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Washington, D.C.

"Additional Attention Warranted for Debt Markets"

Remarks before the National Federation of
Municipal Analysts

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

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I. INTRODUCTION

I had the opportunity to meet with Katherine and Mary Jo earlier this year in Washington and learned a great deal about some of the recent activities of the National Federation of Municipal Analysts ("NFMA"). I want to commend you on producing the Disclosure Handbook last year and for your ongoing efforts to improve disclosure in the secondary market for municipal securities.

II. Growth in the Debt Markets

The universe of the fixed income market has been expanding during the past decade. With the introduction of new financing techniques, the debt markets have become increasingly important. As a taxpayer, it is striking to note that at the end of 1990, long-term debt of state and local government issuers came to nearly $650 billion. Further, during the last decade, U.S. government debt has grown at a rate of approximately 13% annually to almost $3 trillion. And the diversity of products and financing techniques used today in the public securities markets exceeds anything that could have been imagined in the 1970s.

Notwithstanding their growing importance in this country, fixed - income markets, particularly the municipal markets, have taken a back seat to the nation's equity markets. I would like to spend a few minutes discussing the need for bondholders, specifically the members of this audience, to be more militant in preserving their rights under current law, as well as the need for the Commission to focus more attention on strengthening the integrity of our nation's debt markets. Particularly in light of the growth in the municipal markets, I believe that it is time for all of us to undertake an assessment of the protections afforded fixed-income investors.

III. Bondholder Activism

As many of you are aware, since the dawn of time, bondholders have been viewed under state corporate law as contract claimants to whom no fiduciary duty is owed. In theory, debt investors may negotiate the terms of the indenture and preserve their rights by requiring protective covenants in the bond contract. Thus, the responsibilities of corporate directors and municipal issuers to their bondholders are defined precisely by the terms of the contract, and not by the general notions of fiduciary duty or fairness that otherwise would govern the relationship between shareholders and issuers in the corporate market.1/

In a perfect world, with full disclosure, the theory is that bondholders will write contracts to protect themselves from perceived risks or will demand premiums to reflect the risk. But today, in most cases, bond contracts are written largely by issuers and their counsel, perhaps with input from the rating agencies. Moreover, an investor in the secondary market has little opportunity to rewrite the bond contract.

If the sole recourse of bondholders under state law is to enforce contractual rights under the bond contract, then investors need to become more militant. Investors also need the protections of adequate disclosure

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1/ It has been suggested that the distinction between duties owed to shareholders and bondholders can be justified by their different economic interests. Decisions affecting a corporation are likely to have the most significant effect on those on the bottom end of the pecking order - the shareholders. To illustrate this contrast in perspective, economists note that once an issuer has precisely enough revenues to repay the bondholders, the bondholders have no incentive to encourage the corporation to engage in additional activities that are likely to involve risks, because the bondholders will not share in the rewards. See Lehn & Poulson, The Economics of Event Risk: The Case of Bondholders in Leveraged Buyouts, 15 J. of Corp. Law, 199, 205, n.49 (1990), citing, T. Copeland & J. Weston, Financial Theory and Corporate Policy, 509 (3rd ed. 1988). Obviously, the rationale does not exist in the municipal markets in which there is no equity counterpart to the debt investor.

and of a market that can transmit accurate, current price information, so that the value of the bond contract can be reflected in the price of the security.

IV. The Federal Securities Laws

Beyond the fundamental distinctions that exist between bondholders and equity holders under state corporate law, there also is a distinction that is evident in the federal securities laws. Although it is very subtle, I believe that there is discrimination between equity investors, who are perceived as participating in the growth of our nation's capital, and bondholders, who are perceived as mere creditors. Many of the inherent safeguards, and many of the structural market protections, that are present in the equity markets do not exist for debt holders under our federal securities laws. And, until recently, the Commission's focus, in terms of investor protection, has largely been on the most visible segment of the securities markets - the equities market.

In 1975, for example, Congress added Section 11A to the Exchange Act and required the Commission to establish a National Market System for securities. In doing so, Congress found that, among other things, it was "in the public interest" to have: (1) economically efficient execution of securities transactions; (2) fair competition among broker-dealers; (3) the availability of information with respect to quotations for and transactions in securities; and (4) the execution by broker-dealers of investors' orders in the best markets. As a result of this Congressional mandate, the Commission and industry jointly have worked on the development of an efficient National Market System for equity securities. We now have an intermarket trading system and real time quote and trade reports that allow investors the chance to identify and access the most competitive markets for a particular security.

The fixed income markets, however, have largely been an "after-thought" in our regulatory scheme. In the 1975 legislation that required the Commission to take a hard look at the way equity securities were traded, there was little mention of the market for over-the-counter and exchange listed corporate debt; and the legislation made clear that the municipal securities markets were not to be included in the Commission's efforts. While the Commission has discussed for over twenty years the prospect of improving transparency in the fixed-income markets, today,

the corporate, municipal, government, and asset-backed markets have become too important to ignore. Nevertheless, these markets currently lack the disclosure and price discovery mechanisms that characterize modern efficient markets.

Although there are obvious differences between the equity markets and the debt markets, and efforts are underway to make improvements, with the technology and resources we now have available, additional attention should be devoted to improving our debt markets. To illustrate one of the problems that currently exists, The Wall Street Journal reported several weeks ago that a retail customer was quoted bids of $22 and $34 for a company's bonds by different market makers on the same day.2/ I would not be surprised to learn that similar price disparities exist in the municipal bond market. Current trade price reporting would reduce price disparities by enhancing competition among dealers in debt securities and by allowing customers to make more informed investment decisions.

2/ Laurie Cohen, "Let the Small Investor Beware of Those Junk Bond Prices," Wall Street Journal, p.C1 (March 18, 1991).

The different level of regulatory protections afforded debt and equity investors is not only evident in our market structure. It also exists under the Commission's periodic reporting and tender offer regulatory scheme. In fact, in the municipal and high yield corporate debt markets, the absence of secondary market information may be the greatest impediment to increased efficiency. It is not only municipal investors that are denied the Commission's periodic reporting requirements. For corporate issuers, secondary market information is required only if there are 300 or more equity investors, regardless of the number of debt holders the corporation may have.

V. The Future

Although the solution to some of the problems in the fixed income markets may need to come from federal and state legislators, it appears that progress already is underway at the Commission and in the industry. Bloomberg, Cantor, Reuters, Telerate, Bridge and others now provide important market information about segments of the bond market that was not available ten years ago. In addition, in the 1990s, I increasingly sense an awareness at the Commission of the need to focus more attention on improving our debt markets. There already has been movement to increase the price transparency in the non-investment grade corporate debt and government securities markets. However, as I will expand upon in a minute, we do need to determine whether similar systems could be developed in the municipal markets.

A. Active Investors

I am pleased to see that a sleeping giant is awakening in the fixed-income markets. Many of you represent mutual funds and other publicly held corporations that have a fiduciary or regulatory obligation to conduct a prudent review of investments: a task that is made more difficult by inadequate secondary market information. However, in the absence of specific Commission disclosure requirements investors are beginning to demand covenants in indentures that give them the right to receive necessary secondary market information. The well known letter from Loews Corporation, indicating that the company would not purchase bonds that do not offer a covenant to supply periodic disclosure, and the continuing disclosure provisions in last year's Massachusetts Water Resources Authority offering, demonstrate that investors can have a role in influencing disclosure. The "Wall Street Walk" is taking a back seat to shareholder activism in the equity markets, and more "buy side" members of this audience need to become militant as well.

It remains important, however, to be sensitive to the costs imposed on issuers. Disclosure should be relevant and cost justified. For that reason, I applaud the efforts of your organization, the GFOA, and the National Council of State Housing Authorities for working with their members to develop relevant disclosure guidelines.

B. MSRB Library

Once information is prepared, it should be made easily accessible to all investors. For example, the Municipal Securities Rulemaking Board (the "MSRB") has pending with the Commission three rulemaking proposals that would further the goal of improving secondary market information in the municipal bond area. Separate proposals would allow the MSRB: (1) to create an electronic library for disclosure documents used in primary offerings of municipal securities; (2) to require dealers to submit copies of certain refunding documents that are necessary to determine call provisions on outstanding bonds; and (3) to accept, on a voluntary basis, secondary market disclosure from issuers and trustees.

While each of these three separate proposals is important, and interrelated, the development of a central repository for secondary market information is the most significant. Although I have some reservations about particular aspects of the MSRB's library proposal, I believe that the creation of a central library is the next logical stage in the evolution of disclosure in this market. Moreover, the MSRB's proposal, which promotes voluntary disclosure of secondary market information, is probably the least intrusive means of addressing current problems. I also am pleased to see that the prospect of the MSRB's library has been the catalyst for a number of industry organizations to actively seek ways to improve secondary market disclosure, without requesting legislative solutions.

Notwithstanding the obvious benefits of the MSRB's library, commenters have raised serious concerns that will need to be resolved if the library is approved. At a minimum, my support would be premised on the clear understanding that the MSRB would not use the library as a lever to dictate the content of issuer disclosure. Another concern raised by commenters is that the MSRB's proposal is contrary to the statutory requirement that MSRB rules not "impose [a]... burden on competition that would not be necessary or appropriate in furtherance of the purposes of the Exchange Act."3/ I am very sensitive to competitive issues, particularly where a self-regulatory organization is involved. However, I think that the MSRB's library can be a source of innovation that will produce benefits for the industry, without burdening competition.

There are examples of current programs in which limited governmental involvement in private enterprise has proven to be justified when there are public benefits and when individual businesses that are potential competitors have proven to be either too small or too unwilling to incur the necessary costs of an unproven venture. For example, private enterprise may be risk averse, or it may be apparent that the benefits of the undertaking are not likely to sufficiently compensate any individual entrepreneur for the costs incurred. Moreover, antitrust considerations, in some cases, may preclude several enterprises from entering into a joint

3/ 15 U.S.C. §78o-4(b)(2)(C).

venture. The MSRB's proposal has the advantage of allowing private enterprise (i.e., underwriters and dealers) to conduct the experiment, through the auspices of the MSRB, without any government subsidy.

As in other areas, if the MSRB's library proves to be successful, the private organizations like J.J. Kenny, Bloomberg and the Bond Buyer will be able to refine the concept. Rather than crowding out competition, by performing a central storage function, the MSRB's library may ease entry into the market and foster competition. By the same token, however, the MSRB's library would allow the private competitors to reduce their own cost of maintaining documents and to allocate additional resources to the more important functions of synthesizing and disseminating information. Although there may be some restructuring in the short run, the process is likely to produce net benefits to the market participants by increasing the useful information that is available.

Finally, I want to mention a matter that is entirely separate from the issue of whether the MSRB's library should be approved by the Commission. Even assuming that the Commission votes to allow the MSRB to create the library, the lack of information about many of the over 70,000 issuers, and 250,000 issues, will not likely be resolved. A great majority of these issues are not actively traded, and the cost of producing secondary market information will not be justified. Nevertheless, as a result of efforts by the GFOA to encourage voluntary preparation of annual reports, along with state laws requiring some issuers to file annual reports, as well as rating agency requirements, there currently is extensive secondary market information produced by issuers that is not easily accessible to investors.

If the MSRB's library is established, cooperation between the MSRB and industry groups will be critical to its success. Our goal should not be simply to encourage the filing of voluminous information, but to encourage the preparation and dissemination of relevant information. A state-by-state, segment-by-segment, evaluation of current disclosure will be required, similar to that currently being conducted by the GFOA and the National Association of State Auditors, Comptrollers and Treasurers ("NASACT") in their "Demonstration Program". If the MSRB's library is approved, the Commission also should be ready to make a commitment to

work with industry groups to offer the benefit of its resources and experience.

VI. Conclusion

In closing, I would like to commend the NFMA for the work that it has done to date. Although our current securities laws do not require all that is necessary to promote disclosure in the secondary market, the members of this audience control the economic power necessary to force change. Regardless of what the Commission or Congress does in the future, you have the means to effect change today. Make your views on disclosure known to regulators and legislators, but most importantly, make your views known when you invest.