds.[53] Section 17(a) prevents fraud and manipulation in securities' offerings, or the primary market.[54] Similarly, Section 10(b) prohibits fraud and manipulation in the secondary market.[55]

Section 17(a) of the Securities Act has always applied to the municipal bond market because Section 17(a) applies to "persons," which by definition includes governments.[56] In 1975 the Tower Amendment applied Section 10(b) of the Exchange Act to the municipal bond market in response to New York City's "near municipal bond default."[57] These antifraud provisions prevent "any person[] from making an untrue statement of material fact, or omitting any material facts necessary to

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issuers).

47. 15 U.S.C. §§ 77a–77aa (2012).

48. *Id.* §§ 78a–78pp.

49. *See* SEC REPORT, *supra* note 8, at ii (providing that the municipal securities market is not subject to the same level of regulation as other securities markets, but antifraud provisions apply to the municipal securities market); s*ee also* Grommet, *supra* note 1, at 247 n.67 ("These exemptions reflected a congressional belief that constitutional dual-sovereignty issues would arise if municipal securities were subjected to federal regulation.").

50. ROBERT DEAN POPE, MAKING GOOD DISCLOSURE: THE ROLE AND RESPONSIBILITIES OF STATE AND LOCAL OFFICIALS UNDER THE FEDERAL SECURITIES LAWS 5 (2001).

51. 15 U.S.C. § 77q(a) (2012).

52. *Id.* § 78j(b).

53. *See* SEC REPORT, *supra* note 8, at ii (noting municipal bonds have broad exemptions from the Securities Act and the Exchange Act but are not exempt from the antifraud provisions of these acts).

54. 15 U.S.C. § 77q(a) (2012).

55. *Id.* § 78j(b).

56. *See* Grommet, *supra* note 1, at 247 n.68 (discussing Section 17(a) of the Securities Act and its applicability to municipal bonds).

57. *See id.* at 247–48 (describing the effect of New York's near default on municipal bond regulation).

statements made, . . . in connection with the offer, purchase, or sale of any securities."[58]

Further, the Tower Amendment prohibits the SEC or the MSRB from requiring municipal issuers to file disclosures before municipal offerings.[59] Specifically, the SEC and the MSRB cannot require an issuer to file "any application, report, or document in connection with the issuance, sale, or distribution of such securities."[60] The MSRB also cannot require an issuer to provide to the MSRB or a purchaser "any application, report, document, or information with respect to such issuer."[61]

But, the MSRB may require a municipal securities dealer, broker, or advisor to provide the MSRB or any purchasers with information about the issuer that "is generally available from a source other than such issuer."[62] This provision permits the MSRB to regulate underwriters, dealers, brokers, and advisors directly and to regulate issuers indirectly.[63] The Securities Act, the Exchange Act, and the Tower Amendment therefore only restrict direct regulation of municipal bond issuers.[64]

C. Rule 15c2–12

Rule 15c2–12 regulates municipal bond disclosures.[65] The Rule purports to "stimulate greater scrutiny by underwriters of the representations made by issuers and the circumstances surrounding the offering."[66] The SEC adopted Rule 15c2–12 "to

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58. SEC REPORT, *supra* note 8, at 29.

59. *See* 15 U.S.C. § 78o-4(d)(1)–(2) (2012) (prohibiting the SEC or MSRB from requiring an issuer to file any documents before issuing a bond or providing any documents to the SEC, the MSRB, or a purchaser).

60. *Id.*

61. *Id.* § 78o-4(d)(2).

62. *Id.*

63. *See* POPE, *supra* note 50, at 7 (noting that the Tower Amendment does not prevent indirect regulation of issuers).

64. *See* NFMA WHITE PAPER, *supra* note 25, at 6 (discussing the effect of the federal securities law on municipal securities).

65. *See* 17 C.F.R. § 240.15c2–12 (2014) (providing municipal securities disclosure requirements).

66. Municipal Securities Disclosure Proposed Rule, SEC Release No. 34-26100, 53 Fed. Reg. 37,779 (Sept. 28, 1988).

enhance the quality and timeliness of disclosures in the municipal market."[67] Overall, the SEC designed the rule to ensure "the market [receives] certain specified information that in the past it did not receive, either at all or on a timely basis."[68]

This Rule indirectly regulates issuers because no underwriter could purchase bonds from an issuer without an official statement.[69] Without an underwriter, a municipality would have to sell its securities directly to the public; this prospect is not feasible for most municipal issuers.[70] Further, an underwriter cannot purchase or sell municipal bonds unless the "[u]nderwriter has reasonably determined that an issuer" will provide notice within ten business days of the occurrence of specified events.[71] These events reflect on the issuer's financial condition, tax status, modifications to bondholders' rights, and other key features relating to the bond issue; some of these events require disclosure only if the occurrence is material.[72] To ensure that these disclosures are properly disseminated to the market,

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67. Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others, Interpretive Release Nos. 33-7049, 34-33741, 59 Fed. Reg. 12,748, 12,749 (Mar. 17, 1994) [hereinafter SEC Interpretive Release].

68. POPE, *supra* note 50, at 64.

69. *See* 17 C.F.R. § 240.15c2–12(b)(1) (requiring underwriters to "obtain and review an [issuer's] official statement" before purchasing, offering, or selling the security); *see also* POPE, *supra* note 50, at 8 (noting that "an issuer cannot practically sell bonds in a public offering without an official statement").

70. *See* Alan Walter Seiss, *Local Government Finance: Capital Facilities Planning and Debt Administration*, UNIV. OF MICH., http://www-personal.umich.edu/~steiss/page68.html (last visited Feb. 21, 2015) ("Most investors cannot afford to buy whole bond issues, and most local governments do not have the time or resources to market bonds to multiple investors.") (on file with the Washington and Lee Law Review).

71. *See* 17 C.F.R. § 240.15c2–12(b)(5)(i) (2014) (delineating the underwriters' responsibilities for municipal bond offerings).

72. *See id.* § 240.15c2–12(b)(5)(i)(C) (listing the events that must be disclosed upon occurrence within ten business days). The events that must be disclosed, if material, are as follows: non-payment related defaults, any material events affect the bond's tax status, modifications to bondholders' rights, bond calls, release, substitution, or sale of any property securing the bond's repayment, entry into or termination of a definitive agreement to undertake a merger, consolidation, or acquisition involving an obligated person, the sale of all or substantially all assets not in the ordinary course of business, and appointment of successor or additional trustee, or change in the trustee's name. *Id.* § 240.15c2–12(b)(5)(i)(C)(2), (6), (7), (8), (10), (13), (14).

the underwriter and the issuer usually enter into a continuing disclosure agreement under which the issuer agrees to provide the information that Rule 15c2–12 requires and, on occasion, more information that the underwriter requested.[73] Thus, by requiring underwriters first to determine that issuers will provide continuing disclosures, the SEC and MSRB indirectly require issuers to provide continuing disclosures.[74]

The current municipal bond market regulatory scheme possesses several flaws. First, compared to other U.S. capital markets, the federal regulatory scheme is limited.[75] Once known as a sleepy market, the municipal bond market "has outgrown [the] restrictions of the regulatory structure put into place decades ago."[76] Second, the Tower Amendment regime "created a complicated set of disclosure rules without enforcement, and regulations that [do not] directly address the issuers responsible for the disclosure."[77] In theory, the issuer, following its continuing disclosure agreement, provides financial disclosures in the official statement at the time of the offer and provides continuing disclosures until the bond matures.[78] The reality, however, does not reflect this theory.[79] Even former SEC Chairman Christopher

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73. *See id.* § 240.15c2–12(b)(5)(i) (requiring that an underwriter and issuer enter into a written agreement or contract that the issuer will provide certain information to the MSRB). For examples of the kind of content made available through continuing disclosure agreements, see http://www.msrb.org/Market-Transparency/Continuing-Disclsoure.aspx.

74. *See* § 240.15c2–12(b)(5)(i) (requiring underwriters to "reasonably determine" that issuers will provide annual and continuing disclosures); POPE, *supra* note 50, at 57 (noting that Rule 15c2–12 is "an underwriter conduct rule[,]" but unavoidable to an issuer if it wants "to sell its bonds in a public offering").

75. *See* POPE, *supra* note 50, at ii–iii (discussing the lack of statutory authority in the Securities Act, the Exchange Act, and the Tower Amendment to promulgate disclosure standards for municipal issuers).

76. Hamilton, *supra* note 3, at 1019.

77. *Id.* at 1023.

78. *See* SCHMITT, LITMUS TEST APPROACH, *supra* note 20, at 8 ("As designed by the SEC, the disclosure sequence for each issue would start with the final official statement and continue with operating and financial disclosures annually for as long as the issue remained outstanding.").

79. *See id.* (providing that the data illustrated that "the inflow of continuing disclosure filings was not consistent with the rate of new issuance growth in the overall market").

Cox stated that continuing disclosures are "technically voluntary."[80]

In 2010 and 2011, the SEC conducted field hearings to discuss continuing disclosures for municipal bonds.[81] One panelist raised three issues with the continuing disclosures: (1) timeliness, (2) frequency, and (3) completeness.[82] Data collected from several studies on municipal bond continuing disclosures supports the prevalence of these three issues.[83]

The timeliness and frequency of continuing disclosures are closely related. In 2008, DPC Data conducted a study, which revealed that over 50% of bonds outstanding for nine years or more have one year or more of disclosure delinquency.[84] More than 25% of those bonds are in chronic delinquency, missing three years or more of disclosures.[85] As the bond's age increases, the likelihood of delinquency increases.[86] Further, these statistics suggest that chronic delinquency disclosure behavior becomes ingrained in issuers over time.[87] A common practice exists among issuers of filing multiple delinquent disclosures just before a new bond issue.[88] By

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80. *Id.* at 4. But, if continuing disclosures under Rule 15c2–12 were voluntary, then the MCDC Initiative would not have much strength.

81. *See* SEC REPORT, *supra* note 8, at i (noting that the public field hearings occurred in San Francisco, California, Washington, D.C., and Birmingham, Alabama).

82. *See id.* at 65 n.384 (discussing that disclosure problems fall into three categories).

83. *See* NFMA DISCLOSURE SURVEY, *supra* note 20 (surveying around 100 issuers subject to the continuing disclosure requirements to evaluate "the quality and completeness of information being provided"); PETER J. SCHMITT, DPC DATA, CONSEQUENCES OF POOR DISCLOSURE ENFORCEMENT IN MUNICIPAL SECURITIES MARKET 4 (2009), http://www.dpcdata.com/research/ [hereinafter SCHMITT, CONSEQUENCES] (studying the effectiveness of the SEC and MSRB in regulating and enforcing regulations in the municipal bond market); SCHMITT, LITMUS TEST APPROACH, *supra* note 20, at 7 (conducting a study of issuers subject to continuing disclosure requirements and their compliance with the requirements from 1996 to 2005); SCHMITT, RECENT TRENDS, *supra* note 20, at 5–6 (analyzing recent trends in issuers' disclosure habits).

84. SCHMITT, LITMUS TEST APPROACH, *supra* note 20, at 7.

85. *Id.*

86. *Id.*

87. *See id.* at 16 (providing a graph illustrating the sample bonds' chronic delinquencies as percentages).

88. *See id.* (noting that issuers only made up for missed or late filings "in advance of new bond issues").

the time issuers actually file these delinquent disclosures, however, the financial information becomes essentially useless.[89] Despite "over 42,000 unique" issuers bringing at least one bond issue to market, documents filed for unique issuers amounted to "just over 33,000" from 1997 to 2005.[90]

The completeness of continuing disclosures also leaves something to be desired. In a 2002 survey, the National Federation of Municipal Analysts (NFMA) found that, while "59.1% of annual financial information was found to be complete or near complete[,] . . . 40.9% of annual financial information was found to be somewhat inadequate or substantially inadequate."[91] As a result, even if an issuer files a continuing disclosure, many disclosures do not provide sufficient or complete information.[92]

This tardiness, delinquency, and incompleteness frustrates the purposes of disclosures. Disclosures prevent fraud, deception, and manipulation;[93] provide a true valuation of a bond's price on the secondary market;[94] and "give investors an accurate and complete picture of the risks they are taking in buying an issuer's bonds."[95] Continuing disclosures also provide critical information occurring after the bond's issuance[96] and affect transparency of a

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89. *See* SCHMITT, RECENT TRENDS, *supra* note 20, at 17 (stating that "[i]f you consider financial statement filings more than 180 days past the [Fiscal Year-End] date to be too stale," then 72% of issuers in the sample filed stale disclosures).

90. SCHMITT, LITMUS TEST APPROACH, *supra* note 20, at 8.

91. NFMA DISCLOSURE SURVEY, *supra* note 20.

92. *See id.* (discussing the inadequacy of continuing disclosures filed).

93. *See* 17 C.F.R. § 240.15c2–12(a) (2014) (providing that an underwriter shall not act as an underwriter unless the underwriter complies with this Section for the purpose of preventing "fraudulent, deceptive, or manipulative acts or practice").

94. *See* BALLARD SPAHR, MATERIALITY UNDER THE MCDC INITIATIVE: CAN THE SEC PROVE ITS CASE? 14–21 (2014), http://www.ballardspahr.com/events news/events/~/media/files/events/eventmaterials/2014-08-07-materiality-under-the-mc dc-initiative.ashx (last visited Jan. 4, 2015) (hypothesizing the price effect on a bond when an issuer reported a cut in state funding that significantly reduced funding).

95. POPE, *supra* note 50, at 83.

96. *See How the Market Works*, *supra* note 44 (noting that continuing disclosures provide investors important information after the bond's offering); SEC REPORT, *supra* note 8, at ii–iii, 69 (discussing that disclosures give issuers critical information for assessing an issuer's financial condition and whether an issuer will be able to repay its obligations).

bond's creditworthiness in the secondary market.[97] Finally, continuing disclosures allow investors to analyze their investments.[98] These purposes cannot be accomplished when an issuer files disclosures just before a subsequent bond offering, fails to file any disclosures, or files incomplete disclosures.[99]

Continuing disclosures are especially important in the municipal bond market.[100] Lack of disclosures creates more risk for investors.[101] Credit determinants affecting the municipal bond market "usually [do not] manifest in sudden shifts that lead immediately to distress."[102] This stability can also be attributed to issuers "operat[ing] on a more stable economic platform" when compared to corporations.[103] Thus, continuing disclosures are important to provide warning of financial deterioration.[104] The MSRB summarizes the importance of continuing disclosures:

> This information generally would reflect the financial or operating condition of the issuer as it changes over time, as well as specific events occurring after issuance that can have an impact on the ability of the issuer to pay amounts owing on the bond, the value of the bond if it is bought or sold prior to

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97. *See* SCHMITT, LITMUS TEST APPROACH, *supra* note 20, at 4 (explaining that continuing disclosures "affect[] credit transparency of bonds in the secondary market").

98. *See* SEC REPORT, *supra* note 8, at 69 (discussing how investors can analyze their investments from disclosures).

99. *See* U.S. GOV'T ACCOUNTABILITY OFFICE, REPORT TO CONGRESSIONAL COMMITTEES, MUNICIPAL SECURITIES: OPTIONS FOR IMPROVING CONTINUING DISCLOSURE 10 (2012) [hereinafter GAO REPORT] (providing that continuing disclosures are released too long after the end of the fiscal year for the information to be useful and that practically the information becomes stale).

100. *See* Martha Mahan Haines, SEC, *Disclosure in the Municipal Market: Fundamental Concepts for Issuers* (Sept. 19, 2000), http://www.sec.gov/news/speech/spch400.htm (last visited Jan. 21, 2015) ("Disclosure defines the information age in municipal securities.") (on file with the Washington and Lee Law Review).

101. *See* SCHMITT, CONSEQUENCES, *supra* note 83, at 4 (discussing that investors may buy distressed bonds, but they have no available information indicating such distress because of delinquency with continuing disclosures).

102. *Id.* at 10.

103. *Id.* at 10–11.

104. *See id.* at 11 (discussing that timely and regularly filed disclosures can provide warning of financial deterioration).

its maturity, the timing of repayment of principal, and any number of other key features of the bond.[105]

Further, the SEC and the MSRB have poorly enforced the disclosure requirements.[106] Before the Dodd–Frank Act of 2010,[107] the MSRB's board of directors faced an inherent conflict itself because members of the municipal dealer and bank dealer communities comprised two-thirds of the board.[108] Before implementing Electronic Municipal Market Access[109] (EMMA), "[n]either the SEC nor the MSRB monitored disclosure compliance in the [National Recognized Municipal Securities Information Repository (NRMSIR)]."[110] Even with the use of EMMA, the MSRB's ability to monitor missing or late disclosures remains limited.[111] This lack of scrutiny of continuing disclosures set the stage "for the worst possible predatory behavior to take place in distressed bonds."[112] Dual sovereignty between the federal, state, and local governments also leads to poor

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105. *How the Market Works*, *supra* note 44.

106. *See* SCHMITT, CONSEQUENCES, *supra* note 83, at 15 (explaining that the lack of SEC and MSRB enforcement "has created a no-penalty environment that leaves gaping holes in the disclosure fabric of the market").

107. Dodd–Frank Wall Street Reform and Consumer Protection Act, Pub. L. No. 111-203, 124 Stat. 1376 (2010); *see also* Grommet, *supra* note 1, at 254 ("Rule[] 15c2–12 . . . [does] not expressly provide a noncompliance remedy."); *U.S. Financial Reform: Municipal Securities*, DUANE MORRIS, http://www.duanemorris.com/alerts/financial_reform_municipal_securities_3773.html (last visited Jan. 12, 2015) (providing that the Dodd–Frank Act amends the MSRB board so that the majority of board members "[will be] independent of municipal securities brokers, dealers[,] or advisors") (on file with the Washington and Lee Law Review).

108. *See* SCHMITT, CONSEQUENCES, *supra* note 83, at 16 (noting that one of the problems with the MSRB's enforcement of continuing disclosures may come from the Board members and the Board's composition).

109. The Electronic Municipal Market Access is the EDGAR-equivalent for municipal issuers. *Compare EMMA, Electronic Municipal Market Access*, MUN. SECS. RULEMAKING BD., http://www.emma.msrb.org/ (last visited Oct. 8, 2015) (providing a search tool for municipal bonds and disclosures) (on file with the Washington and Lee Law Review), *with EDGAR*, U.S. SECS. & EXCH. COMM'N, https://www.sec.gov/edgar/searchedgar/companysearch.html (last visited Oct. 8, 2015) (providing a search tool for public company filings) (on file with the Washington and Lee Law Review).

110. SCHMITT, CONSEQUENCES, *supra* note 83, at 12.

111. *See* GAO REPORT, *supra* note 99, at 18 (explaining that the MSRB lacks the ability to track which issuances have missed or filed late disclosures).

112. SCHMITT, CONSEQUENCES, *supra* note 83, at 11.

enforcement.[113] Overall, lack of enforcement has bred indifference to filing continuing disclosures.[114]

Last, issuers have not faced direct legal consequences for failing to file continuing disclosures.[115] While underwriters could sue for specific performance as a breach of the continuing disclosure agreement, the remedy would be that the issuer files the continuing disclosure.[116] Thus, underwriters have no incentive to pursue this remedy.[117]

D. Municipalities Continuing Disclosure Cooperation Initiative

Prompted by the widespread noncompliance with Rule 15c2–12, the SEC issued the MCDC Initiative in March 2014.[118] The Initiative incentivizes both issuers and underwriters to self-report "possible violations involving material[ly] inaccurate statements" related to the continuing disclosures in bond offering documents.[119] Self-reporting issuers may not face civil penalties.[120]

Even though issuers are responsible for filing continuing disclosures, underwriters may have also violated the antifraud provisions.[121] Underwriters face liability if they did not complete

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113. *See* SCHMITT, RECENT TRENDS, *supra* note 20, at 13 (noting that dual sovereignty is one of the reasons why "the federal government has little direct governing or enforcement influence on municipal issuers").

114. *See* SCHMITT, CONSEQUENCES, *supra* note 83, at 13 (discussing that the SEC's lack of enforcement contributed to noncompliance with continuing disclosure requirements).

115. *See id.* at 14 (providing that Rule 15c2–12 "amounts to a voluntary disclosure system").

116. *See id.* (noting the lack of direct legal consequences that issuers face).

117. *See id.* (discussing underwriters' lack of enforcement of the continuing disclosure agreements).

118. *See MCDC*, *supra* note 20 (stating that the initiative's purpose is addressing "potentially widespread violations of the federal securities laws").

119. *See id.* (providing that the SEC Division of Enforcement will recommend favorable settlement terms for self-reporting issuers and underwriters).

120. *See id.* (noting that the Division of Enforcement "will recommend that the [SEC] accept a settlement in which there is no payment of any civil penalty by the issuer").

121. *See id.* (discussing that the SEC may file actions against both issuers and underwriters).

adequate due diligence in determining whether issuers complied with their continuing disclosure obligations and failed to form a reasonable basis for believing the issuers' official statements.[122]

The civil penalties for self-reporting underwriters depend on both the offering size and the underwriters' total revenue.[123] For offerings of $30 million or less, underwriters face a penalty of $20,000 per offering containing a materially false statement.[124] Offerings of more than $30 million impose a penalty of $60,000 per offering containing a materially false statement.[125] The total amount of penalties for an underwriter, however, is capped.[126] Underwriters reporting total revenue over $100 million in their annual audited report will pay no more than $500,000.[127] Underwriters reporting total revenue between $20 million and $100 million in their annual audited report will pay no more than $250,000.[128] Underwriters reporting total revenue below $20 million in their annual audited report will pay no more than $100,000.[129]

The theory behind the MCDC Initiative is known as the Prisoner's Dilemma.[130] The idea is that, if Underwriter A self-reports, it will highlight instances where Issuer A failed to make continuing disclosures.[131] This creates the Prisoner's Dilemma—

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122. *See* 17 C.F.R. § 240.15c2–12(b)(5)(i)(C) (2014) (requiring underwriters to reasonably determine that issuers will provide continuing disclosures to the MSRB); *MCDC*, *supra* note 20 (describing how underwriters may face liability under the MCDC).

123. *See MCDC*, *supra* note 20 (discussing the civil penalties self-reporting underwriters may face).

124. *Id.*

125. *Id.*

126. *Id.*

127. *Id.*

128. *Id.*

129. *Id.*

130. *See* Paul S. Maco, Michael D. Bernard, Kristen H. Elizondo & Britt C. Steckman, *A 'Prisoner's Dilemma' for Issuers and Underwriters*, LAW360 (May 27, 2014, 2:51 PM), http://www.law360.com/articles/538908/a-prisoner-s-dilemma-for-issuers-and-underwriters (last visited Jan. 12, 2014) (describing the MCDC Initiative and noting that the offer creates a Prisoner's Dilemma) (on file with the Washington and Lee Law Review).

131. *Prisoner's Dilemma*, INVESTOPEDIA, http://www.investopedia.com/terms/p/prisoners-dilemma.asp (last visited Jan. 12, 2014) (discussing the definition of a Prisoner's Dilemma) (on file with the Washington and Lee Law Review). The

Issuer A will self-report because it believes Underwriter A will self-report.[132] Thus, Underwriter A's self-reporting incentivizes Issuer A to self-report.[133] But, Underwriter A and Issuer A would be better off cooperating with each other so that neither Underwriter A nor Issuer A's violations will come to light.[134] The Prisoner's Dilemma, however, reveals that they inevitably act in their own self-interest and are worse off than if they had cooperated with each other.[135]

In the MCDC Initiative, both the issuer and underwriter would be better off not reporting any violations of Rule 15c2–12 because they would not face the monetary penalties.[136] Instead, the issuer and the underwriter will both self-report violations, fearing that the other will report violations first. While self-reporting issuers may not face civil penalties, "[u]nderwriters have an incentive to over report" violations of compliance with continuing disclosures because of the capped amount of civil penalties.[137]

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following illustration best explains the Prisoner's Dilemma:

> Suppose two friends, Dave and Henry, are suspected of committing a crime and are being interrogated in separate rooms. Both individuals want to minimize their jail sentence. Both of them face the same scenario: Dave has the option of pleading guilty or not guilty. If he pleads not guilty, Henry can plead not guilty and get a two-year sentence, or he can plead guilty and get a one-year sentence. It is in Henry's best interest to plead guilty if Dave pleads not guilty. If Dave pleads guilty, Henry can plead not guilty and receive a five-year sentence. Otherwise he can plead guilty and get a three-year sentence. It is in Henry's best interest to plead guilty if Dave pleads guilty. Dave faces the same decision matrix and follows the same logic as Henry. As a result, both parties plead guilty and spend three years in jail although through cooperation they could have served only two.

Id.

132. *Id.*

133. *Id.*

134. *Id.*

135. *Id.*

136. *See id.* (applying the Prisoner's Dilemma logic in an example). If you apply the logic of Dave and Henry from the example in the previous footnote and replace "guilty" with "report" and "not guilty" with "not report," it would be in both the issuer's and underwriter's best interest to not report; however, they will both report violations like Dave and Henry would both plead guilty.

137. *See MCDC*, *supra* note 20 (providing the civil penalty amounts for eligible underwriters and that the Enforcement Division will recommend a

Because underwriters have an incentive to over-report violations, they may report violations that are not material.[138] These reported violations could create a precedent for future underwriters to report these violations, even if the violations should not be considered material.[139] An overload of information could cause the important and material information to be lost among all of the continuing disclosures.[140] Additionally, some issuers think that filing a continuing disclosure a few days or weeks after the deadline is not a failure to comply with continuing disclosures in any material respects, but the "[SEC] has provided no comfort on this point."[141] Without knowing the meaning of materiality in the continuing disclosure context, issuers and underwriters have little guidance.[142]

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settlement with no civil penalty for eligible issuers); *GFOA Alert*, *supra* note 25 (warning issuers that underwriters have an incentive to over report violations); PFM GROUP, SEC MUNICIPAL ADVISOR RULE AND MCDC INITIATIVE 23 (2014), http://fsfoa.org/documents/MARule-MCDCFSFOAConference-PublicFinancial ManagementInc-2014-06-16_final.pdf (describing consequences if the issuer did not report, but the underwriter reported violations).

138. *See GFOA Alert*, *supra* note 25 (discussing that underwriters participating in the MCDC Initiative may "falsely report[] that statements made by issuers pertaining to their prior continuing disclosure compliance are material misstatements when in fact they are not" because of "erroneous findings of failures to file" within the faulty NRMSIR); NAT'L ASS'N OF BOND LAWYERS, MCDC INITIATIVE: CONSIDERATIONS FOR ANALYSIS BY ISSUERS OF MATERIALITY AND SELF-REPORTING 2 (2014), http://www.nabl.org/uploads/cms/documents/MCDC_Initiative__Considerations_for_Analysis_by_Issuers_of_Materiality_and_Self-Reporting_8-5-14.pdf ("[I]ssuers and underwriters will have different perspectives, both regarding what may be material and what should be self-reported, particularly in light of the cap on liability applicable to underwriters and the direct application of Rule 15c2–12 only to underwriters."); PFM GROUP, *supra* note 137 (advising that an option for the MCDC is to "report everything but tell SEC they are not material").

139. *See* NFMA WHITE PAPER, *supra* note 25, at 37 (discussing that GFOA produces guidelines for continuing disclosures, but these guidelines can also be counterproductive in creating a perception of a disclosure ceiling that does not need to be exceeded).

140. *See* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 448–49 (1976) (discussing that a fear of liability will cause management to "bury the shareholders in an avalanche of trivial information"); Haines, *supra* note 100 (providing that it is "not necessary or desirable to disclose every bit of information about an issuer in an official statement; important information would be buried in unimportant detail").

141. *See* POPE, *supra* note 50, at 62 (discussing the confusion surrounding continuing disclosures).

142. *See GFOA Alert*, *supra* note 25 (explaining that the SEC will not define

E. Municipal Bond Context

Materiality plays an important role in the municipal bond context. First, Rule 15c2–12 requires disclosure of the occurrence of fourteen different events;[143] seven of these events must be disclosed, if material.[144] These events place the determination of materiality in the issuer's hands.[145] The other seven events are events that the SEC must conclude are material per se because the SEC requires disclosure of the events' occurrence without the issuer determining if the events are material.[146]

Second, the MCDC Initiative requires issuers and underwriters to report "materially inaccurate statements in a final official statement . . . prior compliance with . . . continuing [disclosure] obligations" that occurred within the past five years.[147] Both issuers and underwriters must determine whether a material misstatement or omission occurred by referring to

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"material," but will evaluate material violations on a case-by-case basis under the MCDC).

143. *See* 17 C.F.R. § 240.15c2–12(b)(5)(i)(C)(1)–(14) (2014) (requiring underwriters to agree with issuers in a continuing disclosure agreement that the issuers will disclose within "ten business days after the occurrence of the event").

144. *See id.* § 240.15c2–12(b)(5)(i)(C)(2), (6), (7), (8), (10), (13), (14) (noting that the occurrence of these events must be disclosed if material within ten business days). These seven events are (1) non-payment related defaults; (2) adverse tax opinions, any material notices from the IRS about the security's tax status, or any other material events affecting the security's tax status; (3) modifications to bondholders' rights; (4) bond calls; (5) release, substitution, or sale of property securing the bonds' repayment; (6) merger, acquisition, sale of substantially all assets not in the ordinary course of business, or entry into an agreement to take any of these actions; and (7) appointment of a successor or additional trustee or change of name of trustee. *Id.*

145. *See id.* (requiring the disclosure upon the occurrence of these events, if material).

146. *See id.* § 240.15c2–12(b)(5)(i)(C)(1), (3), (4), (5), (9), (11), (12) (mandating that the occurrence of these events regarding the bonds issued in the offering must be disclosed within ten business days).

147. *See MCDC*, *supra* note 20 (providing that issuers and underwriters should self-report any instances of material violations of Rule 15c2–12 in the previous five years); PFM GROUP, *supra* note 137, at 21 (discussing the MCDC Initiative's requirements). Technically, this requirement is actually in 17 C.F.R. § 240.15c2–12 and the MCDC Initiative is just enforcing it. *Compare* 17 C.F.R. § 240.15c2–12, *with MCDC*, *supra* note 20.

their continuing disclosures agreements.[148] Then they must determine if they breached the agreements in any way and if any breaches were material.[149] In essence, the MCDC Initiative provides a complicated two-fold materiality analysis.[150] But to understand this analysis, we must first understand what "materiality" means.

III. What Does Materiality Mean?

When thinking about the meaning of materiality, it is important to remember its purpose in securities regulation: "to substitute a philosophy of full disclosure for the philosophy of caveat emptor and thus to achieve a high standard of business ethics in the securities industry."[151] As the U.S. Supreme Court noted in *Basic, Inc. v. Levinson*,[152] materiality purports to filter out "useless information that a reasonable investor would not consider significant, even as part of a larger 'mix' of factors to consider in making his investment decision."[153] Over-disclosure could bury any pertinent information beneath unimportant detail.[154] The delicate balance of over-disclosure and under-disclosure finds some guidance in this common-sense approach:

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148. *See MCDC*, *supra* note 20 (incentivizing issuers and underwriters to self-report any material violations of compliance with Rule 15c2–12 and continuing disclosure agreements)

149. *See* 17 C.F.R. § 240.15c2–12(b)(5)(i)(C) (2014) (requiring underwriters to reasonably determine in a written agreement or contract with issuers that the issuers will provide certain continuing disclosures to the MSRB).

150. *See MCDC*, *supra* note 20 (permitting issuers and underwriters to self-report violations involving material inaccurate statements in bond offering statements); *infra* notes 249–251 and accompanying text (discussing the MCDC Initiative analysis that issuers and underwriters must undertake when deciding whether the participate); *see also* 17 C.F.R. § 240.15c2–12(b)(5)(i)(C)(2), (6), (7), (8), (10), (13), (14) (requiring disclosure of these events upon occurrence, if material).

151. SEC v. Capital Gains Research Bureau, Inc., 375 U.S. 180, 186 (1963).

152. 485 U.S. 224 (1988).

153. *Id.* at 234 (citing TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 448–49 (1976)).

154. *See* Haines, *supra* note 100 (explaining that it is "not necessary or desirable to disclose every bit of information about an issuer in an official statement; important information would be buried in unimportant detail").

"If I were buying these bonds, what would I like to know?"[155] This approach, however, offers only a subjective standard of what material information to disclose.[156] Other materiality standards require objective measurements of materiality.[157] The following standards provide different methods of determining materiality.[158]

A. Securities Context

In the securities context, *TSC Industries, Inc. v. Northway, Inc.*[159] provides the materiality standard.[160] The U.S. Supreme Court found that, in the context of Rule 14a–9,[161] "an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote."[162] This meaning of materiality is an objective standard

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155. *See id.* (providing continuing disclosure advice in a speech to the Michigan Municipal Finance Officers Association).

156. *See* Saba Ashraf, Note, *The Reasonableness of the "Reasonable Woman Standard": An Evaluation of Its Use in Hostile Environment Sexual Harassment Claims Under Title VII of the Civil Rights Act*, 21 HOFSTRA L. REV. 483, 486–87 (1992) (explaining that using an objective standard evaluates situations from a reasonable person's viewpoint, while using a subjective standard evaluates situations from the actual person's viewpoint).

157. *See infra* notes 162–175, 182 and accompanying text (discussing materiality standards that use reasonable investor and reasonable person viewpoints).

158. The Restatement (Second) of Contracts provides a standard for materiality: "[a] misrepresentation is material if it would be likely to induce a reasonable person to manifest his assent, or if the maker knows that it would be likely to induce the recipient to do so." RESTATEMENT (SECOND) OF CONTRACTS § 162 (AM. LAW INST. 1981). This standard, however, would likely not be applied in the municipal bond context, so it is excluded from this analysis.

159. 426 U.S. 438 (1976).

160. *See id.* at 449 (adopting the materiality standard for Rule 14a–9); *see also id.* at 447 n.8 ("This standard or a close approximation, has been widely recited in cases involving various sections of the securities laws.").

161. *See* 17 C.F.R. § 240.14a–9 (2014) (prohibiting proxy solicitation statements from containing any false or misleading statements or omissions of material facts).

162. *See TSC Indus., Inc.*, 426 U.S. at 449 ("Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been view by the reasonable investor as having significantly altered the 'total mix' of information made available.").

"involving the significance of an omitted or misrepresented fact to a reasonable investor."[163] When discussing materiality, the Court noted that the standard of materiality could not be too low; otherwise, a corporation would "bury the shareholders in an avalanche of trivial information."[164] This standard, however, measures materiality with "a showing of a substantial likelihood that, under all circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder."[165]

Rule 14a–9 prohibits using false or misleading statements and facts or omissions of material facts in proxy solicitation statements.[166] Proxy solicitations occur when a corporation seeks authorization (the proxy) to vote on the shareholders' behalf.[167] Municipal bond issuers, on the other hand, would never participate in a proxy solicitation because they do not issue stocks or equity.[168] Additionally, bondholders possess no voting rights.[169]

In *Basic, Inc.*, the Court adopted the *TSC Industries* materiality standard for Rule 14a–9 as the materiality standard for Rule 10b–5.[170] Like Rule 14a–9, Rule 10b–5 is an antifraud

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163. *See id.* at 445 (providing that materiality is an objective standard despite the many variations of materiality standards).

164. *See id.* at 448–49 (discussing the policy considerations and implications of different materiality standards).

165. *Id.* at 449.

166. *See* 17 C.F.R. § 240.14a–9 (2014) (prohibiting false and misleading statements in connection with proxy solicitations).

167. *See* Gary J. Wolfe, Robert E. Lustrin & Edward S. Horton, *An Introduction to the Proxy Solicitation Process*, SEWARD & KISSELL (June 9, 2009), http://www.sewkis.com/pubs/xprPubDetail.aspx?xpST=PubDetail&pub=181 (last visited Feb. 21, 2015) (describing the purpose of proxy solicitations) (on file with the Washington and Lee Law Review).

168. *See id.* (discussing that "the ultimate purpose of any proxy solicitation is to obtain the ability to vote other shareholders' securities").

169. *See Bonds vs. Stocks—Which Investment is Better for You?*, LEARN BONDS, http://learnbonds.com/bonds-vs-stocks/ (last visited Feb. 21, 2015) (discussing the differences in shareholders' rights and bondholders' rights) (on file with the Washington and Lee Law Review).

170. *See* Basic, Inc. v. Levinson, 484 U.S. 224, 232 (1988) (explaining that the Court adopted the *TSC Industries* materiality standard); *see also* 17 C.F.R. § 240.10b–5 (2014) (prohibiting the use of manipulative and deceptive devices in the securities market).

provision,[171] but it has a broader scope than Rule 14a–9.[172] Rule 10b–5 prohibits any person from making any false or misleading statement or omitting material facts from a statement in connection with the purchase or sale of any security.[173] Unlike many of the regulations in the Securities Act and the Exchange Act, this Rule applies to the municipal bond market.[174] Any disclosure that an issuer makes must not contain any false or misleading statements or omit any material facts.[175]

B. Efficient Market Test

From an efficient market theory, "any act or omission which noticeably affects that market is material because the efficient market depends on the free flow of correct and complete information."[176] Thus, a fact or omission "is material if an eventual disclosure causes a notable market reaction."[177] This standard makes the judgment of materiality more objective by measuring the continuing disclosures' effect on the market rather than through the reasonable investor's viewpoint.[178]

Courts have used an efficient market test in fraud-on-the-market theory cases, which permit investors to rely on the integrity of a security's market price without relying directly on a misleading statement in a claim for fraud.[179] In an efficient

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171. *See* SEC REPORT, *supra* note 8, at ii (noting that the antifraud provisions of Section 10(b) of the Exchange Act apply to municipal bonds).

172. *Compare* 17 C.F.R. § 240.10b–5 (2014) (applying to any security), *with id.* § 240.14a–9 (applying to proxy solicitation statements).

173. *Id.* § 240.10b–5.

174. *See* SEC REPORT, *supra* note 8, at ii (discussing that the antifraud provisions of Section 10(b) of the Exchange Act apply to municipal bonds).

175. *See* 17 C.F.R. § 240.10b–5 (preventing use of false and misleading statements or omissions of material fact in connection with the purchase or sale of any security, including municipal bonds).

176. *See* GARY P. KREIDER, ANTI-FRAUD DILEMMA: DEFINING MATERIALITY 6 (2004), http://www.kmklaw.com/assets/attachments/AntiFraud.pdf (arguing that the SEC should define materiality differently between voting situations and market situations).

177. *Id.*

178. *See id.* at 5 (discussing the differences between the *TSC Industries* materiality standard and a market test standard).

179. *See In re* Countrywide Fin. Corp. Secs. Litig., 273 F.R.D. 586, 609 (C.D.

market, the security's price reflects all available material information.[180] Thus, a security's price "should not change significantly unless there is new information that is material to the security's value."[181]

C. Torts Standard

The Restatement (Second) of Torts provides that a "matter is material if a reasonable man would attach importance to its existence or nonexistence in determining his choice of action in the transaction in question."[182]

In *Smallwood v. Pearl Brewing Co.*,[183] the district court used the torts standard of materiality in its jury instructions, and the Fifth Circuit upheld the jury's conclusion that the omission of a promised stock option to a director from a proxy statement was not material.[184] The omission of the stock option was not material because the proxy statement mentioned that the director would receive "some personal gain from the . . . merger[,]" and shareholders were "'sufficiently alerted' to [the director's] interests 'to be on their guard.'"[185]

In *Gerstle v. Gamble-Skogmo, Inc.*,[186] the court held that a deficiency in the proxy statement was material under the torts standard.[187] General Outdoor Advertising (GOA) planned to

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Cal. 2009) (noting that "[e]stablishing fraud-on-the-market requires evidence of market efficiency"). *See generally* Tim A. Thomas, Annotation, *When Is It Unnecessary to Show Direct Reliance on Misrepresentation or Omission in Civil Securities Fraud Action Under § 10(b) of Securities Exchange Act of 1934 (15 U.S.C.A. § 78j(b)) and SEC Rule 10b–5 (17 C.F.R. § 240.10b–5)*, 93 A.L.R. Fed. 444 (2015) (analyzing fraud-on-the-market cases).

180. *See* Basic, Inc. v. Levinson, 485 U.S. 224, 241–42 (1988) (discussing the hypothesis behind fraud-on-the-market theory).

181. *Countrywide*, 273 F.R.D. at 611.

182. RESTATEMENT (SECOND) OF TORTS § 538(2)(a) (AM. LAW INST. 1979).

183. 489 F.2d 579 (5th Cir. 1974).

184. *See id.* at 603–04 (explaining that the torts standard of materiality "has a rich history of application to the securities laws").

185. *Id.* at 604 (quoting Mills v. Elec. Auto-Lite Co., 403 F.2d 429, 434 (7th Cir. 1968)).

186. 478 F.2d 1281 (2d Cir. 1973).

187. *See id.* at 1302 (providing that the minority shareholders would have wanted to know GOA's actual intent when the shareholders were deciding

merge with Gamble-Skogmo and sell some remaining advertising plants after the merger to realize large profits.[188] The court found that GOA's true intent to sell all of its remaining advertising plants after the merger was "a significant factor in a reasonable shareholder's decision whether or not to vote for the merger."[189] Thus, it was material.

D. Creditworthiness Test

Under a creditworthiness test, a fact or omission is material if the fact or omission substantially affects the creditworthiness of the municipality.[190] A creditworthiness test measures the issuer's financial condition and its ability to meet its debt obligations.[191] The court in *HealthSouth Corp.*[192] recognized that "material[,] new[,] unexpected information concerning the creditworthiness of the issuer or the prospect of default on bond obligations would be of interest to bondholders and affect the price."[193]

IV. Materiality in the Continuing Disclosure Context: Analyzing Materiality Standards and Tests Through the Bond Market Lens

After discussing different materiality standards, we will now consider these standards in the context of the municipal bond market. First, this Note analyzes the policy considerations that

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whether to keep their GOA shares or exchange them for shares in Gamble-Skogmo).

188. *See id.* at 1291 (discussing the merger's details).

189. *Id.* at 1302.

190. *See* SEC Interpretive Release, *supra* note 67, at 12,575 ("[C]ommentators have called for timely disclosure of events that materially reflect on the creditworthiness of municipal securities issuers and obligors and the terms of their securities.").

191. *See* *Credit Worthiness*, INVESTOPEDIA, http://www.investopedia.com/terms/c/credit-worthiness.asp (last visited Feb. 21, 2015) (defining creditworthiness as "[a]n assessment of the likelihood that a borrower will default on [its] debt obligations") (on file with the Washington and Lee Law Review).

192. 261 F.R.D. 616 (N.D. Ala. 2009).

193. *Id.* at 635–36.

"materiality" in the municipal bond market should incorporate. Second, this Note analyzes different standards—the *TSC Industries* standard, the Efficient Market standard, the Torts standard, and the Creditworthiness test—through the municipal bond market lens.

A. Policy Considerations

The meaning of materiality in the municipal bond continuing disclosure context should incorporate the differences between corporate equity and debt markets and the municipal bond market. First, long-term prices matter more in municipal and corporate bond markets, whereas current prices matter more in the corporate equity markets because corporate equity trades more frequently over secondary markets than municipal and corporate debt.[194] Consequently, a material event for a publicly held corporation could be a trivial event for a governmental entity.[195] Investor confidence in a corporation and its management affect stock prices.[196] For example, in *Longman v. Food Lion, Inc.*,[197] when a PrimeTime Live episode about Food Lion grocery stores aired and alleged "widespread unsanitary practices and labor law violations," Food Lion's stock prices dropped the following day.[198] An exposé on a municipal bond

194. *See* Plumbers & Pipefitters Nat'l Pension Fund v. Burns, 967 F. Supp. 2d 1143, 1149 (N.D. Ohio 2013) (noting that stocks trade more frequently than bonds).

195. *See id.* (explaining that the plaintiff's expert testified that "negative information about a company, while affecting its stock price, may not significantly impact bond prices"); *see also In re* HealthSouth Corp. Secs. Litig., 261 F.R.D. 616, 631–32 (N.D. Ala. 2009) ("[I]nformation that affects the price of stocks, such as the announcement of a dividend or earning statements, would not be expected to affect the price of bonds.").

196. *See* Longman v. Food Lion, Inc., 197 F.3d 675, 680–81 (4th Cir. 1999) (discussing the decrease in the Food Lion stock price the day after the PrimeTime Live broadcast aired); PATRICK J. BROWN, AN INTRODUCTION TO THE BOND MARKET 7 (2006) (explaining that stockholders have greater access to information and are able to determine the company's future direction than bondholders).

197. 197 F.3d 675 (4th Cir. 1999).

198. *See id.* at 667, 680–81 (discussing that the broadcast alleged unsanitary practices and employees working "off-the-clock" and that stock prices fell the next day).

issuer might not have the same effect on the municipal bond's price or the yield.[199]

Information concerning the issuer's creditworthiness, however, can affect a bond's price. For example, HealthSouth Corporation, which issued corporate bonds, announced that Medicare payment rules changed, and the changes "would negatively [affect] operating income by $175 million."[200] This announcement caused bond prices to decrease between 5–16%.[201] Unlike stocks, the corporate bond market and the municipal bond market lack sensitivity to day-to-day fluctuations.[202] Rather, general economic conditions and the treasury market affect the bond markets.[203] Further, a municipal bond issuer's financial deterioration can take longer to appear in the municipal bond market than a corporation's financial deterioration in the stock market (or even the corporate bond market).[204] As the District Court for the Southern District of Texas stated, "A comparison between equity and bond markets is a comparison between the proverbial apple and orange."[205]

Second, corporate equity and debt investors and municipal bondholders have different goals and expectations.[206]

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199. *See HealthSouth*, 261 F.R.D. at 635 (providing that material information to a stockholder may not be material to a bondholder if the information would not affect the bond's fixed return).

200. *Id.* at 636.

201. *See id.* (describing the experts' event studies of HealthSouth bonds' price reactions to announced information relevant to bonds).

202. *See id.* at 632 (noting that stock prices fluctuate daily).

203. *See* INST. OF CHARTERED FIN. ANALYSTS, THE MUNICIPAL BOND MARKET: NEW RULES, NEW OPPORTUNITIES, AND NEW STRATEGIES 7, 18–19 (1988) [hereinafter MUNICIPAL BOND MARKET] (providing that "when the Treasury market sneezes, the municipal bond market gets a cold, and vice versa" and economic downturns affect municipalities because local businesses, who supply tax revenue, suffer from the downturn as well and may not provide as much revenue); *see also In re* HealthSouth Corp. Secs. Litig., 261 F.R.D. 616, 632 (N.D. Ala. 2009) ("[T]he price of the investment-grade bonds is not very sensitive to day-to-day stock price fluctuations. . . . [M]ost of the variation in the price of investment-grade bonds comes from the fluctuations in economy-wide interest rates, as opposed to firm-specific information.").

204. *See* SCHMITT, CONSEQUENCES, *supra* note 83, at 10 ("Municipal bond credit determinants . . . usually [do not] manifest in sudden shifts that lead immediately to distress.").

205. Newby v. Enron Corp., 529 F. Supp. 2d 644, 755 (S.D. Tex. 2006).

206. *Compare* TEMEL, *supra* note 34, at 133–34 (adding that bondholders'

Institutional investors dominate the corporate bond market.[207] In the municipal bond market, though, individual households, or retail investors, directly hold about 50% of outstanding municipal bonds and indirectly hold an additional 25% of bonds through other investment funds.[208] Most retail investors are in a high-enough tax bracket to take advantage of municipal bonds' tax benefits.[209] These retail investors usually hold their bonds until maturity.[210] Bonds also trade less frequently than stocks.[211] Stockholders may sell their stocks to take advantage of capital gains or reduce further loss, so the current price of the stock is important to stockholders.[212] Further, bondholders have the right to income through interest payments and the principal at maturity.[213] Stockholders receive a return only by selling their stock or receiving a dividend, which occurs if the corporation

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investment objectives include desire for current income stream, capital preservation, and specific cash needs), *with* MARC M. GROZ, FORBES GUIDE TO THE MARKETS 26–27 (1999) (explaining that stockholders' investment objectives include a desire for long-term capital appreciation and a belief that the potential return from stocks is worth the risk).

207. *See HealthSouth Corp.*, 261 F.R.D. at 631 (comparing and contrasting the corporate equity and corporate debt markets).

208. *See* SEC REPORT, *supra* note 8, at 14 (showing a pie chart with the breakdown of municipal security holders); GAO REPORT, *supra* note 99, at 1 (noting the size of the municipal bond market and that individual investors or households comprise half of the market owning these bonds).

209. *See* TEMEL, *supra* note 34, at 16 ("The principal characteristic of all buyers of municipal bonds is that they are in sufficiently high tax bracket that they can benefit from the tax exemption.").

210. *See* MUN. SECS. RULEMAKING BD., WHAT TO EXPECT WHEN SELLING MUNICIPAL BONDS BEFORE MATURITY (2013), http://www.msrb.org/msrb1/EMMA/pdfs/Selling-Before-Maturity.pdf (noting that most municipal bond investors are "buy and hold" investors); SEC REPORT, *supra* note 8, at v (describing the municipal bond market as a "buy-and-hold market"); Jason Brady, *Stocks vs. Bonds: Why and When?*, AAII J. (Sept. 2012), http://www.aaii.com/journal/article/stocks-vs-bonds-why-and-when?adv=yesaai.com (last visited Jan. 12, 2015) (providing that many investors will hold onto bonds longer to "receive the promised yield return") (on file with the Washington and Lee Law Review).

211. *See In re* HealthSouth Corp. Secs. Litig., 261 F.R.D. 616, 632 (N.D. Ala. 2009) ("Investors generally view bonds as 'buy and hold' securities.").

212. *See* Brady, *supra* note 210 (providing that "non-dividend stock returns are dependent on capital gains").

213. *See id.* (describing the differences in income streams between stocks and bonds).

chooses to issue dividends.[214] Thus, stockholders have unlimited potential return, while bondholders' returns are limited to the interest they collect until the bond matures.

The age differences between municipal bondholders and stockholders may also influence their expectations and goals.[215] Investors with the majority of their holdings in stocks tend to be younger and have an appetite for risk.[216] Municipal bondholders, however, are usually older, closer to retirement, or at retirement and tend to allocate the majority of their investments in fixed income or bonds.[217] Additionally, bondholders are concerned with an issuer's stability because stability is the investors' assurance in receiving interest payments and principal.[218] Most stockholders, while also concerned with a company's stability, care more about the company's profit maximization.[219]

Third, corporate equity and debt investors and most municipal bondholders do not have the same capacity to process the information they gain from disclosures.[220] While institutional

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214. *See id.* (discussing that dividend-paying stocks possess income uncertainty).

215. *See* LYDON, *supra* note 29, at 4 (noting that age is an important factor when looking at a bondholder).

216. *See Bonds Basics 1*, INVESTOPEDIA, http://www.investopedia.com/university/bonds/bonds2.asp (last visited Jan. 23, 2015) (noting that younger investors typically place the majority of their wealth in stocks) (on file with the Washington and Lee Law Review).

217. *See* LYDON, *supra* note 29, at 4 (discussing that retirement aged investors want to preserve their savings and invest in more bonds than stocks); INVESTOPEDIA, *supra* note 216 (discussing that investors closer to retirement or at retirement place their investments in fixed income).

218. *See Bond Basics 2*, INVESTOPEDIA, http://www.investopedia.com/university/bonds/bonds2.asp (last visited Jan. 22, 2015) ("[T]he issuer's stability is your main assurance of getting paid back.") (on file with the Washington and Lee Law Review).

219. *See* BROWN, *supra* note 196, at xi ("People like to think they are able to assess the prospects of a company, presumably better than the market, and in the process make a fortune."); *see also* Dodge v. Ford, 170 N.W. 668, 681–82 (Mich. 1919) (describing how Ford stockholders sued the corporation when Henry Ford decided to reinvest profits in the company rather than distribute special dividends to stockholders and noting that stockholders expect to receive profit from their investment through dividend distributions).

220. *See* GAO REPORT, *supra* note 99, at 2 (expressing concern about whether retail investors in bonds have enough information about issuers); *see also id.* at 11 (noting that receiving annual information is insufficient to monitor an issuer's financial condition); MUNICIPAL BOND MARKET, *supra* note 203, at 10

investors in municipal bonds possess greater access to information about bond prices and market volume, retail investors do not enjoy this same access.[221] Many retail investors rely on their financial advisor or broker for information.[222] Corporate equity and bond investors, like institutional investors in municipal bonds, have greater access to market prices and trading volume due to greater market transparency.[223]

Fourth, the stock market experiences greater volatility in the short run than the bond market.[224] Thus, a bondholder is "less likely to suffer large losses in a short period" than a stockholder.[225] While an investment in stocks produces higher returns in the long run, an investment in bonds provides capital preservation and lower overall risk.[226] Consequently, stocks have

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(discussing that even radical differences exist between the municipal bond market and the corporate bond market for availability, timeliness, and comparability of credit information); BROWN, *supra* note 196, at xi (noting most national newspapers publish daily closing prices of leading stocks, but the majority of outstanding bond prices are not published).

221. *See* SEC Interpretive Release, *supra* note 67, at 12,756 (explaining that investors buy bonds relying upon outdated and incomplete information); Chris Downing & Frank Zhang, *Trading Activity and Price Volatility in the Municipal Bond Market*, J. FIN. 899, 900 (2004) ("Large institutional investors are likely to be much better informed about price and market volume than are individual investors . . . ."); Haines, *supra* note 100 (noting that investors complain about issuers releasing information "too little, too late").

222. *See* Hamilton, *supra* note 3, at 1029–30 ("With limited access to disclosure, a typical investor would be more likely to rely on word of mouth, the credit rating on the bond, and whether the bond enjoyed the protection of bond insurance.").

223. *See* SEC REPORT, *supra* note 8, at 2 (discussing that municipal bond investors have less access to information than investors in other U.S. capital markets); MUNICIPAL BOND MARKET, *supra* note 220, at 10 (describing the radical differences between the corporate bond market and the municipal bond market in terms of availability, timeliness, and comparability of credit information).

224. *See* Brady, *supra* note 210 (contrasting the market volatility between stocks and bonds).

225. *See* Thomas Kenny, *Why Invest in Bonds*, ABOUT MONEY, http://bonds.about.com/od/bonds101/a/Why-Invest-In-Bonds.htm (last visited Jan. 21, 2014) (noting that having a diversified portfolio with fixed income, including bonds, decreases potential loss because stocks may experience high volatility) (on file with the Washington and Lee Law Review).

226. *See* BROWN, *supra* note 196, at xi ("Bonds are intrinsically safer investments than equities.").

unlimited upside, while bonds do not.[227] Additionally, the price movement differs for stocks and bonds.[228] Further, between corporate bonds and municipal bonds, municipal bonds experience less volatility than corporate bonds, and corporate bonds are riskier investments.[229]

Fifth, the corporate bond market and the municipal bond market are distinct and separate. Generally, corporations issue corporate bonds possessing two different credit risks: investment-grade bonds and high-yield (or junk) bonds.[230] While investment-grade bonds are more analogous to municipal bonds because they have higher credit ratings than junk bonds, corporate bonds involve more credit risk and have higher rates of default.[231] Further, junk bonds have a higher correlation to movements in the stock market than the bond market.[232] Particularly during recessions, junk bonds' values fall because of the increase in default rates on these obligations.[233] Even though corporate

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227. *See* Brady, *supra* note 212 (noting the volatility and return differences between the stock market and the bond market).

228. *See* Michael J. Fleming & Eli M. Remdona, *What Moves the Bond Market?*, FED. RES. BANK OF N.Y. ECON. POL'Y REV., Dec. 1997, at 31, 32 ("[S]tock prices depend on both cash flows and the discount rate, while bond prices—for which cash flows are fixed in nominal terms—depend *only* on the discount rate.").

229. *See* SEC REPORT, *supra* note 8, at 22 (providing that municipal bonds have lower default rates than corporate bonds); Kenneth Daniels, Demissew Diro Ejara & Jayaraman Vijayakumar, *Debt Maturity, Credit Risk, and Information Asymmetry: The Case of Municipal Bonds*, 45 FIN. REV. 603, 604 (2010) [hereinafter *The Case of Municipal Bonds*] (discussing that underinvestment and excessive risk taking happen more in the corporate sector than the municipal bond sector).

230. *See* JEFFREY J. HAAS, CORPORATE FINANCE IN A NUTSHELL 215–16 (2004) (describing corporate bond credit ratings); *Types of Bonds*, LEARN BONDS, http://learnbonds.com/types-of-bonds/ (last visited Feb. 23, 2015) (outlining the four major types of bonds and generally describing each type) (on file with the Washington and Lee Law Review).

231. *See* David Waring, *Corporate Bonds*, LEARN BONDS (Feb. 2, 2012), http://learnbonds.com/corporate-bonds/ (last visited Feb. 23, 2015) (explaining general characteristics of corporate bonds) (on file with the Washington and Lee Law Review).

232. *See* David Waring, *Junk Bonds*, LEARN BONDS (Feb. 24, 2012), http://learnbonds.com/junk-bonds/ (last visited Feb. 23, 2015) (discussing junk bonds' performance) (on file with the Washington and Lee Law Review).

233. *See id.* (discussing junk bonds); *see also* HAAS, *supra* note 230, at 217–18 (describing junk bonds and their credit risk).

bonds involve more risk than municipal bonds, corporations are subject to greater securities regulation than municipal bond issuers.[234] Thus, a different materiality standard for the municipal bond market should compensate for the lack of regulation in the municipal bond market.

Last, the nature of the issuer of corporate equity and debt and of municipal bonds differs. Corporate issuers are profit driven and face higher risks of company failure.[235] Because corporations compete with each other to survive, they may face bankruptcy, experience liquidation, or change ownership.[236] As a result, the SEC requires greater financial disclosure from corporations—making them more transparent to the investing public—than it does (even indirectly) from municipalities.[237] Because municipalities do not engage in direct competition for survival, they are not profit driven in the same way that companies are; as a result, they are more stable and secure as vectors for investment.[238] Municipal bond default rarely occurs.[239] Even in the case of bankruptcy, municipalities are semi-

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234. *See supra* notes 46–64 and accompanying text (explaining that municipal bonds, unlike other U.S. capital markets, are largely exempt from regulation under the Securities Act and the Exchange Act).

235. *See* TEMEL, *supra* note 206, at 51 (discussing that "[m]ost state and local governments do not have the same profit motive" as corporations and issue bonds for public purposes); Dodge v. Ford, 170 N.W. 668, 684 (Mich. 1919) (determining that corporate purpose is profit maximization); *see also* SEC REPORT, *supra* note 8, at 22 (providing that municipal bonds have lower default rates than corporate bonds). *But see* Lyman Johnson & David Millon, *Corporate Law After* Hobby Lobby, 70 BUS. LAW. 1, 13–14 (2015) (arguing that corporate law does not require profit maximization and that corporations instead can pursue a wide variety of interests, including religious interests).

236. *See The Case of Municipal Bonds*, *supra* note 229, at 604 ("Corporations could face liquidity problems when [a corporate bond] matures, hence they face suboptimal liquidation.").

237. *See* Downing & Zhang, *supra* note 221, at 900 (noting that publicly held corporations must provide quarterly financial information while municipal bond issuers only provide annual financial information).

238. *See* SEC REPORT, *supra* note 8, at 22 (providing that municipal bonds have historically lower default rates than corporate and foreign bonds).

239. *See id.* at 24–25 (discussing that, although municipal defaults are rare, they do happen and highlighting many recent high-profile bankruptcies); *see also* GAO REPORT, *supra* note 99, at 19 (noting that between 1991 and 1997, 177 municipalities filed for bankruptcy, while 49,000 businesses filed for bankruptcy between March 2008 and March 2009).

sovereign, meaning "they do not undergo liquidation or any change in ownership."[240]

The primary purposes of regulating securities are protecting investors and stimulating efficient markets.[241] As a result, the materiality standard in the municipal bond context should incorporate retail investors' concerns: issuer creditworthiness, capital preservation, tax advantages, and meeting specific cash needs. Capital preservation and meeting specific cash needs depend upon one thing: Whether the issuer will meet its obligations.[242] Thus, the ultimate concern remains whether the investor will be repaid.[243] While the determinants of whether a municipal issuer can make payments depend on the type of bond issued, some determinants are as follows: (1) the municipality's future growth potential; (2) the current tax base; and, if the bonds are insured, (3) the bond insurer's ability to cover any shortfall related to an issuer's default (as measured by its credit rating).[244]

As the following applications show, the creditworthiness test most effectively encompasses these needs. As discussed in Part III.E, a fact would be material under this test if it substantially affects the creditworthiness of the municipality or the municipality's ability to make its debt service payments.[245] While this standard differs from the *TSC Industries* standard, the

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240. *The Case of Municipal Bonds*, *supra* note 229, at 604.

241. *See supra* notes 194–240 and accompanying text (discussing the differences between the municipal bond market and corporate equity and debt markets).

242. *See The Basics of Municipal Bonds*, INVESTOPEDIA, http://www.investopedia.com/articles/bonds/05/022805.asp (last visited Feb. 21, 2015) (discussing that if an issuer becomes unable to meet its financial obligations, then it may not be able to make interest payments or repayment of the principal) (on file with the Washington and Lee Law Review).

243. *See* CITIBANK, MUNICIPAL SECURITIES: AN INVESTOR'S GUIDE 4, 11 (2012), https://online.citibank.com/JRS/popups/Municipal_Securities_Brochure.pdf (explaining that repayment priority and the issuer's credit risk are important factors to consider when purchasing municipal bonds); LYDON, *supra* note 29, at 5 ("Credit quality is one of the main criteria when it comes to judging the investment quality of a bond.").

244. *See* TEMEL, *supra* note 34, at 172, 178, 191–92 (discussing credit determinants affecting an issuer's ability to meet its obligations).

245. *See* SEC Interpretive Release, *supra* note 67, at 12,575 ("[C]ommentators have called for timely disclosure of events that materially reflect on the creditworthiness of municipal securities issuers and obligors and the terms of their securities.").

municipal bond market and the corporate equity and debt markets have clear distinctions.[246]

B. TSC Industries Standard

Under the *TSC Industries* standard, a continuing disclosure or omission of a continuing disclosure meets the materiality threshold if the information would significantly alter a reasonable bondholder's total mix of information.[247] In Rule 15c2–12, if issuers were to replace "if material" with "if it would significantly alter a reasonable bondholder's total mix of information," then the issuers would have to evaluate whether any occurrences of the following events meet this materiality standard: nonpayment related defaults; material notices and determinations about tax status or material events affecting tax status of the bond; modifications to rights of security holders; bond calls; release, substitution, or sale of property securing the repayment of the bonds; mergers and acquisitions; and appointment of a successor or change in trustee.[248]

This standard presents problems for the MCDC Initiative. Issuers and underwriters deciding whether to participate in the initiative must look back over the past five years and determine whether any occurrence of those events that was not disclosed in a continuing disclosure significantly altered a reasonable investor's total mix of available information.[249] For speculative events, analyzing whether a reasonable investor would have considered the omission significant at the time presents

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246. *C.f.* Thomas Kenny, *The Difference Between Stocks and Bonds*, ABOUT MONEY, http://www.bonds.about.com/od/bonds101/a/The-Difference-Between-Stocks-And-Bonds.htm (last visited Jan. 9, 2015) (analyzing differences between stocks and bonds) (on file with the Washington and Lee Law Review).

247. *See* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 448–49 (1976) (describing the materiality standard).

248. *See* 17 C.F.R. § 240.15c2–12(b)(5)(i)(C)(2), (6), (7), (8), (10), (13), (14) (2014) (providing that the occurrence of these events must be disclosed, if material); *TSC Indus., Inc.*, 426 U.S. at 448–49 (discussing the materiality standard applied to Rule 14a–9).

249. *See TSC Indus., Inc.*, 426 U.S. at 448–49 (describing the materiality standard); *MCDC*, *supra* note 20 (providing that issuers and underwriters may self-report all material violations of noncompliance with continuing disclosures within the past five years).

difficulty.[250] Issuers must also consider how significant the reasonable investor would find the occurrence of one of these events.[251]

The *TSC Industries* materiality standard also poses several problems in the context of municipal bond disclosures, namely the distinctions between the stock market and the bond market.[252] First, the materiality standard revolves around stockholders, who possess voting rights.[253] Analyzing materiality from a voting standpoint must be based on subjective analysis of factors affecting voting decisions.[254] Bondholders, however, do not have voting rights.[255] Instead, they possess contract rights.[256] As such, they have no voice in an issuer's future direction of a municipality.[257]

Second, the factors affecting an issuer's creditworthiness "usually [do not] manifest in sudden shifts that lead immediately to distress."[258] A fact or event rising to the threshold of materiality could be a tipping point.[259] Put another way, the occurrence of an event in Rule 15c2–12 may indicate the issuer's financial condition but does not significantly alter a reasonable

250. *See* Basic, Inc. v. Levinson, 485 U.S. 224, 232 (1988) ("Where[] the event is contingent or speculative in nature, it is difficult to ascertain whether the 'reasonable investor' would have considered the omitted information significant at the time.").

251. *See id.* at 240 ("Materiality depends on the significance the reasonable investor would place on the withheld or misrepresented information.").

252. *See supra* notes 194–240 and accompanying text (discussing the differences between the stock market and the bond market).

253. *See* Hamilton, *supra* note 3, at 1032 (noting that stockholders engage in activism as a method of corporate accountability but that bondholders are at a marked disadvantage in comparison).

254. *See* KREIDER, *supra* note 176, at 5 (discussing the differences in viewpoints from a voting perspective and a market perspective).

255. *See* LEARN BONDS, *supra* note 169 (explaining the differences between bondholders' rights and stockholders' rights).

256. *See* David M.W. Harvey, *Bondholders' Rights and the Case for a Fiduciary Duty*, 65 ST. JOHN'S L. REV. 1023, 1036 (2012) (discussing that bondholders often rely on the bond contract for legal remedies).

257. *See* Hamilton, *supra* note 3, at 1032 (providing that bondholders do not have the same opportunities as stockholders to hold issuers accountable).

258. SCHMITT, CONSEQUENCES, *supra* note 83, at 10.

259. *See* MALCOLM GLADWELL, THE TIPPING POINT: HOW LITTLE THINGS CAN MAKE A BIG DIFFERENCE 7–9 (2000) (describing that a tipping point is a moment "when everything can change all at one" and "little causes can have big effects").

investor's total mix of information.[260] Several months or years later, however, when other events occur, it could cause subsequent facts and events to be material. Those subsequent facts and events would then be the tipping point to significantly alter the total mix of information.[261]

Third, the "reasonable investor" standard may not provide the best method of investor protection. The conceptualized "reasonable investor" includes several investor profiles: the rational investor,[262] the speculative investor,[263] and the sophisticated investor.[264] Yet, these profiles suggest a lack of protection for a less sophisticated investor—an investor who lacks strong financial literacy.[265] In fact, Professor Joan Heminway argued the reasonable investor is a female investor because female investors seek investment advice more often than their male counterparts, are more risk averse, and trade less often.[266]

Proponents of the *TSC Industries* materiality standard argue that the additional fact or event acting as the tipping point reveals the pertinent information an investor would consider and, therefore, should be disclosed.[267] At this point, disclosure could be too late before an issuer's financial deterioration and not provide

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260. *See* TSC Indus. Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (discussing that a fact rises to the threshold of material if it "significantly alter[s] the 'total mix' for information made available").

261. *See id.* at 448–49 (describing the need for a materiality standard that balances overdisclosure and underdisclosure); GLADWELL, *supra* note 259, at 7–9 ("[T]he idea that epidemics can rise or fall in one dramatic moment—is the most important[] . . . . The name given to that one dramatic moment in an epidemic when everything can change all at once is the Tipping Point.").

262. *See* Joan MacLeod Heminway, *Female Investors and Securities Fraud: Is the Reasonable Investor a Woman?*, 15 WM. & MARY J. WOMEN & L. 291, 296–98 (2009) (describing the reasonable investor as the rational investor).

263. *See id.* at 298–301 (explaining that the reasonable investor may include the speculative investor).

264. *See id.* at 301–06 (describing the reasonable investor as the sophisticated investor).

265. *See id.* at 306–09 (discussing that the courts, when describing the reasonable investor, exclude the less sophisticated investor, the moody investor, and the moral investor).

266. *See id.* at 319–22 (arguing that female investors conform closer to the reasonable investor than male investors).

267. *See* TSC Indus., Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (explaining that a material omission would have "assumed actual significance in the deliberations of the reasonable shareholder").

enough information in a timely manner to bondholders. Issuers that provide timely and regularly filed disclosures will provide adequate notice to investors of their deteriorating financial stability.[268]

Despite these problems with the *TSC Industries* materiality standard, the SEC will likely apply this standard in the municipal bond context. First, it is the classic definition of materiality.[269] Second, the U.S. Supreme Court adopted this test for Rule 10b–5 in *Basic Inc.*, so it seems likely that the Court would adopt it for other SEC rules.[270] Third, when speaking to the Michigan Municipal Finance Officers Association in 2000, SEC attorney Martha Haines cited the *TSC Industries* materiality standard when discussing continuing disclosures in the bond market.[271] Further, she noted that the concepts of materiality, accuracy, and completeness found in Rule 10b–5 apply to municipal bonds.[272] Finally, in the corporate bond market context, courts have applied this materiality standard.[273] Notwithstanding these reasons the SEC may rely on to apply the *TSC Industries* standard, this standard possesses many flaws for application in the municipal bond market.[274]

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268. *See* SCHMITT, CONSEQUENCES, *supra* note 83, at 11 (discussing that regular filing of continuing disclosures provides investors with warning of issuers' financial deterioration).

269. *See* KREIDER, *supra* note 176, at 6 (noting that, even though *TSC Industries, Inc.* was in the context of Rule 14a–9, the Court's definition of materiality remains the classic definition and that Sarbanes–Oxley Act also used this standard for professional conduct rules).

270. *See* Basic, Inc. v. Levinson, 485 U.S. 224, 232 (1988) (adopting the *TSC Industries* materiality standard for Rule 10b–5).

271. *See* Haines, *supra* note 100 ("A fact is 'material' if there is a substantial likelihood that the disclosure of the omitted fact would have been viewed by reasonable investors as having significantly altered the 'total mix' of information made available.").

272. *See id.* (advising that the materiality standards from Rule 10b–5 apply to municipal bonds).

273. *See* Valente v. Pepsico, Inc., 454 F. Supp. 1228, 1242–43 (D. Del. 1978) (concluding that an omission was not material where bondholders claimed that a tender offer omitted material facts).

274. *See supra* notes 249–266 and accompanying text (explaining the *TSC Industries* materiality standard in the municipal bond market context).

C. Efficient Market Test

Applying the Efficient Market Test, a fact or event meets the materiality threshold if it causes a change in the municipal bond market.[275] In Rule 15c2–12, issuers must file a continuing disclosure if the occurrence of the events with the qualifier "if material" causes a change in the bond market.[276]

This materiality standard functions better for equity markets. The standard requires issuers to analyze whether the occurrence of an event caused the bond's price or interest rate to change in the market.[277] Bond market fluctuations usually occur due to other market factors, such as a rise in interest rates or movements in the Treasury market.[278] Issuers would have to speculate whether a change in the market resulted from a larger, macroeconomic cause or from the occurrence of one of the events.[279] Because noncompliance with continuing disclosures is already widespread, requiring issuers to make these kinds of speculations might worsen compliance.[280] In hindsight, experts use event studies to determine the effect of material information on a security's market price.[281] Rule 15c2–12, however, requires

275. *See* KREIDER, *supra* note 176, at 5–6 (arguing that materiality should be analyzed by measuring a disclosure's effect on the market).

276. *See* 17 C.F.R. § 240.15c2–12(b)(i)(C)(2), (6), (7), (8), (10), (13), (14) (2014) (requiring that occurrence of these events must be disclosed within ten business days, if material); KREIDER, *supra* note 176, at 5–6 (discussing that the efficient market materiality test measures a disclosure's effect on the market).

277. *See* KREIDER, *supra* note 176, at 6 (noting that "any act or omission which noticeably affects that market is material because the efficient market depends on the free flow of correct and complete information").

278. *See* INST. OF CHARTERED FIN. ANALYSTS, *supra* note 203, at 18 (discussing that general economic conditions affect municipalities).

279. *Cf. In re* Countrywide Fin. Corp. Secs. Litig., 273 F.R.D. 586, 611 (C.D. Cal. 2009) ("[E]fficiency is somewhat harder to establish for non-exchange markets . . . where trades are less centralized."); *id.* at 615 ("Debt and equity respond differently to some types of news. Debt reacts to the risk of a change in interest rates . . . . Until the financial situation becomes severe enough that the issuer is likely to default, there is relatively little effect on debt price.").

280. *See* SEC REPORT, *supra* note 8, at 63 (noting that some panelists at the SEC field hearings urged the SEC not to impose more disclosures or standardized disclosures because small issuers may not have the resources and the municipal bond market is not a one size fits all market).

281. *See Countrywide*, 273 F.R.D. at 614 (describing the use of event studies to test for a causal connection between disclosure of information and price movement).

disclosure of the occurrence of an event within ten business days.[282] The market may not immediately incorporate the occurrence of the event.[283]

In reality, the markets are not as efficient as the economic models assume, so determining price changes from omitted disclosures can be speculative and difficult.[284] The lack of efficient market occurs because municipal bonds are not highly traded; thus, new information does not affect the price of municipal bonds as quickly as the price of equities. Additionally, applying this standard in court would likely result in a "battle of the experts."[285] The expert for the issuer would likely say that the omission of the event would not have affected the market, while the expert for the government would say that it would have affected the market.[286] Like the *TSC Industries* standard, the efficient market test is not the most optimal test for the municipal bond market.

D. Torts Standard

Applying the torts materiality standard to the continuing disclosure context, the occurrence of the events with the qualifier "if material" meets the materiality threshold "if a reasonable man would attach importance to its existence or nonexistence in determining his choice of action."[287] Like the *TSC Industries*

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282. *See* 17 C.F.R. § 240.15c2–12(b)(5)(i)(C) (2014) (providing the list of events).

283. *See Countrywide*, 273 F.R.D. at 612 (noting that "even an efficient market may not impound all material information immediately").

284. *See* BALLARD SPAHR, *supra* note 94 (discussing that the market effect of a disclosure or omission reliably measures a bond's price effect when the market is efficient and noting that "[t]he SEC has reported that the [municipal bond] market exhibits features inconsistent with efficiency").

285. *See In re* Countrywide Fin. Corp. Secs. Litig., 273 F.R.D. 586, 610 (C.D. Cal. 2009) (explaining that the defendants' experts and the plaintiffs' experts disagreed about "the degree of efficiency that is demonstrated by the record").

286. *See id.* at 615–23 (discussing the plaintiffs' expert's opinions and studies vis-à-vis the defendants' experts' opinions and studies regarding the efficiency of the securities' markets at issue).

287. *See* 17 C.F.R. § 240.15c2–12(b)(5)(i)(C)(2), (6), (7), (8), (10), (13), (14) (2014) (requiring that occurrence of these events, if material, must be disclosed within ten business days); RESTATEMENT (SECOND) OF TORTS § 538(2)(a) (AM. LAW INST. 1979) (explaining the materiality standard in the torts context).

standard, issuers would analyze an occurring event's importance.[288] Thus, an issuer must analyze whether the occurrence of any event in Rule 15c2–12 would cause a reasonable man to attach importance to its occurrence in determining his choice of action.[289]

This definition of materiality poses several problems for the municipal bond context. First, this definition lowers and broadens the materiality threshold.[290] If the materiality standard is too low and broad, then issuers over-disclose, burying important information in "an avalanche of trivial information."[291] This reasoning led the *TSC Industries* Court to reject this test and adopt the *TSC Industries* materiality standard.[292] Likewise, it seems improbable that the SEC or a court would apply the torts materiality standard in the context of Rule 15c2–12.

Second, this standard is not tailored to the securities market or the bond market because it uses a "reasonable man" standard rather than a "reasonable investor" standard.[293] Perhaps this slight distinction appears trivial, but a materiality standard should be based on a reasonable investor, not a reasonable man, which is used primarily in torts negligence claims.[294] While the

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288. *Compare* RESTATEMENT (SECOND) OF TORTS § 538(2)(a) (explaining that materiality depends on whether the "reasonable man would attach importance" to the matter), *with* TSC Indus., Inc. v. Northway, Inc. 426 U.S. 438, 449 (1976) (discussing that the material standard is whether the reasonable investor would consider it to "significantly alter[] the 'total mix' of information made available").

289. *See* 17 C.F.R. § 240.15c2–12(b)(5)(i)(C)(2), (7), (8), (10), (13), (14) (requiring that occurrence of these events must be disclosed within ten business days, if material); RESTATEMENT (SECOND) OF TORTS § 538(2)(a) (discussing the materiality standard in the torts context).

290. *See TSC Indus., Inc.*, 426 U.S. at 445 (discussing that the court of appeals applied the tort standard of materiality, but other courts rejected this standard because of the low threshold for liability).

291. *See id.* at 448–49 (analyzing the problems with the conventional tort materiality standard).

292. *See id.* (rejecting the application of the torts materiality standard for Rule 14a–9).

293. *See* RESTATEMENT (SECOND) OF TORTS § 538(2)(a) (AM. LAW INST. 1979) (determining materiality from the perspective of the "reasonable man").

294. *See* Michael J. Duffy, *Testing Good Securities Disclosure: Tales of the Reasonable Investor*, 38 MONASH UNIV. L. REV. 25, 26 (2012) (describing that the reasonable investor is a more specialized version of the reasonable man); James O. Hewitt, *Developing Concepts of Materiality and Disclosure*, 32 BUS. LAW. 887,

"reasonable man" possesses the perspective of the ordinarily prudent man, the "reasonable investor" possesses an understanding and sophistication of the securities markets.[295]

Overall, the torts materiality standard lowers the materiality threshold too much and fails to evaluate this threshold from the reasonable investor's perspective. As the standard is not applied in the context of Rule 14a–9 or Rule 10b–5, the standard should not be applied in the context of Rule 15c2–12.

E. Creditworthiness Test

Applying a creditworthiness test to the meaning of materiality in Rule 15c2–12 would mean that an event is material if it substantially affects the issuer's creditworthiness or ability to make its debt service payments.[296] Thus, an issuer must file a continuing disclosure if the occurrence of the events with the qualifier "if material" substantially affects the issuer's creditworthiness or its ability to make debt service payments.[297]

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895 (1977) ("Not all men are investors so it would seem that a test focusing on the 'reasonable man' would not reflect those added attributes, such as degree of knowledge about the markets, that a 'reasonable investor' would possess."); *see also In re* Caremark Int'l Inc., 698 A.2d 959, 967 n.16 (1996) (explaining why negligence allegations of a corporation's board of directors should not be evaluated from a "reasonable man" standard and providing that "[i]t is doubtful we want business men and women to be encouraged to make decisions as hypothetical person of ordinary judgment and prudence might").

295. *See* Josephine Coffey, *The Reasonable Investor Test Across Two Continents*, 1 J. AUSTRALASIAN L. TEACHERS ASS'N 45, 45 (2008) (comparing the reasonable investor test between Australia and Ireland); Heminway, *supra* note 262, at 301 (explaining that the courts expect the reasonable investor to "understand, for example, the time-value of money, diversification and risk, and the securities industry's compensation structure").

296. *See* SEC Interpretive Release, *supra* note 67, at 12,757 (noting that commenters requested that issuers make continuing disclosures for events that reflect upon the issuers' creditworthiness).

297. *See* 17 C.F.R. § 240.15c2–12(b)(5)(i)(C)(2), (6), (7), (8), (10), (13), (14) (requiring that occurrence of these events must be disclosed within ten business days, if material); *see also In re* HealthSouth Corp. Secs. Litig., 261 F.R.D. 616, 635–36 (N.D. Ala. 2009) ("[M]aterial unexpected information concerning the creditworthiness of the issuer or the prospect of default on bond obligations would be of interest to bondholders . . . ."); SEC Interpretive Release, *supra* note 67, at 12,757 (noting that commenters requested application of a creditworthiness test for continuing disclosures).

This test places the materiality threshold as the municipal bondholders' primary concern—whether the issuer will be able to meet its obligations.[298] Issuers, who have full access to information about their financial condition, can better evaluate whether the occurrence of any event in Rule 15c2–12 substantially affects their creditworthiness or default risk.[299] They do not have to make judgment calls about whether the occurring event will significantly affect the reasonable investor's total mix of information.[300] Using this standard could improve issuers' compliance with the continuing disclosure requirements. Greater compliance improves investors' access to information in the market, improving market efficiency.[301]

The standard also requires disclosure if the occurring event substantially affects the issuer's creditworthiness.[302] Disclosure of all events related to whether issuers will be able to service debt payments protects investors because it gives them timely notice of financial deterioration.[303]

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298. *See supra* notes 206–219, 243–244 and accompanying text (discussing bondholders' primary concern when investing in municipal bonds).

299. *See* Peter Borkin, *SEC's Message: Bond Issuers Must Provide Full, Accurate and Timely Information About Their Financial Condition or Face Prosecution*, HAGENS BERMAN (Nov. 2013), http://www.hb-securities.com/news/newsletters/Issue%205/sec-s-message-bond-issuers-must-provide-full-accurate-and-timely-information-about-their-financial-condition-or-face-prosecution (last visited Mar. 1, 2015) (quoting Rosalind Tyson, an SEC director of the Los Angeles Regional Office, "Municipal officials have a personal obligation to ensure that investors are provided with complete and accurate information about the issuer's financial condition") (on file with the Washington and Lee Law Review).

300. *See supra* text accompanying notes 249–266 (discussing the problems with the *TSC Industries* materiality standard).

301. *See* SEC REPORT, *supra* note 8, at ix (providing that transparency is vital to promoting competition); SCHMITT, CONSEQUENCES, *supra* note 83, at 11 (noting that if regular continuing disclosures show that the creditworthiness of a bond was deteriorating, an investor would not likely buy bonds at par or premium prices, so greater information leads to a more efficient market); Hamilton, *supra* note 3, at 1020 (discussing that the advice is only as good as the quality of available information).

302. *Cf. Credit Worthiness*, INVESTOPEDIA, http://www.investopedia.com/terms/c/credit-worthiness.asp (last visited Feb. 24, 2015) (defining creditworthiness as "[a]n assessment of the likelihood that a borrower will default on their debt obligations") (on file with the Washington and Lee Law Review).

303. *See id.* (discussing the meaning of creditworthiness); *see also* POPE,

Finally, this standard, to some extent, absorbs other materiality standards. The reasonable investor would consider new information important (tort standard) in relation to the total mix of information available (*TSC Industries* standard) if it reflects the issuer's ability to pay.[304] So, this test cuts more directly to the point, while also incorporating some benefits from the other materiality standards. Thus, the creditworthiness test provides the optimal materiality standard for the municipal bond market and Rule 15c2–12.

V. Application of a Creditworthiness Test in Rule 15c2–12

Of the materiality tests discussed in Part IV, the SEC should adopt the creditworthiness test to determine materiality in Rule 15c2–12. The following examples compare the application of the creditworthiness test with the *TSC Industries* materiality standard.[305]

In Scenario 1, a city issues tax-increment revenue bonds[306] to improve the municipality's urban residential area.[307] The project increases property values, which increases the property tax revenue flowing from the parcels near the improvements.[308] This incremental increase in property tax revenue collections provides the revenue stream for the bonds.[309] Suppose the issuer agreed to

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supra note 50, at 81 (explaining that disclosures provide to investors the risks associated with the particular bond).

304. *See supra* notes 160–165, 182 and accompanying test (explaining the *TSC Industries* materiality standard and the torts materiality standard).

305. *See supra* notes 269–273 and accompanying text (discussing the reasons why courts will likely apply the *TSC Industries* standard).

306. *See* Alexander D. Flachsbart, Note, *Municipal Bonds in Bankruptcy § 902(2) and the Proper Scope of "Special Revenues" in Chapter 9*, 72 WASH. & LEE L. REV. 955, 1012 (2015) (explaining that this type of financing is actually called tax-increment financing).

307. *See Urban Renewal Areas*, WESTMINSTER COLORADO, http://www.ci.westminster.co.us/CityGovernment/CommunityDevelopment/UrbanRenewalAreas.aspx (last visited Mar. 1, 2015) (describing Westminster's urban renewal areas and the revenue bonds issued to provide the funding) (on file with the Washington and Lee Law Review).

308. *See id.* (explaining that the redeveloped area with a shopping center and grocery store in South Westminster improved property values).

309. *See id.* (noting that increased property tax revenue from the redevelopment of Holly Park will generate the repayment of the bonds).

use the proceeds of the bond issue to plant trees in the improved area. Instead, due to structural and spatial concerns, the issuer used the proceeds to build additional sidewalks. Failing to plant the trees would be a nonpayment related default.[310] An issuer must disclose its occurrence within ten business days, if material.[311] Failing to plant the trees likely would not substantially affect an issuer's creditworthiness because the property tax revenue continues to provide the funding for the revenue bond obligations.[312] Likewise, applying the *TSC Industries* standard, failing to plant the trees likely would not significantly alter a reasonable investor's total mix of information. Thus, in some circumstances, the determination of whether an event is material applying either the creditworthiness test or the *TSC Industries* standard will be the same.

As a contrasting example,[313] suppose a municipality finances the purchase of a new city hall by marketing lease obligations through a third-party lessor.[314] The third-party lessor buys the property and leases it to the municipality.[315] Then the third-party lessor assigns the lease to a trustee, who sells fractional interests in the lease—called "certificates of participation" (COPs)—to investors.[316] Thus, the municipality makes lease payments, which

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310. *See* 17 C.F.R. § 240.15c2–12(b)(5)(i)(C)(2) (2014) (providing that one of the continuing disclosures is the occurrence of a non-payment related default, if material).

311. *Id.*

312. This scenario assumes that the lack of trees does not mean that property values will not increase, which would jeopardize bondholder repayment.

313. In scenario 1, the increase in property tax collections caused by the increase in property values provides the revenue stream for the bonds. In scenario 2, certificates of participation function like general obligation bonds. Repayment of the certificates of participation can come from any available municipal revenue. Thus, in scenario 1, bondholders are concerned about the issuer's creditworthiness related to the increase in property taxes, while in scenario 2, bondholders are concerned about the issuer's overall creditworthiness.

314. *See* CAL. DEBT ADVISORY COMM'N, GUIDELINES FOR LEASES AND CERTIFICATES OF PARTICIPATION 4 (1993), http://www.treasurer.ca.gov/cdiac/reports/Guidelines93-8.pdf (explaining certificate of participation lease structures).

315. *See id.* (describing the typical certificate of participation offering).

316. *See id.* ("[A] COP entitles its owner to a proportionate share of

the trustee splits up proportionally and distributes to the COP holders.[317] Then, suppose the municipality leases part of the city hall building to a small business, which has a history of missing lease payments.

Under Rule 15c2–12, this event could be considered a "substitution . . . of property securing repayment of the securities."[318] Under a continuing disclosure agreement, the issuer would have to disclose the occurrence of this event within ten business days, if material.[319] Applying the creditworthiness test for materiality, the issuer would likely not have to report the occurrence of this event.[320] Because the creditworthiness test focuses on the *sources of revenue available for repayment*, it would recognize that COPs are secured by *all available municipal revenues*, not just those derived from leasing portions of city hall. Assuming the city otherwise is in solid financial shape, the mere occurrence of leasing part of city hall to a small business does not substantially affect the issuer's creditworthiness or ability to meet its obligations.

Alternatively, under the *TSC Industries* standard, the occurrence of this event would likely significantly alter the reasonable investor's total mix of information.[321] Because the *TSC Industries* standard considers *all* information about an issuer, including how it manages certain elements of its property, it could easily place too much emphasis on an event that, though relatively minor, directly affects the collateral securing the COPs.[322]

Applying the creditworthiness test and the *TSC Industries* standard reaches the same conclusion regarding materiality in

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lease . . . payments made by a government agency pursuant to a lease . . . agreement. For all intents and purposes, COPS function like municipal bonds.").

317. *Id.*

318. 17 C.F.R. § 240.15c2–12(b)(i)(C)(10) (2014).

319. *Id.*

320. *See supra* notes 190–193 and accompanying text (describing the creditworthiness test).

321. *See supra* notes 160–162 and accompanying text (discussing the *TSC Industries* materiality standard).

322. *See* Flachsbart, *supra* note 306, at 966 (explaining that, because COPs are fractional lease interests, they are ultimately property rights secured by the right of foreclosure).

the first scenario but different conclusions in the second scenario. Even though the creditworthiness test would not require the occurrence of the second example to be disclosed, the test targets bondholders' main concern—whether the issuer will meet its obligations. The *TSC Industries* standard considers the event's occurrence within the total mix of information, but the creditworthiness test considers whether the event's occurrence substantially affects the issuer's ability to meet its obligations.[323] Therefore, disclosures under the creditworthiness test will deliver information municipal bondholders need.[324]

While it is unclear whether the creditworthiness test will provide more or fewer disclosures than the *TSC Industries* standard, under-disclosure and over-disclosure present problems for investors. The former does not provide enough material information to investors, and the latter provides too much information such that the investor loses material information among the trivial information.[325] Finding the creditworthiness test's place on this spectrum of under-disclosure and over-disclosure can be challenging. Whether the creditworthiness increases or decreases the number of disclosures required of any given municipality, it is guaranteed to improve the flow of the most relevant information to bondholders.[326] Further, as a "buy and hold" market, investors hold municipal bonds to receive the interest payments and principal when the bond matures.[327] This test imparts to the investors the issuer's creditworthiness throughout the bond's lifetime. Thus, providing material information regarding the creditworthiness of an issuer accomplishes the goal of investor protection.[328]

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323. *See supra* notes 247–266, 296–303 and accompanying text (explaining the *TSC Industries* materiality standard and the creditworthiness test in the context of municipal bonds).

324. *See supra* notes 296–303 and accompanying text (discussing the creditworthiness test in the context of municipal bonds).

325. *See supra* note 164 and accompanying text (providing the *TSC Industries* materiality standard).

326. *See supra* notes 76–83, 101 and accompanying text (describing the current problems with continuing disclosures in the municipal bond market and the need for increased transparency).

327. *See supra* note 210 and accompanying text (explaining that most retail bondholders hold their bonds until maturity).

328. *See* SEC Interpretive Release, *supra* note 67, at i (describing that the

Issuer feasibility for a potential increase in disclosures is also a concern. Securities regulations balance investor protection by preventing burdensome regulation of issuers. Small issuers who rarely go to market with an offering may not have the resources to make more disclosures.[329] Issuers also resist added disclosures because of the costs associated with making the disclosures and fear of potential liability related to disclosures.[330] Even so, the amount of regulation issuers must follow remains minimal compared to publicly held corporations.[331]

VI. Conclusion

Overall, the SEC should adopt and apply the creditworthiness test to determine materiality in the context of Rule 15c2–12. Currently, municipal bond issuers have little guidance as to the meaning of materiality in this context and fail to provide important continuing disclosures. Municipal bondholders, whose primary concern pertains to issuers' creditworthiness, need material information to evaluate and value municipal bonds. Disclosures concerning the issuers' creditworthiness provide the critical information bondholders need and increase transparency in the municipal bond market. The municipal bond market's unique structure—the SEC's limited regulation and the differences from the corporate equity and debt markets—lends itself to application of a different materiality standard from the *TSC Industries* standard. The materiality standard should provide investor protection and recognize the municipal bond market's needs. The creditworthiness test accomplishes both of these goals.

SEC's mission includes protecting investors, maintaining efficient markets, and facilitating capital formation).

329. *See id.* at 64 (expressing concern on smaller issuers' limited resources to make more disclosures).

330. *See* SEC REPORT, *supra* note 8, at 12,755 (explaining that issuers are resistant to developing routine, ongoing disclosures).

331. *See supra* notes 46–64 and accompanying text (discussing that the Securities Act, the Exchange Act, and the Tower Amendment exempt municipal bonds from the vast majority of the regulations).