Remarks Of

Richard Y. Roberts
Commissioner*
U.S. Securities and Exchange Commission
Washington, D.C.

Regulatory Issues in the Municipal Securities Area

Remarks delivered to the
Municipal Division Executive Committee of the
Public Securities Association

Phoenix, Arizona
February 29, 1992

---

*/ The views expressed herein are those of Commissioner Roberts and do not necessarily represent those of the Commission, other Commissioners or the staff.

U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

I. INTRODUCTION

Over the past year-and-a-half that I have been a member of the Commission, a great deal has been accomplished. A couple of examples are that we have attempted to remove some of the confusion that existed for officers and directors that must report securities transactions under Section 16 of the 1934 Act; and we have crafted new rules that are designed to assure the credit quality of money market funds that invest in short-term corporate debt. And there have been many more accomplishments. But, we have yet to approve the MSRB's proposal to create a repository for secondary market information, or to address in any serious fashion the adequacy of information flows in the municipal market.

The municipal securities market is a national asset that has served investors and issuers well for many years. I would like to take a few minutes today to talk about ways that it might be improved. Among other things, I will suggest a specific suitability requirement for dealers selling unrated bonds to retail investors and the need for Commission action to facilitate industry efforts to improve access to secondary market disclosure.

II. PRIMARY MARKETS

A. Registration

The success of the municipal securities industry in improving primary market disclosure cannot be over emphasized. Voluntary efforts on the part of groups such as the Government Finance Officers Association and others, including the PSA, have had a significant effect on improving the disclosure that is available to investors. In the absence of a Regulation S-K or S-X, and without guidance from the Commission or Congress, the industry has developed its own primary disclosure standards. Based largely on the improvements achieved by the industry, the Commission has determined that the exemption from registration for governmental issuers continues to be justified.

B. Conduit Bonds

The Commission consistently has been careful to note, however, that whatever accolades are deserved by the municipal market as a whole are not necessarily shared by each of its components. Over the past five years, for example, industrial revenue bonds, housing bonds, and nursing home and hospital bonds yearly have accounted for roughly three quarters

or more of the total dollar amount of payment defaults of all municipal securities.[1] Moreover, frequently the defaulted issues were unrated, sold to unsophisticated investors, and subject to limited governmental controls, if any.

Although these conduit offerings account for only a portion of the total municipal volume, they have produced a disproportionate amount of the problems attributable to the municipal markets as a whole in recent years. Unlike bonds issued by governmental issuers, the issuers of many of the unrated bonds are subject to the same vagaries of the business and housing cycle as their taxable corporate counterparts whose securities are registered with the Commission. Investors in these tax exempt securities, however, are denied the full measure of protection offered by the federal securities laws.

In the 1960's and 70's, governmental issuer groups resisted all forms of federal encroachment in the municipal securities market. There were concerns that extending the federal securities registration requirements to even a limited portion of the tax exempt securities market was an

---

[1] Source: Bond Investors Association.

unacceptable burden on states' rights. Increasingly, however, I sense a recognition within the industry that federal tax policy and the application of the federal securities laws need not be linked. Indeed, an argument is often advanced that the current registration exemption for certain issuers pays too much homage to the needs of the individual communities at the expense of both governmental issuers and individual investors.

C. Suitability

While I believe that registration of securities offerings by some of these issuers may ultimately be necessary, there are other, less intrusive, short-term methods of reducing risks to investors that may be appropriate. As many of you are acutely aware, following a default on special tax district bonds or on nursing home bonds, reports fill the newspapers and television shows about small investors who simply had no business investing in some of these high-risk securities. Many of these investors may have made a conscious choice to take the risk, but inevitably, some did not.

I intend to urge that the Division of Market Regulation strongly consider drafting a rule to recommend to the Commission that would

require any broker-dealer that "recommends" unrated municipal bonds to retail customers, whether in primary or secondary market transactions, to fully document its reasons for determining that the investment was suitable for a particular investor. Broker-dealers currently are required by law to make such suitability determinations, and most already do so. Nevertheless, in other circumstances, requiring a written record of that suitability determination has proven valuable in focusing the dealer's attention on the need to ascertain the investor's objectives, and on the ability of both the Commission's and the NASD's enforcement staffs to detect problems before investors are seriously harmed.

III. SECONDARY MARKET DISCLOSURE

A. Overview

I also would like to say a few words about secondary market disclosure. It should be obvious to everyone that the municipal securities industry needs to work together to make sure that the partnership between investors and the issuer continues into the secondary market.

Cost effective secondary market disclosure is an idea whose time has come. Many municipal issuers have recognized the value of secondary

market disclosure and voluntarily provide information to the market. In addition, some municipal issuers must make available annual reports to satisfy state law requirements, and more limited periodic information may be required by rating agencies.

One must recognize, however, that the preparation and dissemination of secondary market information entails costs. While these costs may be prohibitive for some small issuers, the marginal expense associated with collecting and disseminating information already available to a great number of issuers should not be significant. Nevertheless, the willingness of an issuer to provide information to the secondary market should produce value in terms of liquidity and accurate pricing at the time of resale that can be factored into the return demanded by investors.

Although I believe that a decision to provide secondary market information should be intuitive, a great deal of effort already has been devoted to creating awareness among issuers of the need for secondary market disclosure. The efforts of the GFOA, the American Bankers Association's Corporate Trust Committee, the National Federation of Municipal Analysts, and the PSA, to name a few, will be the catalysts for

continued improvement in secondary market disclosure. I particularly want to praise the PSA and NFMA for encouraging issuers to disclose, at the time of sale, the extent, if any, of their commitment to provide secondary market disclosure. I also wish to congratulate the NFMA for its ongoing project to recognize exemplary disclosure efforts by the issuer community.

There also should be sensitivity to the fact that more disclosure is not necessarily better disclosure. The information that is provided to the secondary market should be both reliable and relevant. In this regard, I wish to emphasize that concerns about the legal liabilities of issuers disclosing information into the secondary market are not a legitimate reason for slowing the progress that already is underway. Each day, both corporate and municipal issuers talk to analysts, issue press releases, make speeches, and engage in other activities that reasonably can be expected to reach investors. The one requirement imposed by the general antifraud provisions of the federal securities laws is that when issuers speak, they speak accurately and completely.

Lawyers have an important role to play in any industry efforts to develop disclosure guidelines. Moreover, they should impress upon clients their responsibilities under the federal securities laws. Nevertheless, I do not view the voluntary, organized presentation of information to the secondary market as a source of greater liability for issuers than they already encounter. If there are liability issues that need to be addressed, those issues should be placed in their proper perspective and should not become an impediment to improving voluntary disclosure efforts.

B. MSRB Proposal

The Commission also has a role to play. It is unfortunate that the Commission has not done more thus far to work with the industry as it attempts to implement a voluntary disclosure program. As many of you are aware, last June the Commission tabled a proposal by the MSRB to create a system that rapidly transmits pre-default notices from trustees to the market. The proposal, dubbed the Continuing Disclosure Initiative/Electronic Submission ("CDI/ES"), would have been limited initially in its scope, yet it could be expanded in the future to allow for the submission and dissemination of other types of relevant secondary

market information. In fact, issuer groups, including the National Council of State Housing Finance Agencies and the National Council of Health Facilities Financing Authorities, as well as the ABA's Corporate Trust Committee, have spearheaded efforts to develop uniform periodic reporting formats in anticipation of disseminating the information through the MSRB's facilities.

Several Commissioners, particularly the Chairman, expressed concern about the initially limited scope of the MSRB's proposal, and the requirement that information be submitted only in electronic form. The MSRB, I believe, has responded in a satisfactory manner to these concerns. While I would eventually like to see a more comprehensive approach, there are a number of difficult issues that would need to be resolved before it will be prudent to undertake a more significant effort. Among other things, as I alluded to earlier, the secondary market information currently produced comes in a variety of formats that, in many cases, bears little resemblance to the periodic reports that are produced by public companies for Exchange Act purposes. Moreover, the

MSRB itself, is constrained from requiring issuers to submit information or to dictate the form and content of documents that are supplied.

The lengthy documents that municipal issuers use for other purposes, including comprehensive annual financial reports, may prove difficult to disseminate and in some cases would provide only limited marginal benefit to investors. In my view, it simply is not realistic to expect any repository to act as a dumping ground for useless information. Before an efficient central source of secondary market information can be established, the first step must be for issuers and investors to develop uniform forms that will present information that is relevant and that can be economically justified. Nevertheless, it is important for everyone to continue moving forward. I hope that the Commission will act soon to permit the MSRB to begin implementation of its pilot program.

C. Amendments to Rule 2a-7

I also believe that the willingness of an issuer to provide secondary market information, or to indicate sources from which it may be obtained, should be significant to mutual funds investing in municipal securities. The need for funds to have access to current information about issues of

VRDNs, in particular, was highlighted for me by the problems experienced by tax-exempt money market funds holding notes that were insured by Mutual Benefit Life Insurance. Upon seizure of the insurer, which had provided credit support for over $244 million in VRDNs, funds operating under Rule 2a-7 were required to divest themselves of these securities. Nevertheless, without information concerning the current financial condition of the underlying issuers, there were significant problems in valuing the securities for resale.

Where the maturity of a security is determined by reference to a demand feature (as is the case with a large percentage of tax exempt bond portfolios), the instrument is, in reality, a long-term instrument. If the demand feature is not exercised, a considerable amount of time may pass since the fund made the initial determination that the demand feature and the underlying security present minimal credit risks. In contrast, monies invested in short-term securities must be periodically reinvested by the funds, triggering the obligation to perform a new risk evaluation.

While some investors place great faith in the presence of credit enhancement, Chairman Breeden recently noted that:

> **The seizure of Mutual Benefit . . . reinforces the principle that the existence of a guarantee or other form of credit enhancement from an insurance company, bank, or other financial institution does not obviate the need for complete and current disclosure concerning municipal and conduit issuers and, with respect to industrial revenue bonds, the financial viability of the projects financed with bond proceeds.[2]**

I hope that if, and when, any amendments addressing tax-exempt money market funds are published for comment, members of the industry will have the opportunity to express their views on the adequacy of current information concerning issuers of VRDNs, and on whether an explicit information requirement is necessary to assure the integrity of tax-exempt money market funds.

IV. ENFORCEMENT

A. General

Finally, I wish to mention that the Commission also must play a greater role in insuring the reliability of information that is provided to

---

[2] Letter from Richard C. Breeden, Chairman, U.S. Securities and Exchange Commission to the Honorable John D. Dingell, Chairman, Committee on Energy and Commerce, U.S. House of Representatives (October 29, 1991).

the market. In the municipal market, unlike the corporate market, the Commission does not review filings, or come into contact daily with issuers, underwriters, and their counsel as offerings are being prepared for sale to the public. Instead, the Commission relies on the members of the PSA and others who draft the documents, perform the investigations, and write the disclosure opinions.

One of my predecessors at the Commission, Justice William O. Douglas, stressed the importance of voluntary efforts, but added that the Commission kept a well oiled shotgun behind the door. While the vast majority of the issuers, dealers and attorneys involved in the offering process strive to provide investors with necessary, accurate disclosure, with the tools that the Commission has available, the Commission has not focused enough attention in its enforcement program on the municipal securities market.

Without the deterrent effect of an active Commission enforcement program, some issuers, dealers and their counsel have not had a full appreciation of their obligations under the law. The Commission also owes a responsibility to investors and members of the industry to increase

its enforcement presence in the municipal market, so that the whole industry is not tainted by the activities of a minority of its members.

B. Coordination with IRS & Treasury

Along this line, I have encouraged the development of a dialogue between the senior staff of the Division of Enforcement and representatives of both the IRS and Treasury that are actively involved in the municipal market. A member of my staff already has met with IRS and Treasury officials, and it is my understanding that Bill McLucas, the Division Director of Enforcement, is beginning to explore ways to share information between the agencies - just as the Commission has in memoranda of understanding with other federal agencies that permit the Commission to detect securities law violations that may not otherwise come to our attention. I look forward to the progress of this dialogue toward the development of a meaningful intra-agency information sharing arrangement.

V. CONCLUSION

In conclusion, let me say that the members of this audience will face many difficult policy and legal issues as they attempt to improve the

municipal securities market. I look forward to working with the PSA in attempting to successfully resolve all of these issues.