

**IN THE
SUPREME COURT OF MISSOURI**

NO. SC93532

**STATE OF MISSOURI, ex rel.
MORGAN KEEGAN & COMPANY, INC.**

Relator

vs.

HON. PATRICIA JOYCE

Respondent

**On a Writ of Prohibition from the Circuit Court of Cole County
Cause No. 12AC-CC00184
The Honorable Patricia Joyce**

**BRIEF OF THE SECURITIES INDUSTRY AND FINANCIAL MARKETS
ASSOCIATION AS AMICUS CURIAE IN SUPPORT OF
RELATOR MORGAN KEEGAN & COMPANY, INC.**

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INTEREST OF AMICUS CURIAE

The Securities Industry and Financial Markets Association (SIFMA) brings together the shared interests of hundreds of securities firms, banks and asset managers.¹ Many SIFMA members serve as underwriters of municipal bonds. Bond underwriters assist municipalities with the issuance of bonds to generate capital for schools, hospitals, housing, and economic development projects. By issuing bonds, municipalities borrow money from the investing public, which reasonably expects that the municipalities will be honest and forthright in their dealings regarding the bonds. Investors and underwriters alike also expect municipalities to honor their commitments to pay the principal and interest owed to the investors on the municipal bonds.

SIFMA has an interest in a legal environment that will facilitate successful bond issues at the lowest cost to governmental entities and their taxpayer/constituents. The beneficiaries of such a legal environment are the governmental bond issuers, their taxpayers, and the purchasers of bonds (investors). The investors include individuals, bond funds that sell to individuals, and institutional investors.

¹ SIFMA's mission is to support a strong financial industry, investor opportunity, capital formation, job creation and economic growth, while building trust and confidence in the financial markets. SIFMA, with offices in New York and Washington, D.C., is the U.S. regional member of the Global Financial Markets Association (GFMA). For more information, visit www.sifma.org.

SIFMA has a specific interest in this case because of the destabilizing impact on bond markets and the erosion of investor confidence that would result should municipal governments enjoy sovereign immunity for acts of fraud in bond issues. Bond underwriters have long believed, quite reasonably, that municipalities are not immune from fraud under common law sovereign immunity principles. Indeed, the antifraud provisions of the federal securities laws specifically apply to municipal securities,² and the United States Securities and Exchange Commission (ñSECò) has this year alone brought at least seven separate enforcement actions against municipal issuers for failing to make honest and forthright disclosures regarding the municipal bonds that those municipalities issued.³

The trial court's decision removes a right of recourse for non-payment due to fraud and exposes bond underwriters to a previously unidentified risk. The trial court's decision, if upheld by this Court, will make it more difficult for municipalities in Missouri to access the capital markets to finance important projects in their communities. If municipal issuers in Missouri enjoy sovereign immunity from fraud, either (a) municipal bond underwriters will not underwrite bonds in Missouri, or (b) the costs of municipal bond issuance in Missouri will increase significantly as underwriters and

² See Section 17(a) of the Securities Act of 1933 (15 U.S.C §77q(a)) and Section 10(b) of the Securities Exchange Act of 1934 (15 U.S.C. §78j(b)).

³ See Section C , below.

investors alike try to compensate for increased risk from lack of recourse against the issuer, even for fraud.

Either result is against the interests of bond underwriters, many of whom are members of SIFMA. Moreover, the harm to the bond markets from granting immunity for fraud also hurts municipal bond issuers whose ability to borrow or cost to borrow will be severely impeded.

SIFMA submits this brief in support of Relator Morgan Keegan to provide this Court with a practical understanding of the effect that allowing the trial court's ruling to stand would have on sellers and buyers of municipal bonds, an effect that will reach far beyond the parties to this case.⁴

⁴ SIFMA presents its arguments for the purpose of showing the impact of a fraud-immunity rule like that established by the trial court here. SIFMA does not express any opinion on the specific allegations or conduct engaged in by the parties to this litigation.

ARGUMENT

I. IMMUNIZING FRAUDULENT ACTS BY MUNICIPAL OFFICIALS WILL INCREASE THE RISK TO BOND PURCHASERS, WHICH WILL IMPEDE ISSUANCE OF BONDS OR INCREASE THEIR COSTS, A BURDEN THAT WILL ULTIMATELY BE BORNE BY TAXPAYERS

A. What Bond Underwriters Do And The People They Serve.

Bond underwriting is a mechanism for state and local governments to borrow money for capital or economic development projects. The issuance of bonds is often much more feasible than the alternative of the governmental body saving money from tax revenues until enough is accumulated to commence a capital project.

Municipal bonds (also called municipal securities) are a promise by state or local governmental units (called issuers) to repay to lenders (the investors or purchasers) the amount borrowed, plus interest. Bonds are repaid, or mature, anywhere from one to 40 years from the date they are issued.⁵

An underwriter of municipal securities is a broker-dealer that purchases some or all of the bonds issued and attempts to sell those bonds to investors. The underwriter earns a fee for its services by buying the bonds at one price and selling the bonds at another price.⁶ The difference in the price the underwriter pays for the bonds and the

⁵ N. O'Hara, *The Fundamentals of Municipal Bonds* (6th Ed. 2012) (published by SIFMA), at 1 (ñ*Fundamentals*) (A3).

⁶ *SEC v. Fitzgerald*, 135 F. Supp.2d 992, 998 (N.D. Cal. 2001).

price at which the underwriter sells the bonds is called the “spread” or “discount.”⁷

Underwriters must master the delicate balance of finding the yield that produces lowest borrowing cost for the municipality but also the highest yield for the investor consistent with the issuer’s credit.⁸

As the risk associated with non-payment from the municipality increases, the interest needed to induce potential purchasers to invest increases. In the case of bonds, if the risk of non-payment to the investors creates enough uncertainty, underwriters will choose not to underwrite (purchase, for sale to the public) the bonds at all.

Municipalities typically issue an “Official Statement” in connection with a bond offering. Underwriters are required to review the Official Statement before bidding on or purchasing the bond offering. The Official Statement informs the investors about the issuer and the specific offering, including the terms, sources of payment, and credit enhancements.⁹ Ultimately, it is the issuing municipality that controls and is responsible for the contents of the Official Statement. The contents of the Official Statement are intended to be relied upon by municipal underwriters and investors alike. As information regarding the bonds is distilled into the marketplace, the primary reliable source for that information is the Official Statement of the Issuer. In this case, as in most every

⁷ *Fundamentals*, at 97 (A9).

⁸ *Fundamentals*, at 99-100 (A10-A11).

⁹ *Fundamentals*, at 46-47, 73-75 (A4-A8).

municipal bond, the Official Statement included a specific disclaimer that forecloses reliance on information inconsistent with the Official Statement:

"No dealer, broker, salesman, or other person has been authorized by the Authority to give any information or to make any representations with respect to the Bonds offered hereby other than those contained in this Official Statement, and, if given or made, such other information or representations must not be relied upon as having been authorized by the Authority."¹⁰

Sovereign immunity for fraud in the preparation of the Official Statement will undermine the reliability of these primary descriptions of municipal securities, and have broad-reaching effects. Individual or "retail" investors hold more than 75% of the outstanding principal amount of municipal bonds, either directly or indirectly.¹¹ Direct ownership by households or individuals accounts for 50% of the outstanding bonds. Another 25% of bonds are owned indirectly by individuals in the form of mutual funds, money market funds, or similar funds.¹²

¹⁰ Official Statement (A16).

¹¹ U.S. Securities and Exchange Commission, *Report on the Municipal Securities Market*, 7/31/2012, at 1, available at <http://www.sec.gov/news/studies/2012/munireport073112.pdf> ("SEC Report") (A19).

¹² SEC Report, at 12 (A20).

A vibrant municipal bonds market is critical to municipal governments both nationally and in Missouri. There were \$3.7 *trillion* in municipal bonds outstanding nationwide in 2012.¹³ Those outstanding bonds came from more than one million offerings issued by 44,000 issuers.¹⁴ According to data compiled by the Missouri State Auditor, Missouri municipalities issue hundreds of millions of dollars in municipal general obligation bonds each year. In all, there have been more than \$14.8 billion in municipal general obligation bonds issued in Missouri since 1999.¹⁵ While this is a significant piece of the municipal bond market from Missouri, it does not capture all of the Missouri municipal bonds. Appropriation bond structures (such as the Moberly bonds) or certificates of participation are not tracked by the Missouri State Auditor, but they account for significant additional sources of capital investment. According to publicly available records provided to the Court by Relator Morgan Keegan, there was more than \$1.2 billion in appropriated municipal debt outstanding at the time it filed its writ of prohibition.¹⁶

¹³ *SEC Report*, at 1 (A19).

¹⁴ *SEC Report*, at 1 (A19).

¹⁵ <http://www.auditor.mo.gov/Bonds/Index.aspx>

¹⁶ Writ Petition, Ex. H.

B. Bond Underwriters And Investors Carry Less Risk When Municipal Bond Issuers Can Be Liable For Their Own Fraudulent Conduct.

It is not surprising that immunity for persons engaged in fraud increases risk. This is the case for two reasons even when the underwriter thoroughly investigates the creditworthiness and integrity of the issuer. First, immunity for fraud removes a source of recourse for the lender/investor after a default by the issuer. A limitation on a source of recovery for an unpaid debt inevitably increases risk.

Second, immunity reduces the risk *to the municipal issuer* of engaging in fraud or concealment, thereby eliminating an incentive to disclose all material information in a full and accurate way. Most municipalities presumably disclose information as they should. But with 44,000 issuers, the elimination of an incentive for full disclosure is certain to have an impact on some issuers. The difficulty facing underwriters and investors is that they do not know which issuers will not fully and fairly disclose, especially if the issuers believe they have immunity from fraud charges, depressing the overall market and hurting those issuers that have proper disclosures.

C. Bond Underwriters Have Believed That Municipal Bond Issuers Can Be Liable For Fraud.

The decision of the trial court creates an aberration from standard commercial activity in the United States. Commerce, and specifically lending, is facilitated by a legal system that creates consequences for fraudulent activity. But the trial court held that one type of seller can commit fraud with impunity and immunity: municipal bond issuers.

Bond underwriters did not, and could not, have anticipated that ruling. There is not one published decision of any state court immunizing municipal bond issuers from fraud under sovereign immunity principles. The United States Court of Appeals for the Ninth Circuit is the only court of which SIFMA is aware to immunize fraud for municipal issuers, and it did so based on a specific California *statute* granting immunity. *Nuveen Municipal High Income Opportunity Fund v. City of Alameda*, 730 F.3d 1111 (9th Cir. 2013). The *Nuveen* court specifically referred to “statutory immunity,” and did not use the phrase “sovereign immunity” anywhere in the opinion. 730 F.3d at 1115, 1125-27.

Nor are municipalities immune under federal law. The United States Securities and Exchange Commission specifically stated in a 2013 Report that “antifraud provisions of the federal securities laws prohibit any person, **including municipal issuers** . . . from making any untrue statement of material fact, or omitting any material facts necessary to make statements, in the light of the circumstances under which they were made, not misleading”¹⁷

This has long been the position of the SEC. For instance, when the SEC promulgated rule amendments in 1994, it stated: “Both the Securities Act and the Exchange Act were enacted with broad exemptions for municipal securities from all of their provisions except the antifraud provisions of the Securities Act Section 17(a) and

¹⁷ *SEC Report*, at 29 (A21) (emphasis added).

the Exchange Act Section 10(b).¹⁸ Also, the SEC declared in 1994 that the statements in a municipal issuer's Official Statement are "made" by the issuer, not by the underwriter:

The rule requires that underwriters . . . obtain and distribute to their customers the issuer's official statements for the offerings. This mechanism provides underwriters an opportunity to review *the issuer's disclosure documents* before commencing sales to investors.¹⁹

The SEC has brought numerous enforcement actions against municipalities and other governmental agencies over the last 20 years, including Orange County (California), Maricopa County (Arizona), Syracuse (New York), Miami (Florida), the Massachusetts Turnpike Authority, San Diego (California), and the State of New Jersey.²⁰ At least seven similar actions against municipal issuers have been brought by the SEC in 2013 against issuers across the country, confirming that fraud by issuers is

¹⁸ SEC's 1994 Amendment to Rule 15c2-12 under the Exchange Act, 17 CFR Part 240, Release No. 34-34961; File No. S7-5-94 (available at <http://www.sec.gov/rules/final/adpt6.txt>).

¹⁹ *Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others*, SEC Release No. 33-7049; 34-33741, 59 Fed. Reg. 12747, 12749 (March 17, 1994) (emphasis added) (available at <http://www.sec.gov/rules/interp/1994/33-7049.pdf>).

²⁰ *SEC Report*, at 59-60 (A22-A23).

neither appropriate nor subject to sovereign immunity under the applicable federal securities laws:

- State of Illinois (March 11, 2013)²¹
- City of Victorville, California (April 29, 2013)²²
- City of Harrisburg, Pennsylvania (May 6, 2013)²³
- City of South Miami, Florida (May 22, 2013)²⁴
- City of Miami, Florida (July 19, 2013)²⁵
- West Clark Community School, Indiana (July 29, 2013)²⁶

The SEC's pursuit of fraud by municipal bond issuers most recently resulted in its first assessment of a financial penalty against a municipal issuer: the Greater Wenatchee [Washington] Regional Events Center Public Facilities District (November 5, 2013) (\$20,000 penalty).²⁷ Clearly, the SEC recognizes the importance of enforcing anti-fraud

²¹ <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171513202#.UnvM5KjTmo4>

²² <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171514980#.UnvIP6jTmo4>; see also <https://www.sec.gov/litigation/complaints/2013/comp-pr2013-75.pdf>

²³ <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171514194#.UnvKl6jTmo4>

²⁴ <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1365171514424#.UnvJuqjTmo4>

²⁵ <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539727618#.UnvI8ajTmo4>

²⁶ <http://www.sec.gov/News/PressRelease/Detail/PressRelease/1370539734122#.UnvKEajTmo4>

²⁷ <http://www.sec.gov/litigation/admin/2013/33-9471.pdf>

laws against municipal bond issuers. Unfortunately, with 44,000 issuers, the SEC (like other regulators) will not be able to prosecute all instances of wrongdoing.

Missouri statutes would also lead underwriters and investors to believe that municipal bond issuers are not immune. The anti-fraud provisions of the Missouri Securities Act of 2003 make it unlawful for a "person" to make an untrue statement or omit a material fact, and define a "person" to include "government, governmental subdivision, agency, or instrumentality." Mo. Rev. Stat. §§ 409.5-501(2), 409.1-102(20).

In this context, municipal bond underwriters and investors assumed and should have assumed that municipal issuers were subject to fraud claims. Missouri should not be the first state to strip away that right through application of common law sovereign immunity.

D. Immunizing Fraud By Issuers Would Motivate Underwriters And Investors To Refrain From Purchasing Bonds Or Require Higher Interest.

As explained above, the trial court ruling, if adopted by this Court, would create an unprecedented and unexpected increase in risk for municipal bond underwriters and investors. Missouri would stand alone if it invoked sovereign immunity for municipal fraud. Even California provided immunity only in the face of a legislative directive.

Unexpected changes in risk allocations destabilize the market and jeopardize continued investor confidence. No matter how thorough the investigation and due diligence of underwriters and how great the confidence in the municipality, immunity necessarily increases risk. When that occurs, it is inevitable that investors will lose

confidence in bond markets and they will either be dissuaded from participating in that market or incentivized to require a higher interest rate to offset the risk. As conduits between the municipal bond issuers and the ultimate investors, the bond underwriters will have to factor in the increased risk and uncertainty on the investor side in determining the price paid by the underwriter. If fraud causes a bond default (and issuers are immune from suit), underwriters will inevitably be sued for failure to detect the fraud, whether or not detection was possible. The increased potential of legal expense to underwriters will lead them to require a larger spread from every issuer. This means that all issuers will receive less of the bond proceeds from an offering.

As noted above, underwriters engage in the delicate balance of finding the yield that produces lowest borrowing cost for the municipality but also the highest yield for the investor consistent with the issuer's credit. The effect of the trial court's ruling is, essentially, to **impair the credit** of every municipal issuer. That means yields must rise to pay investors for additional credit risk. The cost of paying those higher interest rates will be borne by taxpayers.

It is difficult to achieve a delicate balance for multi-million dollar deals when an unknown and unexpected weight throws off the balance.

Skewing the market does more than hurt underwriters. It will, at best, make it more costly for municipal governments to borrow and increase the burden on taxpayers throughout Missouri and possibly many other states. In some cases, the opportunity to raise funds through bond issues will be lost entirely.

CONCLUSION

Municipal officials who engage in fraud, conceal material information, or otherwise are not candid with prospective lenders (bond purchasers) will undoubtedly support the ruling of the trial court. But for those government officials who believe in candor and accountability, the effect of the trial court's decision, if upheld by this Court, will be to make borrowing through bond issues impossible in some cases or more costly to the issuer and its taxpayers in many others.

For the benefit of the many municipalities who follow high ethical and legal standards, for the benefit of the taxpayers and constituents of those municipalities, and for the benefit of vulnerable senior citizens and others who rely on honest government officials when investing their retirement, education, health care, or other savings in municipal bonds, this Court should order the trial court to vacate its Order of dismissal of the City of Moberly.

Respectfully submitted,

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CERTIFICATE OF COMPLIANCE AND SERVICE

This brief complies with Rule 55.03 and the requirements of Rule 84.06(b), and contains 3,103 words (excluding the cover, signature block and this certificate); has been prepared in proportionally spaced typeface using the software application for Microsoft Word 2010 in 13 point Times New Roman font.

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