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Remarks of

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Chairman
Securities and Exchange Commission

Before the
Public Securities Association

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# DISCLOSURE IN MUNICIPAL SECURITIES MARKETS

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The views expressed herein are those of Chairman Ruder and do not necessarily reflect those of the Commission, other Commissioners or the staff.

REMARKS TO
PUBLIC SECURITIES ASSOCIATION

DAVID S. RUDER
CHAIRMAN, SECURITIES AND EXCHANGE COMMISSION

OCTOBER 23, 1987

# DISCLOSURE IN MUNICIPAL SECURITIES MARKETS

Thank you for inviting me here today to speak with you about Disclosure in Municipal Securities Markets. While the focus of my remarks today is municipal securities, I understand that the Public Securities Association includes participants in the other major public securities markets, including mortgage-backed securities, and government securities. In the mortgage-backed securities area the PSA's recent focus has been on clearance and settlement, an effort the Securities and Exchange Commission has fully supported and encouraged. Of course, in the government securities area, the most notable recent regulatory event has been the enactment of the Government Securities Act of 1986. As the PSA and the Commission had both urged, this Act preserved the status of U.S. government securities as exempted securities and developed a limited regulatory system that focused on known abuses.

This coalition was not new. The Commission and the PSA's predecessor, the Public Finance Council of the Securities Industry Association, also had worked together in the early 1970s to fashion a limited regulatory system for municipal securities that focused on the known abuses and specific problems in that market. Today, I will discuss the current pressures on that system.

Municipal securities are issued primarily to raise funds for a variety of state and local governments and projects sponsored

by those governments. Nevertheless, when the offerings of these issuers are national in scope and national secondary market trading exists, there is clearly a federal interest in ensuring that the customers who invest in these securities have sufficient information to make intelligent, informed investment decisions. The question is whether developments in these markets in the 1970's and '80s indicate a need for increased federal disclosure requirements.

In my discussions today I will refer to the Washington Public Power Supply System default, but my remarks will be based only on publicly available information.

I. Background

In terms of sheer size the importance of the municipal bond market is obvious. In 1985 new issues of long-term municipal bonds topped $208.4 billion, and 1986 topped every year prior to 1985 with $151.5 billion issued. This year there appears to be a return to 1984 levels with $78.9 billion issued in the first three quarters. 1/ New issues of municipal notes accounted for

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1/ During 1985 and 1986 general obligation ("GO") bonds accounted for $41.1 billion and $42.9 billion of new issues respectively Revenue bonds exceeded GO issues with $167.4 billion issued in 1985 and $108.6 billion issued in 1986. This year for the first three quarters revenue bonds accounted for $54.2 billion in securities issued. The Treasury Department estimates that of the bonds issued in 1985, over half were private activity bonds, i.e., conduit financings. 17.1% of the long-term bonds issued were bonds for private nonprofit hospitals and educational facilities, 11% were multi-family rental housing industrial development bonds ("IDBs"), 8% were small-issue IDBs, 8.9% were other IDBs, and 5.5% were single-family mortgage subsidy bonds. Department of the Treasury, Office of Tax Analysis, Private Activity Tax-Exempt Bond Volume in 1985: Preliminary Data (July 15, 1986).

an additional $23.1 billion in 1985 and $21.1 billion in 1986. Moreover, the secondary market volume in municipal securities is generally estimated at $300 to $400 billion annually. 2/

The sales force for this large market consists of 2600 dealers 3/ registered with the Commission and the Municipal Securities Rulemaking Board ("MSRB"). Of those, about 375 dealers serve as lead managers of long-term bond offerings and 650 have wire connections to the largest of the municipal securities broker's brokers. 4/

The biggest single source of demand for municipal securities currently comes from investment companies registered with the Commission under the Investment Company Act of 1940. These companies held 38% of the $729.9 billion in municipal securities outstanding as of March 1987. 5/ Individual investors are a

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2/ A healthy futures market also has developed in the Chicago Board of Trade's Long-Term Municipal Bond Index Futures Contract. Volume in that contract has grown from $29.2 billion in 1985 to $115.2 billion in the first three quarters of 1987.

3/ The terms "dealers" and "municipal securities dealers" refer collectively to brokers, dealers, and municipal securities dealers, both securities firms and banks, that trade municipal securities.

4/ A "broker's broker" or "municipal securities broker's broker" deals solely with other municipal securities brokers and dealers, not with public investors. A broker's broker makes its services available only to the municipal securities professionals that it selects and establishes its own standard fees. A broker's broker also does not take inventory positions in municipal securities. MSRB, Glossary of Municipal Securities Terms 21 (1st ed. 1985).

5/ Unit investment trusts hold $90 billion in municipal securities, intermediate and long-term municipal bond funds hold $119.7 billion, and tax-exempt money market funds and other short-term funds investing in municipal securities hold $68.4 billion.

growing source of demand, holding 22% of outstanding issues. This category includes investors as sophisticated as Morgan Guaranty's Trust Department and as unsophisticated as those fictional investors -- Aunt Minnie and Uncle Albert. Other major holders of these securities are commercial banks and insurance companies, 6/ although the attractiveness of municipal securities to these purchasers as tax-exempt investments was reduced by the Tax Reform Act of 1986. 7/

As you are aware, there have been some well-publicized recent cut-backs in the municipal securities operations of some major firms, including Salomon Brothers and Kidder Peabody. 8/ These cut-backs reflect this year's decline in the number and size of new offerings, and a reduction in profit margins. Nonetheless, municipal securities markets continue to form a substantial segment of our nation's securities markets, with significant levels of individual investor participation.

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6/ As of March 1987, commercial banks held 197.1 billion or 27% of outstanding issues, and property/casualty insurance companies held $89 billion or 12.2%.

7/ Prior to the Tax Reform Act of 1986 financial institutions could not deduct 20% of the amount of interest attributable to tax-exempt obligations. Under the Act such interest is not deductible at all. An exception remains for interest on qualified tax-exempt obligations of certain small issuers. In addition, property/casualty insurance companies must now reduce their deductions for loss reserves by 15% of tax-exempt interest income. See Public Securities Association, Report on The Tax Reform Act of 1986 (H.R. 3838): Provisions Affecting Tax-Exempt Obligations 32-33 (Sept. 30, 1986).

8/ See, e.g., 100 Kidder Jobs Cut in Municipals, New York Times, October 14, 1987, at D-1.

## II. Current Disclosure Regulation

Currently, municipal securities issuers are not subject to the regulatory provisions under the Securities Act 9/ that require registration of public offerings of securities and impose specified liabilities for material misrepresentations or omissions in registration statements. 10/ Nor are municipal securities issuers subject to periodic reporting under the Exchange Act. 11/ Nevertheless, the general antifraud provisions of federal law, which are applicable to municipal issuers and other offering participants, require them to be accurate in disclosures that are made. 12/

A brief description of the differences between the corporate disclosure system and the municipal disclosure system will be useful.

First, corporate disclosure is mandatory. While exemptions exist for small, private, nonprofit, and intrastate offerings, all similarly situated corporate issuers must make the same types of disclosure every time they go to market, and periodically thereafter. In contrast, municipal securities issuers must provide only sufficient disclosure to market the bonds at an acceptable

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9/ Securities Act of 1933 ("Securities Act") section 3(a)(2).

10/ Securities Act sections 11 and 12(2).

11/ Securities Exchange Act of 1934 ("Exchange Act") sections 3(a)(12)(A)(ii), 13 and 15(d).

12/ Securities Act section 17(a); Exchange Act section 10(b) and the rules thereunder. Securities Act section 17(c) provides that the exemption for municipal securities in section 3(a)(2) does not apply to the antifraud provisions of section 17(a). Exchange Act section 10(b) and the rules thereunder apply to all securities.

interest rate and must not recklessly or intentionally deceive purchasers. 13/

Second, in offerings registered with the Securities and Exchange Commission, corporate issuers are liable without regard to fault for deficient disclosure 14/ and their officials, underwriters, experts, accountants, and others all must exercise a certain degree of care and responsibility or "due diligence" to ensure that disclosure is adequate. 15/ In contrast, participants in municipal securities offerings have only the obligations imposed by their professions and the antifraud provisions. 16/

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13/ The question of whether there is a cause of action for negligent misrepresentation raises interesting legal issues. See American Bar Association, Disclosure Roles of Counsel in State and Local Government Securities Offerings 39-40 (1987) ("ABA Report").

14/ Securities Act section 11(b).

15/ Securities Act section 11(b)(3).

16/ The Commission has prosecuted securities law violations by issuers and others in a number of relatively small, negotiated offerings. See, e.g., S.E.C. v. Busby, Civil Action No. C-79-2442-M (W.D. Tenn. Jun. 20, 1979), Securities and Exchange Commission Litigation Release No. 8812 (Jul. 5, 1979) ($4.6 million in Gibson County Municipal Water District revenue bonds); S.E.C. v. Senex Corp., 399 F. Supp. 497, 499 (E.D. Ky. 1975) ($4,425,000 in City of Covington Health Care revenue bonds). The Commission has taken action against municipal officials who took kick-backs, see, e.g., S.E.C. v. Washington County Utility District, 676 F.2d 218 (6th Cir. 1982), and against underwriters who failed to investigate the financial condition of a municipal securities issuer, see, e.g., In the Matters of Walston & Co., Inc. and Harrington, Securities Exchange Act Release No. 8165, [1966-67 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶77,474 (Sept. 22, 1967), or who siphoned away some of the offering proceeds directly or indirectly. Senex, id. at 501, 505 (nondisclosure of

(footnote continued)

One recent report suggests that, since there is no strict underwriter liability or a statutory due diligence defense, underwriters still do not generally engage independent counsel for competitive bid offerings. 17/

Third, although the Government Finance Officers Association ("GFOA") has published guidelines for annual information statements and the dissemination of other current information, few issuers prepare them. 18/ In contrast, corporate issuers must

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16/ (footnote continued)

fact that project's underwriter was owned and controlled by project's developer). The Commission has moved against bond counsel who took responsibility for preparing disclosure documents that were incomplete or inaccurate, Washington County Utility District, id. at 220 n. 1 (bond counsel consented to permanent injunction); Busby, id. (bond counsel who received some proceeds from offering did not disclose knowledge that water district issuing bonds intended to use pipe unacceptable to state health department); S.E.C. v. Reclamation District 2090, Case No. C-76-1231 (N.D. Cal. Sept. 1, 1976), Securities and Exchange Commission Litigation Release No. 7590 (Sept. 28, 1976) (permanent injunction against bond counsel for nondisclosure); In the Matter of Jo M. Ferguson, Securities Act Release No. 5523 (Aug. 21, 1974)(bond counsel failed to disclose facts of Senex case, of which he knew or should have known), and issued a section 21(a) report on the duties of underwriters' counsel. Attorney's Conduct in Issuing an Opinion Letter Without Conducting an Inquiry of Underlying Facts Failed to Comport with Applicable Standards of Conduct, Securities Exchange Act Release No. 17831 (June 1, 1981)(role of attorney who represented underwriter in public offering of industrial revenue bonds). The Commission also has pursued experts who had serious undisclosed conflicts of interest. See, e.g, Senex, id. at 500-501 (promoter's consulting firm issued favorable feasibility study regarding proposed health care facility after two unfavorable independent studies).

17/ ABA Report at 30.

18/ Id. at 35. Nevertheless, in some cases they are required by covenants "to make certain periodic disclosures and prepare financial statements on a current basis." Id.

file annual reports, which are supplemented with quarterly reports and interim filings concerning material events. 19/

Fourth, where there is not periodic reporting, detailed registration statements must be filed in advance of sale. Thus, information is available prior to the sale of corporate securities, and final information is always available immediately after the sale and maintained at the Commission for several years. In contrast, the practice of making available offering statements for municipal securities prior to sale varies. Offering statements are not always finalized on a timely basis and may not be readily available even after the offering.

Fifth, corporate securities issuers must provide independently audited financial reports that are prepared in accordance with generally accepted accounting principles and audited in accordance with generally accepted auditing standards. These financial reports must comply with detailed requirements as to form and content that are designed to assure full disclosure and foster comparability in financial information. No such independent audit requirements apply generally to municipal securities issuers, although the GFOA's recent voluntary efforts are reported to have improved the quality and reliability of the information contained in municipal issuers' financial statements. 20/

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19/ Exchange Act section 15(d).

20/ Peterson, State of the Art: Revisions to the Disclosure Guidelines Underway, Government Finance Review 28 (June 1987).

Despite differences in statutorily mandated disclosure obligations, some municipal securities issuers provide disclosure that accords with the highest standards applicable to corporate securities. In part this result is occurring because professional organizations that represent municipal securities issuers, underwriters, bond counsel, and accountants are committed to improving the disclosure standards in use in the municipal securities industry.

Until 1975, dealers in municipal securities also were exempted from regulation under the Exchange Act. In 1975, the Congress enacted legislation 21/ that created the MSRB to regulate municipal securities dealers, 22/ required dealers to register with the Commission, and gave the Commission regulatory authority over their activities.

That legislation also contained two provisions designed to respond to concerns that the power to regulate underwriters of municipal securities could be used to impose pre-issuance require-

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21/ Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (June 4, 1975).

22/ The MSRB is a self-regulatory organization (Exchange Act section 3(a)(26)) for purposes of the provisions of the Exchange Act that require its rules to be submitted to the Commission for approval (Exchange Act section 19(b)(1)) and authorize the Commission to approve or disapprove those rules (Exchange Act section 19(b)(2)) and to amend the MSRB's rules (Exchange Act section 19(c)). For enforcement purposes, however, the MSRB's substantive rules have the same status as do the rules of the Commission. See Exchange Act section 15B(c)(1).

ments on issuers. 23/ First, the Commission and the MSRB are prohibited from directly or indirectly requiring an issuer to make any filing with the Commission or the MSRB prior to the sale of its securities. 24/ Second, the "Tower Amendment" prohibits the MSRB from requiring an issuer, through a broker, dealer, or municipal securities dealer, to furnish information to a purchaser or prospective purchaser of such securities. 25/

Nevertheless, within the constraints imposed by these provisions, the MSRB is empowered to regulate transactions in municipal securities by brokers, dealers, and municipal securities dealers to prevent fraudulent acts and practices, promote just and equitable principles of trade, and protect investors and the public interest. 26/ Under that authority, the MSRB has required that, if offering statements are prepared, they must be sent to investors. 27/ But the MSRB cannot require that those offering statements be prepared, establish timetables for their preparation, or require that underwriters exercise "due diligence" to assure that

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23/ Evans, SEC's Role in "Municipal Fiscal Crises," Address to the National Institute: "Freedom From Fiscal Fiasco," American Bar Association, Section of Local Government Law, Washington, D.C. 9-10 (December 3, 1976).

24/ Exchange Act section 15B(d)(1).

25/ Exchange Act section 15B(d)(2).

26/ Exchange Act section 15B(b)(2)(C).

27/ MSRB Rule G-32, Disclosures in Connection with New Issues, MSRB Manual (CCH) ¶3656 at 5251-2. It also has required disclosure of an underwriter's compensation in connection with a negotiated sale of new issue securities. Id.

the contents of offering statements are accurate. The MSRB also requires that transactions in municipal securities be confirmed and that those confirmations contain yield calculations and information as to the existence of call provisions, 28/ but it cannot establish requirements concerning the notice that will be given in connection with puts or calls.

III. Exemptions: Continuing Vitality

Three factors are cited in the legislative history of the Securities Act and the Exchange Act as the basis for the exemptions for municipal securities from disclosure and other provisions of the federal securities laws: first, the absence of

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28/ MSRB Rule G-15, Confirmation, Clearance and Settlement of Transactions with Customers, MSRB Manual (CCH) ¶3571 at 4501-9. In interpreting these rules, the MSRB has specifically emphasized the duty of municipal securities professionals to disclose at or before the sale of municipal securities all material facts about the transaction, including a complete description of the security and its tax status. Thus, for example, the MSRB has emphasized that disclosure of the existence of call features, put options, and credit enhancements is essential and that the value of those features must be reflected in the dealers' quotations and the price of the security. See, e.g., Notice Concerning Disclosure of Call Information to Customers of Municipal Securities (Mar. 4, 1986); Application of Board Rules to Transactions in Municipal Securities Subject to Secondary Market Insurance or Other Credit Enhancement Features (Mar. 6, 1984); Notice Concerning the Application of Board Rules to Put Option Bonds (Sept. 30, 1985); Notice Concerning Disclosure of Uncertain Tax Status of 1986 Issues of Municipal Securities (Mar. 7, 1986), MSRB Manual (CCH) ¶3581. See also MSRB interpretation of January 4, 1984 by Donald F. Donahue, Deputy Executive Director, Re: Transactions in stripped bonds and stripped coupons, MSRB Manual (CCH) ¶3581.25.

"recurrences of demonstrated abuses;" 29/ second, the fact that purchasers of municipal securities were generally banks, insurance companies, and other institutional investors with expertise in financial and investment matters; 30/ and third, governmental comity. 31/ These three considerations continue to form an appropriate analytical framework for considering whether municipal securities should be exempt from federally mandated disclosure requirements. The current question is whether changes in the marketplace have undercut the reasons underlying these exemptions.

A. Abuse

Are there demonstrated abuses that should lead to the introduction of federal disclosure requirements in the offerings of any of three major categories of municipal securities?

1. General Obligation Bonds

Issuers of general obligation bonds range in size and type from the largest states and cities to small districts that are created for a special purpose. The disclosure problems that can arise with the largest of these issuers were dramatically illustrated in the 1970s when the City of New York experienced

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29/ H.R. Rep. No. 85, 73rd Cong., 1st Sess. 7 (1933).

30/ Hearings on S. Res. 84, S. Res. 56, and S. Res. 97 Before the Senate Committee on Banking and Currency, 73rd Cong., 2d Sess. 7443 (1934).

31/ See Landis, The Legislative History of the Securities Act of 1933, 28 Geo. Wash. L. Rev. 29, 39 (1959).

difficulties in redeeming its notes. In its report on New York City, the Commission singled out accounting practices and internal controls of the City as the main problems affecting the quality of disclosure received by investors in the City's notes. 32/ New York City also had other types of disclosure deficiencies. For example, the City had public buildings on its tax rolls and had overestimated both its actual and potential revenues. 33/

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32/ Securities and Exchange Commission, Final Report in the Matter of Transactions in the Securities of the City of New York Submitted to the Senate Committee on Banking, Housing, and Urban Affairs, 96th Cong., 1st Sess. 3 (Comm. Print 1979) ("NYC Final Report"), and Staff Report on Transactions in Securities of the City of New York Submitted to the Subcommittee on Economic Stabilization of the House Committee on Banking, Finance and Urban Affairs, 95th Cong., 1st Sess., Chapter Two (Comm. Print 1977) ("NYC Staff Report"). Similar problems occurred in disclosure concerning bonds issued by the Board of Education of the City of Chicago. See Illinois Auditor General, Chicago Board of Education Investigation - Final (Jan. 13, 1981) and Joint House and Senate Chicago Board of Education Committee, 81st Illinois General Assembly, The Chicago Board of Education's 1979 Financial Crisis and Its Implications on Other Illinois School Districts (Jan. 13, 1981). In that case, the financial statements of the Board suggested that there were large cash balances restricted for use in repaying note and bondholders when, in fact, those funds had been commingled with operating funds of the Board and utilized to meet current operating expenses. These financial statements had been audited by a major accounting firm, which apparently believed that it had made sufficient disclosure to the contrary in an ambiguous footnote to the financial statements. That apparently was not the case. Just as in the New York City case, when the actual deficits were clearly identified, there was no market for the bonds and the control systems for the finances of the Board had to be restructured before it could reenter the bond market.

33/ NYC Staff Report, Chapter Two at 7-9, 27-34. See also S.E.C. v. Reclamation District No. 2090, Case No. C-76-1231 (N.D. Cal. Aug. 27, 1976), Securities and Exchange Commission Litigation Release No. 7551 (Sept. 8, 1976). Reclamation

(Footnote continued)

While there clearly have been some isolated disclosure abuses, based on the evidence to date it would be difficult to characterize disclosure problems or general obligation defaults as recurrent. There were ten municipal note defaults in the period from 1972 to 1983, 34/ some of which involved obligations owed only to local banks. 35/ In the same period there was only one long-term bond default that was not connected with a bankruptcy of a special district. 36/ Of more concern are the small special-purpose districts. In the period from 1972 to 1984 there were eleven special district bankruptcies. 37/ Two Commission enforcement actions covering special district general obligation

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33/ (Footnote continued)

District 2090, a raw land district, took this problem to an extreme. Reclamation District 2090 had no tax base and no taxpayers, although under California law it had general taxing power, and thus its bonds were general obligation bonds. Securities and Exchange Commission Litigation Releases No. 7551 (Sept. 8, 1976) and No. 7460 (June 22, 1976). This case was one of only a few in which the issuer of a general obligation bond was named in a Commission enforcement action. See also S.E.C. v. San Antonio Municipal Utility District No. 1, Civil Action No. H-77-1868 (S.D. Tex. 1977), Securities and Exchange Commission Litigation Release No. 8195 (Nov. 18, 1977) (raw land district in Bexar County, Texas formed in connection with real estate development).

34/ Advisory Commission on Intergovernmental Relations, Bankruptcie Defaults, and Other Local Government Financial Emergencies 20 (March 1985) ("Advisory Commission Report").

35/ E.g., Cleveland, Ohio. Id. at 24-25.

36/ Id. at 20.

37/ Id. at 9.

bonds also were brought during this period. 38/ All in all, disclosure problems in the general obligation bond area do not seem to justify increased regulation.

2. Revenue Bonds

A revenue bond is a bond that is to be repaid from income from a facility or from special purpose taxes. Thus, a toll road bond or sewer bond would be a revenue bond. Some revenue bonds are issued to fund a single project, while others fund a project that has ongoing borrowing needs. In some isolated instances the Commission has found lack of disclosure of financial operations, such as the operating history of a hospital. 39/

Nevertheless, operating history disclosure needs are not typical, since for the first of a series of revenue bonds the fund balance usually will be zero until the bond proceeds are received. The most important information to buyers of these bonds generally will be the likelihood that the project will be completed and the probability that demand for the services to be rendered will generate sufficient revenues to repay the bondholders. 40/

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38/ Reclamation District 2090, supra n. 33; San Antonio Municipal Utility District, supra n. 33.

39/ S.E.C. v. Calhoun County Medical Facility, Inc., Civil Action No. WC-81-61-WK-P (N.D. Miss. May 28, 1981), Securities and Exchange Commission Litigation Release No. 9366 (Jan. 1, 1981) (nondisclosure of unfavorable past annual financial statements regarding hospital's first mortgage revenue bonds).

40/ See, e.g., Busby, id.; Senex, id. ; S.E.C. v. Whatcom County Water District No. 13, Case No. C77-103 (W.D. Wash. Apr. 27, 1977), Securities and Exchange Commission Litigation Release No. 7912 (May 10, 1977) (water and sewer revenue bonds).

(Footnote continued)

The Washington Public Power Supply System default has raised concerns of the latter type. 41/ It has been suggested in the press and elsewhere that disclosure in connection with the Supply System's cost projections and power demand forecasts was incomplete -- that Supply System management and others knew or should have known more about the likely accuracy of these projections than was stated in offering circulars. Whether or not that was the case, it is generally agreed that the event that triggered the default was the Washington State Supreme Court's holding that Washington municipalities were not bound by the "take-or-pay" contract.

Despite the magnitude of the Washington problem and the problems found in Commission enforcement cases, no indications exist that there are sufficient numbers of disclosure abuses or revenue bond defaults to justify imposition of a complete disclosure system. For instance, in the period from 1972 to 1983, there were only 25 revenue bond defaults in non-conduit financing bonds. 42/

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40/ (Footnote continued)

Another example of this type of problem is the Calumet Skyway revenue bonds, which have been in default since 1963. In 1954 and 1957 the Calumet Skyway issued an aggregate of $101 million in revenue bonds to build a 7 3/4 mile toll bridge opened in 1958 linking Chicago to the Indiana border. The main reason for the default was that projected traffic for the toll bridge never developed. Further, Interstate 94, which opened in the 1960s and does not charge a toll, also links Chicago to the Indiana border.

41/ This Supply System discussion is based on a series of four Weekly Bond Buyer articles: Gleckman, WPPSS: From Dream to Default (January, 1984).

42/ Advisory Commission Report at 20.

3. Conduit Financing Bonds

The third major type of municipal obligation bonds are conduit financing bonds, known under the old tax code as "industrial development bonds." A municipality can offer its tax-exempt status to a private entity through such bonds without obligating itself to fund payments to bondholders. Some of the Commission's cases concerning municipal securities have grown out of abuses in small-issue conduit bonds, 43/ and they have also accounted for a significant number, if not dollar amount, of municipal securities defaults. There were at least 82 private-purpose bond defaults during the period 1972 to 1983. 44/

This type of financing was substantially restricted under the most recent amendments to the tax laws, 45/ and taxable industrial development bonds must be registered if they amount to purely conduit financing for corporations. 46/ Nevertheless,

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43/ See, e.g., S.E.C. v. Astro Products of Kansas, Inc., Civil Action File No. 76-359-C6 (D. Kan. Aug. 31, 1976), Securities and Exchange Commission Litigation Release No. 7557 (Sept. 13, 1976) ($2,200,000 in industrial development revenue bonds issued by the City of Haysville, Kansas); Senex, supra n. 16; and Ferguson, supra n. 16.

44/ Of the cases about which information is available, nine involved less than $1 million, about an equal number involved between $1 million and $2 million, and the largest amounts were for large privately-owned nursing homes, which involved up to $50 million. Advisory Commission Report at 20-21.

45/ The Tax Reform Act of 1986 contained provisions that limit the types of facilities that can be financed, the percentage of proceeds that can be used for private purposes, and the amount of debt service that can be supported by payments from private persons. See Tax Reform Act of 1986, Pub. L. No. 99-514, 100 Stat. 2085 (Oct. 22, 1986).

46/ See Rule 131 under the Securities Act, infra n. 52.

this type of financing may be too attractive ever to be completely eliminated. Thus, even with reduced availability of such financing I support the Commission's previous recommendations that when a security is, in fact, a corporate obligation, it should not be exempted from the disclosure provisions of the Securities Act or the Exchange Act. 47/

4. Arbitrage Bonds

A municipal securities issuer that is exempt from federal income taxes can make money, at the expense of the U.S. Treasury, by borrowing money at the tax-exempt rate and investing it at the higher rate paid on taxable investments. 48/ Under the rules in effect prior to the Tax Reform Act of 1986, issuers were permitted

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47/ In the past, the Commission has supported the repeal of the exemption from registration for IDBs under the Securities and Exchange Acts. Letter from John S.R. Shad, Chairman, SEC, to Representative Timothy E. Wirth, Chairman, House Subcommittee on Telecommunications, Consumer Protection, and Finance (March 12, 1985). One of the Commission's legislative proposals concerning municipal securities, the 1978 Industrial Development Bond Act, S. 3323, 95th Cong., 2d Sess. (1978), sought treatment of commercial entities responsible for the debt obligation under an IDB financing agreement equivalent to that accorded other corporate entities obtaining financing in the securities markets.

48/ Since this is a money-generating proposition, some suggest that investment bankers can persuade municipal officials to pay rather high underwriting fees because those fees will be paid out of arbitrage earnings. Indeed, recently there have been allegations that direct persuasion in the form of bribes and campaign contributions to municipal officials was used in connection with certain offerings reported to be under investigation by several federal agencies. Shea, FBI Sets Meeting to Coordinate Investigations of Muni Industry, Bond Buyer, Jul. 14, 1987 at 22, col. 2.

to invest, for three years or longer, proceeds of a bond issue in securities yielding a higher rate if there was a reasonable expectation that the project being financed would be built.

The Tax Reform Act of 1986 limited such arbitrage opportunities by requiring issuers, subject to certain limited exceptions, to rebate arbitrage earnings to the Treasury. 49/ Questions have been raised concerning whether disclosure in connection with the sales of certain securities at the time these new provisions were going into effect met the basic standards of the antifraud provisions of the federal securities laws. The questions include whether adequate disclosure was made concerning the circumstances surrounding the original sale, concerning the likelihood that a project would be built, and concerning the effect on the tax-exempt status of the bonds if it was determined that the bonds had not been sold by the deadline or if the projects were deemed not to have been reasonably feasible. These questions are serious, but it is not clear at this time that they support calls for new disclosure legislation.

B. Nature of Investors

The second major factor identified in 1933 as supporting exemptions from disclosure requirements was that the primary buyers of these securities were financial institutions. This factor has changed since 1933. Today banks and insurance companies

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49/ December 31, 1985 and September 1, 1986 were the effective dates of these provisions in the Tax Reform Act of 1986.

purchase a lower percentage of municipal securities, and this trend is likely to continue. 50/ Today, households hold 22% of all municipal securities. Unit investment trusts, which are not actively managed and thus do not bring to bear continuing financial expertise, hold an additional 12.4% of municipal securities. Another 25.6% of municipal securities are held by mutual funds, and although these funds are managed by persons with financial sophistication, it should be noted that Congress has determined that these investment vehicles require special protection under the Investment Company Act of 1940.

C. Comity

The third factor, governmental comity, is still a strong and valid consideration in most respects. 51/ This consideration is not equally applicable to conduit financings, which were largely non-existent at the time of the enactment of the securities

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50/ See supra n. 7.

51/ In this area, comity is not a constitutional requirement. In Garcia v. San Antonio Metropolitan Transit Authority, 469 U.S. 528 (1985), the Supreme Court, in considering the boundaries of state immunity from federal regulation, rejected an analysis based on distinctions between protected and unprotected state governmental functions. Instead, the Court indicated that the principal means for protection of State sovereignty was the federal government's structure, that is, the "procedural safeguards inherent in the structure of the federal system." Id. at 552. Thus, under Garcia, the appropriate inquiry is whether "the internal safeguards of the political process have performed as intended." Id. at 556.

laws, 52/ and are more akin to corporate securities than to municipal securities and to that degree they seem to be entitled to less federal deference.

IV. Timely Delivery of Disclosure Documents

An additional disclosure concern is that sufficient numbers of offering statements are not always made available in time to be delivered to customers purchasing new issues. 53/ Repeal of the Tower Amendment may be desirable to allow the MSRB to effect uniform procedures to address this problem. Of course, strict compliance with existing MSRB requirements that dealers timely

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52/ Not until 1968 did the Commission note that "substantial amounts of these bonds [IDBs] have been sold to the public." Securities Exchange Act Release No. 4896 (Feb. 1, 1968). In response, the Commission adopted Securities Act Rule 131 and Exchange Act Rule 3b-5, which deemed any part of an IDB payable by a corporate obligor, and not a municipal issuer, a separate security subject to federal regulation, with some exceptions. Securities Act Release 4921 (Aug. 28, 1968). See also Securities Act Release No. 5055 (Mar. 31, 1970) (amending). Congress, however, reacted by amending Securities Act section 3(a)(2) and Exchange Act section 3(a)(12), together with section 304(a)(4) of the Trust Indenture Act of 1939, to exempt from federal securities regulation IDBs that were tax-exempt under section 103(b) of the Internal Revenue Code of 1954. Employment Security Amendments of 1970, Pub. L. No. 91-373, §401, 84 Stat. 718 (Aug. 10, 1970); Act of December 23, 1970, Pub. L. No. 91-567, §6(b), 84 Stat. 1499. This amendment arose from Congressional dissatisfaction with the Commission's position. Concerns were raised over requiring registration for IDBs, which were perceived as relatively small offerings, and thus effectively depriving small communities of a financing vehicle necessary for local development. See 116 Cong. Rec. 10578-79 (April 7, 1970) (Statements of Senators Sparkman and Baker).

53/ See MSRB Reports, Vol. 7, Number 2, at 7 (March 1987).

deliver the offering statement, when one is prepared, is also important. 54/

V. Technical and Operational Problems

Recently, the Commission and the MSRB also have become concerned about a number of technical and operational problems related to call provisions. Great concerns are currently being expressed regarding calls of bonds "escrowed to maturity." In some cases issuer exercises of early call provisions in securities raised significant disclosure problems for holders who, based on issuer-prepared documents, thought the instruments were not callable.

In addition to problems related to call provision disclosure, customers have been dissatisfied with the lack of notice of called bonds. In fiscal year 1987 notice questions were raised in over 200 investor complaints about this matter received by the Commission's Office of Consumer Affairs. Call notices are not published in nationally available newspapers, 55/ much less available in an accessible disclosure system. 56/ The magnitude of the call problems has been dramatized by the problems encountered by the municipal securities depositories, which are holding

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54/ See MSRB Rule G-32.

55/ This is especially true with respect to bearer-form bonds, where publication in a newspaper may be the only method of notifying bondholders of calls.

56/ There are private information services that publish call notices, but these services are hampered by the same communications deficiencies that hamper bondholders.

bearer-form securities for the securities industry and many customers, particularly investment companies and other institutional investors. Missed opportunities to exercise put options and delays in exercising call rights on securities held by depositories have cost hundreds of thousands of dollars. While the issuers' failure to provide for adequate notice procedures is responsible for some of these losses, it has become clear that a large part of the problem also is due to the fact that there are some municipal securities transfer agents and redemption agents that seem to be free from accountability. 57/ In addition, delays in transferring and settling securities continue to be a serious problem.

## VI. Conclusion

This analysis has suggested that while there is no clear need to impose registration and continuous disclosure requirements on municipalities, there may be a case for removing an exemption for a security when a corporate obligor is involved in conduit financing.

There also is a need to assure that sufficient copies of an issuer's disclosure statement are available to the underwriting syndicate before the offering commences. Repeal of the Tower

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57/ In response to problems associated with municipal calls, the Commission has endorsed voluntary compliance with minimum standards to improve bond redemption processing, including criteria for adequate descriptive information, especially CUSIP numbers, and timely redemption notices. Securities Exchange Act Release No. 23856 (Dec. 3, 1986), 51 FR 44398.

Amendment to permit the MSRB to address this need may be an attractive solution. 58/ Similarly, efforts to address technical and operational problems concerning efficient certificate turnaround and timely notice of puts and calls do not intrude excessively on the governmental prerogatives of municipal securities issuers. Indeed, the logical focus of any regulation in this area would be on transfer agents, redemption agents, remarketing agents, and others charged by municipal issuers with carrying out these functions. Accordingly, a grant of direct authority to the Commission to regulate such activities in connection with its regulation of the national clearance and settlement system would be an appropriate companion to repeal of the Tower Amendment. Such a direct approach would provide the Commission with the authority necessary to attack operational problems.

Although I do not urge mandated disclosure with respect to general obligation and revenue bonds, problems do exist in this area. Again, the analysis involves a balancing of the continuing respect due local interests against the federal interests in maintaining the integrity of the national markets for municipal securities, in light of the changed nature of investors as well as the magnitude and frequency or lack of frequency of abuses. In addition, the proliferation of new products such as puts

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58/ In 1985, the Commission supported the repeal of the Tower Amendment's prohibition against MSRB-imposed disclosure requirements on municipal issuers. See letter from John S.R. Shad, Chairman, SEC, to Representative Timothy E. Wirth, Chairman, House Subcommittee on Telecommunications, Consumer Protection, and Finance (March 12, 1985).

and other forms of credit enhancements 59/ requires that we be continually alert to the need for systematic disclosure with respect to the basic terms of a security, that is, the description of what is bought and sold that must be commonly understood in order to form a contract to purchase or sell the security. Here again repeal of the Tower Amendment may be an attractive first step.

In sum, the case for continuing the exemptions in their current form still exists, but only if the industry continues to develop practices and systems that assure accurate, accessible, and timely information as to the basic terms of a security and subsequent developments that affect that security.

Finally, the public has no means of knowing at what prices most municipal securities trade. Thus, the most basic type of information -- that provided by "the efficient market" -- isn't available to everyone who could use it.

I urge you, together with the MSRB, municipal securities issuers, accountants, and counsel, to be alert to your responsibilities to assure that the regulatory problems I have identified are met. The time is ripe for action to avoid these problems and to improve disclosure systems and practices.

Thank you.

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59/ The volume of insured long-term (par value over $5 million) bonds, in billions, has been as follows: 1985, $43.9; 1986, $19.5; first three quarters of 1987, $12.7. The volume of bonds backed by letters of credit, in billions, has been as follows: 1985, $34.2; 1986, $10.3; first three quarters of 1987, $6.4. The volume of long-term (par value over $5 million) variable rate demand bonds, one type of "put bonds," in billions, has been as follows: 1985, $56.6; 1986, $25.7; first three quarters of 1987, $7.2.