Remarks Of

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# "Modernize Customer Protection Rules Too"

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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 appreciate the opportunity to participate in a Municipal Forum of New York program. While I prefer southern weather and southern traffic, not to mention a southern dialect, it is a pleasure to be here all the same.

It is an exciting time for municipal securities market enthusiasts. The municipal securities market is receiving more investor attention than ever before, much of it of the retail nature. The vast bulk of this attention, save for a few exceptions, is positive.[1] As a general proposition, it is gratifying to see the debt markets receive the visibility that they have so long deserved.[2]

I have always held the view that it is wise during the good times to step back, consider the developments that are taking place, and attempt to prepare for the future. While this view goes against the grain of the old saying "if it ain't broke, don't fix it," more often than not, a little fine tuning is helpful to avoid the necessity for more massive and expensive tinkering under a pressure cooker environment when times are not so good.[3] Thus, I am pleased that the Municipal Securities Rulemaking Board ("MSRB") is now in the throes of a customer protection study. With all the additional investor attention now being focused on the municipal securities market, I believe that it is timely and appropriate to undertake such a project.

## II. Customer Protection Study

As a result of the comment process conducted by the MSRB for the study, a couple of positive developments have already occurred for the municipal securities marketplace in my judgment.

### A. Developments

The Commission, the MSRB, and the National Association of Securities Dealers ("NASD") have been reviewing their collective municipal securities compliance and enforcement efforts to determine how those efforts can be improved. I suspect that, at a minimum, the coordination and communication among the Commission, the MSRB, and the NASD will be enhanced. I also expect that more resources will be directed by these organizations toward additional enforcement efforts in the municipal securities marketplace.[4] I know that all three organizations are committed to performing the best job possible given the fragmented jurisdiction that exists in the municipal area.

Several comment letters to the MSRB identified, correctly in my view, the lack of secondary market information as one of the more serious problems in the area of customer protection for the municipal securities market.[5] Certainly most municipal bondholders now lack access to the information they need to assess the continuing creditworthiness and value of the bonds they own, or may consider purchasing, in the secondary market.[6]

The lack of secondary market disclosure will continue to be an impediment to the liquidity and efficiency of the municipal securities secondary market. While this problem remains a long way from being solved, there are indications that the heightened awareness caused, among other things, by the study comment letters has accelerated the progress of the improvements beginning to take place in the municipal securities secondary market disclosure area.[7] Hopefully, with time, secondary market disclosure in the municipal securities market will improve dramatically through voluntary means.

B. MSRB Rulemaking Action

The MSRB's study should generate MSRB rulemaking action as well. Currently I understand that the MSRB is considering revising its suitability rule, Rule G-19.[8] I am of the opinion that Rule G-19 should at least be amended to conform generally to the NASD's equity suitability requirements.

A municipal firm recommending securities should determine the suitability of its recommendation based on what has been disclosed by the customer and, in the absence of such disclosure, should not be able to assume that its recommendations are suitable. Given the flood of new products with complex features and the increase in retail investor interest in the municipal securities market, this appears to be a reasonable proposition. Even assuming there existed an original justification, I am unaware of any logical justification now supporting the continued presence of the "no reasonable grounds to believe . . ." clause currently contained in MSRB Rule G-19.

By strengthening Rule G-19 to conform the rule to requirements currently imposed on broker-dealers outside of the municipal securities market, the MSRB's suitability rule would then match the highest professional standards in dealers' relationships with customers. Again, that appears to be a reasonable requirement for a marketplace known for its integrity. Consistency between the NASD's and the MSRB's suitability requirements should also make the NASD's compliance examination efforts in the municipal securities area much simpler.

I am encouraged by the MSRB's announced intention to amend Rule G-19, and I look forward to the publication of a proposed revised rule in the near future.

There are other rulemaking actions that the MSRB may contemplate as a result of its study. For example, I understand that the MSRB may consider changes to its confirmation rules. If so, I urge that strong consideration be given to expressly requiring municipal securities dealers to emphasize to customers the potential special risks related to an unrated security prior to or at the time of the trade.[9] This approach should provide information to allow the customer to protect himself or herself, rather than relying only on broker-dealer suitability determinations.

I do not need to tell the members of this audience that there are often special circumstances associated with the purchase of an unrated security, such as credit or liquidity concerns, that should be emphasized to potential investors.[10]

I noticed along these lines, in its comment letter to the MSRB, the National Association of Bond Lawyers ("NABL") indicated, if necessary, that it "would support a rule [which] required confirmations to contain the following statement for unrated securities:

The security you have purchased has not, to our knowledge, received a rating from any national credit rating agency. Absence of a rating may involve special circumstances of which the purchaser should be aware."[11]

Some firms apparently already include such disclosure as a matter of course.[12] The NABL suggestion strikes me as a sound proposal, and one that I generally recommend to the MSRB for consideration.

While the official statement remains the principal disclosure document, I understand that it is not reviewed with the same intensity as the confirmation by the municipal securities retail investor. Alerting investors that they are purchasing an unrated security through the confirmation should not be burdensome to the securities industry and could help avoid substantial future problems.

I do not agree as some have stated, that such a requirement would result in a bifurcated market for unrated securities. In fact, I submit that only unrated securities issued by a tax-exempt issuer, without any significant positive operating history, would be adversely impacted from a pricing standpoint by such a requirement, and I suspect that those issuers encounter pricing problems already.

III. Derivatives

There is another area that I understand the MSRB is giving some consideration to addressing through its customer protection study and that is the area of derivative municipal securities.[13] The subject of derivatives, and the need for the MSRB to consider those instruments as a part of its customer protection study will be the focus of the remainder of my presentation today.

As I have mentioned previously, during the past few years, the municipal securities market has witnessed the rapid proliferation of complex derivative products.[14] These products generally have been targeted to large institutional investors who have used them to tailor risks and returns in light of changing market conditions and rising and falling interest rates.[15] My notion of customer protection for large institutional investors, from a regulatory standpoint, has long been dictated by the maxim "big boys should not bellow when their bold interest rate bets bomb."

However, now, new derivative products are being developed apparently with retail investors in mind.[16] While previously these products raised questions as to the risks they posed only for institutional investors, that is apparently no longer the case. Since these new products will be arriving on "Main Street" soon, a question both the Commission and the MSRB must ponder is how these instruments should be treated from a customer protection standpoint to best ensure investor protection in the market for municipal securities.[17] It may be helpful at this juncture to briefly describe and discuss some of the derivative products.

A. Detachable Call Options

One of the newly developed municipal derivative products is the so-called detachable call option. First offered by Paine Webber in early 1992, and later by Goldman Sachs & Co. and other firms, detachable call options involve the division of a typical callable bond into two separate securities -- the underlying debt security and a separate option to call the bond. This separate option may be retained by the issuer or sold to investors at the time the bonds are first sold, or thereafter. Once sold, the option may be freely bought and sold by investors having no ownership interest in the underlying municipal debt obligation.

Like most of the other derivative municipal securities products, the detachable call options being offered to investors in so-called "stripped call" deals have been designed primarily for institutional investors as a hedge against declining interest rates. With these institutional investors in mind, I understand that the detachable calls have been issued in units representing the ability to call up to $100,000 in bonds. Detachable call options, however, may be exercised one bond at a time and may be traded in the secondary market in increments representing the right to call only a single bond.

Ordinary callable municipal bonds allow issuers to reduce their borrowing costs when interest rates fall by calling high interest bonds away from investors and issuing new bonds at a lower rate of interest. If retained by issuers, detachable call options enable issuers to obtain the economic benefit of lower rates by selling the in-the-money calls to an investment bank or investor for a premium, thus capturing much of the benefit of the interest rate differential without the costs of a refunding debt issuance.

The economic benefit of selling bonds with detachable calls depends, however, on whether the bonds are priced at a discount because of the detachable call. Generally, the price of a callable bond is affected by the likelihood the bond will be called. Initially, investment banks claimed that bonds with detachable calls were sold without any price differential, but there are indications that this circumstance may be changing.[18]

In determining the likelihood that bonds will be called by the issuer, investors factor into their investment decision the issuer's cost of issuance, other outstanding bond obligations, and revenue flow. When call options are held by unknown third parties who presumably have the funds to call the bonds, these factors are not relevant; and the probability that a particular series of bonds will be called is increased if interest rate movements on or after the call date make it worthwhile.[19]

B. Other Municipal Derivatives

The detachable call option of course is only one of the new municipal derivative products being issued. Some, like the so-called "Strips and Pieces" products issued by Lehman Brothers, are akin to the structure of many Treasury strip securities in that they divide municipal securities into more than two dozen separable principal and interest income components.[20] Other proprietary derivative products, variously known as RIBs (residual interest bonds), SAVRs (select auction variable rate securities), "Bulls" and "Bears", and Short/Rites, Cap/Rites and Float/Rites, involve both short-term floating rate securities and "inverse floaters," or securities that promise increasing returns on municipal debt as interest rates decline. Like detachable call options, most of these securities have been developed to permit institutional investors to adjust the risks and returns of their municipal bond portfolios.

Inverse floaters may be created in one of two ways, but each begins with a municipal issuer undertaking the basic obligation to pay a fixed rate of interest on its indebtedness. So-called "swap driven" derivatives are created when the issuer enters into a swap agreement with the underwriter. Under this agreement, the issuer trades its fixed rate obligation for the underwriter's agreement to pay a variable rate of interest. The variable rate paid by the underwriter is passed on to investors holding the derivative securities, while the issuer bears the counterparty risk regarding the underwriter. Non-swap driven derivatives are created by issuers without entering into swap agreements or incurring any counterparty risk.

A typical inverse floater offering has two securities -- an "inverse" and a "floater". The floater is a standard, short-term debt investment that resets interest rates periodically either through dutch auctions or in relation to an established municipal bond index. The floater typically offers attractive short-term returns and is used by corporate investors as a cash management tool. During periods of declining interest rates, the floater rate is likely to fall below the issuer's basic fixed-rate obligation. The difference between the fixed and floating rate is added to the issuer's fixed rate and paid to investors holding "inverse" securities. In return for providing investors with the ability to adjust portfolio risks and returns with these specialized securities, issuers are rewarded with the ability to shave 10 or more basis points off the usual fixed-rate obligations underlying these derivative products, thus reducing the costs of issuing municipal debt.[21]

Typically, as I indicated, these derivative products have been sold exclusively to institutional investors. One recent derivative product, however, was sold to a select group of high net worth retail investors. This new product, called a Tax-Exempt Enhanced

Municipal Security, or TEEMS, was offered by Merrill Lynch in connection with the recent $740 million bond offering by the Puerto Rico Telephone Authority.[22]

Like inverse floaters, the creation of a TEEMS begins with the issuance of fixed rate bonds. The TEEMS, however, functions like the "inverse" component of an inverse floater. For approximately five years, it pays a variable rate of return that increases as interest rates fall. In the event interest rates go up, returns will fall, but not below a pre-determined floor, now apparently set at 3 percent.

C. Regulatory Issues

The potential movement of derivative products such as TEEMS and detachable call options into the investment portfolios of individual investors raises new concerns regarding investor protection, investment suitability, and market liquidity in the municipal bond market. I encourage the MSRB to consider all of these concerns as a part of its customer protection study.

As everyone here is aware, municipal securities broker-dealers selling municipal securities are subject to the rules of the MSRB rather than the NASD. However, because the municipal market historically has been a "traditional" debt market, the MSRB rules presently governing sales practices require review and probably revision in order to keep pace with the development of complex derivative municipal securities.

For example, registered representatives of broker-dealers engaged in the offer and sale of equity options must be separately licensed to sell option products. They also must evaluate whether options are a suitable investment for their customers based on special options suitability rules.[23] Moreover, Rule 9b-1 under the Securities Exchange Act of 1934 requires broker-dealers to deliver an options disclosure document to customers before accepting customer orders to trade standardized options.

Existing MSRB rules impose upon broker-dealers and municipal dealers an obligation to determine customer suitability for specific investments. The MSRB rules, however, do not have specific training and qualification requirements regarding options or other derivative municipal products and lack affirmative disclosure obligations with respect to inherently risky investments such as options. While most institutional investors either are, or treated as if they are, capable of understanding and managing the risks associated with investing in these complex products, suitability and qualification concerns become more magnified as the market for municipal derivatives expands to include a broader base of smaller institutional and retail investors.

For example, detachable call options, like options on corporate securities, have different risks than traditional municipal bonds and may fluctuate widely in value or expire worthless. Likewise, the universe of investors for whom conventional municipal bonds may be an appropriate investment may not be, in most cases, the group of investors for whom inverse floaters and other variable rate derivative products are suitable.[24]

Less sophisticated investors may not be able to comprehend fully the risk-reward ratio involved in municipal derivative products, thus placing even greater emphasis on the role of the salesperson to inform investors and to determine how appropriate a product may be for a particular investor.[25] As firms expand sales activity in this area, the need for special training and qualification standards, sales and supervisory procedures, and adequate disclosure to investors becomes much greater.[26]

Moreover, the lack of standardization among derivative products that are tailored to the specific investment goals of individual institutional investors, or classes of institutional investors, raises questions regarding their liquidity. For instance, although inverse floaters are attractive to investors as interest rates decline, the liquidity of such products, if current market trends reverse and interest rates begin to climb, is unknown.[27]

## IV. Conclusion

In conclusion, I submit that the development of derivative municipal securities, including detachable call options and inverse floaters, merits continued close scrutiny as the market for these products expands to include smaller institutional investors and retail customers. Given the risks associated with investing in these products, careful scrutiny is needed not only to monitor the evolution of a market for these securities, but more importantly, to ensure that sufficient measures are taken by the appropriate authorities to maintain investor protection and to articulate adequate suitability criteria for investment in these complicated products.[28]

I know that the MSRB is taking a look at the current market practices in the derivatives area in conjunction with its study, and I hope that one result of this examination will be the modernizing of the MSRB's customer protection rules. Municipal securities have historically been viewed by investors as a relatively "safe" investment, and I believe that everyone wishes for that view to continue, particularly with the recent influx of new investors.

If handled appropriately, derivatives should continue to be a boon to all municipal securities market participants. If not handled appropriately, though, that boon can quickly become a bomb chasing investors out of this market. I would prefer to retain the current investor flow into the municipal securities marketplace, and I suspect that everyone here would as well.

ENDNOTES

1. See, e.g., "Majority of Investors Considering Municipals, MBIA Survey Reports," The Bond Buyer (April 6, 1993), at 2; and Pierog, "Midwest Firms Predict More Demand for Munis Thanks to Clinton Plan," The Bond Buyer (March 31, 1993), at 2. See also Mitchell, "Salomon Tests Water for Muni Bonds, A Market It Led, and Abandoned, in '87," The Wall Street Journal (March 18, 1993), at C1. But see, e.g., Schifrin, "Hello, sucker," Forbes (Jan. 18, 1993), at 40; Wayne, "The Fuss Over Nonrated Bonds," The New York Times (Jan. 24, 1993), at F15; and Merrigan, "Investors Need to Have Ratings on Speculative Deals," Letters to the Editor, The Bond Buyer (Jan. 18, 1993), at 17.

2. See, e.g., Norris, "Bond Traders Love Clinton, And Vice Versa," The New York Times (March 14, 1993), at F1; and "What Next For the Clinton Bond Market," Fortune (April 5, 1993), at 22.

3. See Antilla, "Short Memories for the Bad Times," The New York Times (April 18, 1993), at F13; and O'Neill, "New Investors Are Entering the Bond Market; Educate Them Now to Avoid Disruption Later," The Bond Buyer (April 19, 1993),at 26.

4. See Stamas, "SEC Intensifies Muni Inspections As Sales Increase To Individuals," The Bond Buyer (March 9, 1993), at 1.

5. Letter from Gerald P. McBride, Chairman, Municipal Securities Division, PSA, to Harold L. Johnson, Deputy General Counsel, MSRB, dated January 8, 1993 ("PSA Letter"); letter from Victoria Westall and Richard Ciccarone, Chairperson of the NFMA Board of Governors and the NFMA Standards & Practices Committee, respectively, to Harold L. Johnson, Deputy General Counsel, MSRB, dated December 16, 1992 ("NFMA Letter"); and letter from Michael G. Wadsworth, Senior Vice President, Southwest Securities, to Harold L. Johnson, Deputy General Counsel, MSRB, dated December 1, 1992 ("Southwest Letter").

6. See Apfel and Reguer, "Point and Counterpoint: Bond Lawyers And Secondary Market Disclosure," The Quarterly Newsletter of the National Association of Bond Lawyers (Feb. 14, 1993), at 14.

7. For example, J.J. Kinney Co. has recently signed an agreement with Bloomberg Financial Markets to provide municipal bond price quotes and other financial information via Bloomberg's global electronic news network. See King,

"J.J. Kinney to Transmit Muni Data Via Bloomberg Network," The Bond Buyer (March 24, 1993), at 4.

For another example, the National Federation of Municipal Analysts ("NFMA") in January approved the first standardized format for tax-exempt bond issuers and trustees to use to provide the municipal securities secondary market with disclosure information. See Stamas, "Analysts Group Approves Standardized Disclosure Format, The Bond Buyer (Feb. 1, 1993), at 5.

See also Stamas, "PSA Proposes Dealers Disclose Detachable Calls on Pricing Wire," infra note 26. See generally Roberts, "Continue Secondary Market Disclosure Progress," Remarks delivered to the Government Finance Officers Association's Committee on Governmental Debt & Fiscal Policy, Washington, D.C. (Jan. 20, 1993).

8. See Stamas, "MSRB to Amend Suitability Standard Saying Intricate Deals Raise Risk for Buyers," The Bond Buyer (Feb. 24, 1993), at 1.

9. See Stamas, "SEC Commissioner Wants Brokers to Put Warnings On Bond Confirmations," The Bond Buyer (March 1, 1993), at 1. See generally Roberts, "Commentary on Customer Protection Study Comments," Remarks delivered to the PSA's Regional Issues and Answers Forum on Customer Suitability, Chicago, Illinois (Feb. 25, 1993).

10. See, e.g., Schifrin, "Hello, sucker," supra note 1; Wayne, "The Fuss Over Nonrated Bonds," supra note 1; and Merrigan, "Investors Need to Have Ratings on Speculative Bonds," supra note 1.

11. Letter from John M. Gardner and Robert Dean Pope, Chair and Vice Chair, respectively, of the Committee on Securities Law and Disclosure, NABL, to Harold L. Johnson, Deputy General Counsel, MSRB, dated December 1, 1992 ("NABL Letter").

12. See Stamas, "Some Firms Already Alert Investors in Writing About Risky Bonds, Dealers Say," The Bond Buyer (June 22, 1992), at 6. See also NFMA Letter, supra note 5.

13. See Stamas, "MSRB to Amend Suitability Standard, Saying Intricate Deals Raise Risk for Buyers," supra note 8.

14. See generally Carey, "Hedge Hogs," Financial Worth (March 5, 1993), at 1.

15. See Pressman, "Buy-Side Demands Get Even More Attention As Market Focuses on Customizing Products," The Bond Buyer (March 5, 1993), at 1.

16. See Vogel, "Munis' Placid Turf Faces Invasion Of Tigrs, Other Exotic Creatures," The Wall Street Journal (April 19, 1993), at C13; and Vogel, "Muni Floaters Are Marketed To Individuals," The Wall Street Journal (March 16, 1993), at C1.

17. See Granito, "New Derivative Products Are Surprisingly Complex," The Wall Street Journal (April 12, 1993), at C1.

18. See Pressman, "Spurred by Worries of Overvaluation, Market Reevaluates Stripped-Call Bonds," The Bond Buyer (March 5, 1993), at 1.

19. Detachable call options are not tied to any specific bond. Upon the exercise of an option, the choice of which bonds are called is made by lottery. Once a bond is called, it is removed from the remaining pool of callable bonds. However, bond holders wanting to protect their bonds from being called may create a kind of synthetic "call protection" by purchasing a bond and then purchasing a detachable call option on the secondary market. In the event a holder's bond is called, the holder retains the ability to exercise the option and call another bond which is withdrawn from the pool of callable bonds. Id.

20. See Pressman, "Lehman's 'Strips and Pieces' Allow Investors Multitude of Options in Structuring Portfolio," The Bond Buyer (March, 26, 1993), at 1.

21. See Carey, "Hedge Hogs," supra note 14. By way of example, assume that a municipal issuer would be required to offer a 5 percent fixed rate of interest in a conventional municipal bond offering. The same issuer would be able to offer a rate such as 4.8 percent in an offering featuring inverse floater products. Under this example, the floater may have an interest rate set by dutch auction or in accordance with an index-based formula equal to 3 percent. This rate will be paid to holders of the "floaters." Investors holding "inverse floaters" would receive returns equal to the sum of the difference between the floating and fixed rate plus the fixed rate, that is the sum of 1.8 and 4.8 percent, or 6.6 percent.

22. See Pressman, "Merrill Lynch Launches TEEMS to Expand Universe for Complex Municipal Products," The Bond Buyer (March 25, 1993), at 1. Other prominent investment banking firms are apparently countemplating similar actions. See

Vogel, "Munis' Placid Turf Faces Invasion Of Tigrs, Other Exotic Creatures," _supra_ note 16.

23. Interestingly enough, the NASD options suitability rule is somewhat inconsistent with its equity counterpart by requiring a determination "that the recommended transaction is _not_ _unsuitable_ for such customer" (emphasis added). NASD Rules of Fair Practice, Act III, Appendix E, NASD Manual (CCH) ¶ 2184. Section 2 of Article III, on the other hand, requires a determination that the recommendation is _suitable_.

24. However, many investors have already unknowingly accumulated a sizeable position in municipal derivatives. It has been estimated that municipal bond funds buy more than 90% of all inverse floaters. _See_ Vogel and McGough, "Muni Funds Sink or Swim With Inverse Floaters," _The Wall Street Journal_ (March 16, 1993), at C1.

25. Incurring losses in new securities products is not necessarily a recent development, even for savvy securities dealers. It has been reported that J.P. Morgan lost $100 million trading mortgage-backed securities in 1992 and that Salomon Inc. lost $250 million trading similar securities this year. _See_ "Wall Street's New Toys Are Costing It Plenty," _Business Week_ (March 29, 1993), at 76.

26. In a March 19, 1993 memorandum, the Public Securities Association ("PSA") expressed concern regarding the adequacy of market disclosure in bond issues involving detachable call options. The PSA memorandum suggested that dealers selling bonds with detachable call options should disclose that feature through pricing wires. _See_ Stamas, "PSA Proposes Dealers Disclose Detachable Calls on Pricing Wire," _The Bond Buyer_ (April 6, 1993), at 1.

27. One development in the derivatives liquidity area is the recent announcement of Standard & Poor's to explore the possibility of providing ratings on derivative products to assess risks other than credit risk. _See_ Pressman, "Standard & Poor's May Offer Extensive Ratings On Derivatives Products," _The Bond Buyer_ (March 26, 1993), at 3.

28. _See_ Pressman, "Turbulent Market Pushes Hedge Derivative Out of New York City's Debt Refunding Deal," _The Bond Buyer_ (April 8, 1993), at 1.