Remarks Of

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"Continue Secondary Market Disclosure Progress"

Government Finance Officers Association's
Committee on Governmental Debt & Fiscal Policy
Washington, D.C.
January 26, 1993

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"Continue Secondary Market Disclosure Progress"

I. Introduction

For the second time during my tenure at the Commission, I have the opportunity to address the Government Finance Officers Association ("GFOA") on the subject of secondary market disclosure.[1] To a large degree, the GFOA directly has been responsible for the great improvement that has occurred in primary disclosure in the municipal securities market. I challenge you to continue to work to achieve the same degree of improvement in the secondary market disclosure area.

It is my intention today to discuss the need for adequate secondary market disclosure in the municipal securities market, to identify and to commend some of the many voluntary initiatives underway that are making progress in this area, to discuss the need for secondary market disclosure to be cost-effective and readily available, and to encourage all municipal market participants to intensify efforts to improve secondary market disclosure.

II. Overview of Municipal Securities Market

However, first, I wish to spend a few minutes reflecting on the positive state of affairs that exists for the municipal securities market. This market was an exciting and active one in 1992. The volume was recordbreaking, with a total of approximately $275 billion of municipal securities issued.[2] Much of this volume was caused by the low level of interest rates which, in conjunction with a very positive yield curve, spurred a record number of refundings.[3] Several market watchers have opined that the fall in interest rates resulted from an easy monetary policy coupled with a slack economy and low inflation.[4] All of these conditions may persist in 1993, which means that this year may also prove to be an exciting and active year for the municipal market.

While 1992 was an excellent year for the municipal securities market, some nagging problems continue to exist. Reports continue to surface concerning frauds perpetrated on investors in the unrated bond area, usually involving health care facilities.[5] Investors remain shaken by the large defaults engendered by the failures of Mutual Benefit Life, Executive Life, and Tucson Electric Power. The Bond Investors Association for one has complained vociferously about the failure of Mutual Benefit Life to identify which of its guaranteed bond issues are self-funding and which are running negative cash flows. The Richmond Unified School District of California certificates of participation ("COPs") default and the upcoming referendum on whether to terminate annual lease payments on a COPs issue in Brevard County, Florida, have called into question the credit quality of all COPs issues.[6] The attempted taxpayer challenge to the validity of certain COPs issued by Fairfax County in Virginia simply adds more fuel to this fire. The potential taxability of certain vendor lease offerings also portends trouble.

In 1992, state and local governments flooded the financial markets with a tidal wave of early bond redemptions, and investors are still reeling from the "call" shock.[7] The re-refunding of certain bonds that have already been escrowed to maturity have raised questions both at the Commission and at the Department of the Treasury.[8] Such a situation raises particular concerns if issuers engaged in a refunding fail to clearly disclose that the refunded bonds remain subject to optional redemption. This problem will continue and may even become more magnified in the future, since I understand that the call phenomenon will continue through 1995. In fact, some predict that this month will contain the biggest barrage of municipal bond calls in history.[9] The bond call problem may be best exemplified by the recent controversial decision of Memorial Health Services, a nonprofit medical center located in California, to redeem certain bonds already allegedly escrowed to maturity.[10]

These problems, although minor in scope for the most part, peck away at the municipal securities market and undermine what is otherwise a generally trouble free market known for its integrity. At the least, their existence should cause governmental issuers to redouble efforts to improve secondary market disclosure. While adequate secondary market disclosure will not eliminate defaults or even eliminate these problems, it will enable investors to better understand some risks taken and the compensation available for those risks. By reducing uncertainty, the owner and the potential municipal bond buyer in the secondary market will have greater liquidity, dealers can more readily determine whether there is a reasonable basis for recommending particular securities, and the municipal securities market will be more efficient. A more efficient municipal securities market should be beneficial to all the participants in this marketplace, including governmental issuers.

The ability of thousands of governmental issuers to enter the municipal bond market and to service the needs of their communities depends upon the strength of the relationship that has been forged with investors. The integrity of the municipal securities market, which is central to this relationship and central to the success of that market, can only be enhanced by the existence of adequate secondary market disclosure.

It is interesting to note that enthusiastic investor demand easily absorbed the 1992 record issue volume. Some believe that individuals purchased, directly or through their mutual funds, about 85% of this volume.[11] It is clear that the municipal securities market, as a result of the Tax Reform Act of 1986, now has a much greater retail orientation.[12] Of course, wherever the retail investor goes, the Commission is sure to follow.

Since the Commission historically has pressed for transparency improvements in other retail dominated investor markets, it is logical to assume that ultimately similar attention will be focused on the municipal securities market. Improved price transparency, in turn, depends in large part upon improvement in the area of secondary market disclosure. The presence of adequate secondary market disclosure should only be helpful in the fight to stave off well-intentioned regulators and legislators concerned with the growing retail orientation of this market.

Further, there have been a number of suggestions made by myself and others for the need to adjust the municipal securities suitability rules in order to eliminate the reoccurrence of certain suitability abuses which have taken place in that market.[13] The Municipal Securities Rulemaking Board ("MSRB") is involved in a study of the customer protection rules as a result of these suggestions. In its comment letter to the MSRB on its customer protection study, the Public Securities Association ("PSA") identified improved secondary market disclosure as the solution for most of the suitability problems which currently exist in the municipal securities market.[14] This PSA statement represents yet another important reason for municipal securities market participants to intensify efforts to achieve adequate secondary market disclosure in that market.

III. Voluntary Industry Initiatives

Many municipal securities market participants have been working diligently to achieve adequate secondary market disclosure and have been making some progress. I wish to specifically mention a few of those initiatives.

I recognize that the GFOA currently has a number of exemplary secondary market disclosure projects underway. It is my understanding that the GFOA is now working with the National Federation of Municipal Analysts ("NFMA") on an Illustrations and Examples of Disclosure publication, which, among other things, in its second phase will provide examples of, and worksheets for, secondary market disclosure for general obligation, revenue, and special district bonds.[15] This publication should be a useful supplement to the NFMA's Disclosure Handbook for Municipal Securities, the NFMA's 1992 Update, and the GFOA's Disclosure Guidelines for State and Local Government Securities. I further understand that the GFOA is working with the NFMA to refine the comprehensive annual financial reports ("CAFRs"). I encourage the GFOA to continue to work diligently on both of these projects.

Since I have mentioned the NFMA, any accolades concerning secondary market disclosure progress should include the NFMA's outstanding Certificate of Recognition program. This program, introduced in January of last year, rewards municipal securities issuers that provide ongoing, audited financial statements and other information relevant to their outstanding securities.

I know that the GFOA encourages its members to participate in this Certificate of Recognition program. I noticed that the GFOA bestowed its 1992 Award for Excellence in the debt management category to one such Certificate recipient, the City of Tallahassee, for its 1991 Report to Bondholders, which was designed to respond to secondary market disclosure needs.[16] I suspect that most governmental issuers, with a little effort, would discover, that like the City of Tallahassee, providing secondary market disclosure through an annual report to bondholders makes sense and serves the issuer's own best interest.

The Certificate of Achievement for Excellence in Financial Reporting, awarded by the GFOA, represents still another outstanding voluntary issuer initiative designed to enhance secondary market disclosure. This Certificate encourages local governments to publish easily readable and understandable CAFRs, satisfying both generally accepted accounting principles and legal requirements.

For another example, there is the NFMA Model Language Resolution which calls for municipal bond official statements to disclose, at the time of sale, the extent, if any, of issuer commitments to provide secondary market disclosure of financial and credit information. I predict that the NFMA pledge will eventually trigger a market pricing and demand reaction to issuers who are forthright in their voluntary dissemination of future credit information.

The NFMA pledge and the issue of secondary market disclosure have recently received additional impetus. Several prominent bond attorneys have apparently decided, correctly in my view, that existing securities regulations, which require disclosure of all material information, in effect require issuers to identify what continuing disclosure issuers are obligated to make by contract or by law and what they plan to do as a matter of policy.[17] By stating clearly what information will be made available and to whom, arguably an issuer has satisfied this aspect of the materiality disclosure standard; and the marketplace is then in a position to react accordingly. Again, it is my view that over time, the marketplace will reward those issuers who pledge to provide secondary market disclosure with a "liquidity premium."

There are already indications that the municipal buy side is beginning to form a pricing differential that recognizes secondary market disclosure efforts. In a survey conducted last summer by the NFMA, about 65% of the institutional analysts responding to the survey said, they almost always, or frequently, require additional yield from, or reject the bonds of, issuers who do not cooperate in making secondary market disclosure.[18] Almost 94% of the analysts responding to the survey believed that issuers should disclose whether or not the issuer would provide secondary market information. As one prominent municipal bond commentator stated recently, "it can now be stated without qualification that there is an upward rate pressure from a substantial segment of the market, and that the pressure inevitably translates into additional yield cost, for issuers who are noncooperative on continuing disclosure, and, correspondingly, into a yield benefit to cooperative issuers."[19] Thus, the evidence is indeed mounting that secondary market disclosure does provide pricing benefits for issuers.

There are other positive developments occurring in the secondary market disclosure area. Kemper Securities Group is operating a system for evaluating unrated municipal bonds.[20] This system should fill an otherwise existing information gap and should help identify for its customers high-quality, unrated municipal bonds. The Investment Company Institute is apparently developing suggested secondary market disclosure guidelines for tax-exempt money market funds and for tax-exempt bond funds.[21] And, in an attempt to improve secondary market disclosure concerning Mello-Roos bonds, the California Public Securities Association prepared and published an approximately 300-page report devoting one page to each outstanding Mello-Roos issue, listing information such as assessed value and ownership.[22]

Finally, the National Association of State Auditors, Comptrollers and Treasurers ("NASACT") has recently released a report on state and local government securities secondary market information and has also created a blue ribbon committee to develop methods for streamlining and enhancing information collection within the states for secondary market purposes.[23] While NASACT has been a leader in advocating adequate disclosure of state and local government finances and operations and should be commended for its leadership, I would prefer a national, central repository or repositories approach, rather than a state-by-state one.

IV. Cost-Effective, Relevant, and Available

For secondary market disclosure initiatives to work, the disclosure provided must be designed to inform investors and must be cost-effective. The usefulness of this information to investors depends upon its reliability, relevance, and accessibility. In terms of cost-effectiveness, frequent issuers will receive more benefits and experience lower marginal costs from providing disclosure to the market than will infrequent issuers. Likewise, for many small issuers that go to market infrequently, the economic benefits obtained from providing secondary market disclosure may not justify the costs.

One key will be to find the right balance of disclosure that will satisfy investors and will not impose excessive costs on issuers. That is why the joint GFOA/NFMA project designed to provide issuers with standardized methods of providing secondary market disclosure information is so important. Hopefully, improved, cost-effective, and more frequent secondary market disclosure by the appropriate issuers will be the result.

Another key to the development of adequate secondary market disclosure is the presence of a national, central repository system that makes that information readily available to investors. Unlike the municipal securities market, in the corporate market, secondary market disclosure practices are aided by the discipline of mandated periodic reporting. The absence of an effective repository system in the municipal securities market has been used as an excuse to forego continuing disclosure practices. Fortunately, the MSRB has recently announced the beginning of the operation of its secondary market disclosure pilot system, which may solve this repository problem.[24] The MSRB's Continuing Disclosure Information ("CDI") pilot system will initially accept and make available three-page documents on paper, by facsimile machine, or over computer modem containing information on municipal securities in the market. I anticipate that later this year, the MSRB will attempt to modify its rules so that CDI will accept up to 25-30 pages of information electronically. I am inclined to be in favor of such an amended rule.

Looking ahead, the GFOA may wish to consider designing an alternative secondary market disclosure format in order that such disclosure could be submitted either through a three page written format or through a longer 25-30 page electronic format. I understand that the NFMA has already designed a three page prototype secondary market disclosure form which would include the issuer's most recent available audit as an addendum thereto. This prototype was apparently drafted with three objectives in mind --- one, to help smooth the issuer's task of responding to investors' requests for ongoing information; two, to produce an appropriate document for submission to the MSRB's CDI system or other repository; and three, to enable issuers to more easily apply for the NFMA's Certificate of Recognition. The NFMA should be congratulated for its efforts with respect to this prototype. The GFOA may consider recommending this prototype to its members.

Obviously, submissions to CDI are voluntary. The American Bankers Association's Corporate Trust Committee and the PSA have been active in their support of the CDI system. I am optimistic that the MSRB's CDI system, if given time, will go a long way toward providing the necessary repository system to make secondary market disclosure information readily available.

As the PSA stated in its customer protection study comment letter to the MSRB, "[w]e believe that the efforts of the MSRB and other organizations involved with the disclosure process will improve information flows in the secondary market. At this point in time, however, a sanctioned mechanism for the dissemination of information does not exist, which is why we believe that secondary market disclosure is the most important issue confronting dealers and customers alike."[25] I agree with the PSA on this point.

V. Conclusion

Having discussed briefly the need for secondary market disclosure as well as having pointed out some exemplary, voluntary efforts to improve such disclosure, I should say that I would prefer to see adequate secondary market disclosure established in the municipal securities market through voluntary means.[26] However, the simplest way to achieve such disclosure would be through the adoption of a Commission regulation that would encourage municipal issuers to provide such disclosure to investors. While there does not exist at the present clear Commission jurisdiction to promulgate a rule applying directly to municipal issuers, a failure or stalling of voluntary efforts could prompt regulatory or legislative action to establish minimum secondary market disclosure standards. In recognition of the voluntary efforts on the part of many participants in the municipal securities market, including the GFOA, to improve secondary market disclosure, I am not advocating a regulatory or legislative approach that would effectively mandate such disclosure at this time. Of course, any decision to defer regulatory or legislative action must be reevaluated over time, and it is therefore important for municipal securities market participants to continue to make progress with the voluntary initiatives.

There are those who would prefer immediate regulatory action to insure adequate secondary market disclosure for the municipal securities market. Almost 60% of the analysts surveyed by the NFMA strongly supported or supported the proposition that issuers should be required by the Commission to disclose whether they would provide periodic reporting.[27] Among institutional investors, the response in this category was over 80%. Moreover, almost 75% of those surveyed strongly supported or supported the proposition that the Commission should require issuers to provide such periodic reports. Among institutional investors, the response in this category was almost 80%. To repeat, I prefer to give the voluntary initiatives underway more time and to allow the NFMA pledge and the MSRB's CDI system to fully develop. In this voluntary fashion, I believe that the marketplace, through pricing, can impose its own secondary market disclosure discipline in a manner that provides greater economic benefits to all concerned, than would a government mandate.

Today, I simply wish to encourage the GFOA to continue to press forward with the secondary market disclosure projects and programs already underway. I also wish to stress that the Commission will continue to follow your progress on these initiatives with interest.

ENDNOTES

1. Roberts, "Improving Secondary Market Disclosure," Remarks delivered to the Government Finance Officers Association's seminar on Disclosure Guidelines and Recent Developments in Municipal Securities, Chicago, Illinois (March 7, 1991).

2. See "Municipal Market Update," Public Finance Digest, a newsletter published by the Government Finance Group, Inc. (Jan. 1993), at 1.

3. See Lebherz, "Refundings Spur Record Year for Munis," The Washington Post (Dec. 20, 1992), at H7.

4. See Allan, "The Good Times Aren't Over Yet," The Bond Buyer (Dec. 28, 1992), at 18, and Davies, "A Look Back at a Satisfying Year for Bonds, And Why Another One Is Coming in 1993," The Bond Buyer (Dec. 28, 1992), at 18.

5. See Schifrin, "Hello, sucker," Forbes (Jan. 18, 1993), at 40, and Wayne, "The Fuss Over Nonrated Bonds," The New York Times (Jan. 24, 1993), at F15.

6. See Gottschalk, "Embattled COPs Give Muni Market the Blues," The Wall Street Journal (Dec. 14, 1992), at C1.

7. Herman, "Municipal-Bond Holders: Watch Out for 'Call' Shock," The Wall Street Journal (Aug. 29, 1992), at C1, and Gasparino, "Balancing Budgets Through Lease Deals May Pose Credit Risks, Rating Agency Warns," The Bond Buyer (Jan. 25, 1993), at 1.

8. Hume, "Rise in Re-Refundings of Escrowed Bonds Likely to Gain Attention of Treasury, SEC," The Bond Buyer (May 12, 1992), at 1.

9. Herman, "Coping With January's Barrage of Bond Calls," The Wall Street Journal (Dec. 24, 1992), at 13.

10. See Walters, "Dealer Asks SEC To Investigate Call by Hospital In California," The Bond Buyer (Oct. 21, 1992), at 1.

11. See Lebherz, supra note 3.

12. See Chamberlin, "New Directions in Public Finance," Institutional Newsletter, a newsletter published by Dean Witter Reynolds, Inc. (March 30, 1992), at 1.

13. See, e.g., Roberts, "Regulatory Issues in the Municipal Securities Area," Remarks delivered to the Municipal Division Executive Committee of the Public Securities Association,

Phoenix, Arizona (Feb. 29, 1992) at 4; Roberts, "Proposals to Improve the Integrity of the Municipal Securities Market," Remarks delivered to the Bond Club of Virginia, Irvington, Virginia (June 13, 1992), at 7; Roberts, "Public Finance and Tax-Exempt Market Concerns," Remarks delivered to the Midwest State Treasurers' Conference, Minneapolis, Minnesota (Aug. 24, 1992), at 2. See also Letter from William H. Heyman, Director, Division of Market Regulation, SEC, to Christopher A. Taylor, Executive Director, MSRB, dated May 8, 1992.

14. Letter from Gerald P. McBride, Chairman, Municipal Securities Division, PSA, to Harold L. Johnson, Deputy General Counsel, MSRB, dated January 8, 1993. ("We however believe that the most serious problem in the area of customer protection continues to be secondary market disclosure.")

15. See "Muni Issuers, Analysts Join Forces On Secondary Mkt Info.," Wall Street Letter (Sept. 14, 1992), at 6.

16. Inzer & Klein, "Responding to Secondary Market Disclosure Needs: Tallahassee's Annual Report to Bondholders," Government Finance Review (Aug. 1992), at 23.

17. See Stamas, "Issuers' Intentions on Secondary Disclosure Are Starting to Appear in Official Statements," The Bond Buyer (Dec. 14, 1992), at 1.

18. "Membership Survey Results," Municipal Analysts Bulletin, a newsletter published by the NFMA (Nov. 1992), at 3.

19. Doty, "The Evidence Mounts That Continuing Disclosure Provides Pricing Benefits For Issuers, " The Bond Buyer (Jan 11, 1992), at 21.

20. See Dickson, "Kemper Securities Group Announces System for Evaluating Unrated Municipal Bonds," The Bond Buyer (Feb. 25, 1992), at 2.

21. See Stamas, "Investment Company Panel Will Draft Secondary Market Disclosure Guidelines," The Bond Buyer (July 1, 1992), at 1.

22. See Altman and Walters, "Mello-Roos Report Providing Issue Data Expected to Improve Trading, Disclosure," The Bond Buyer (Dec. 24, 1992), at 1.

23. See Stamas, "Panel Is Formed To Help Out States In Their Collection Of Continuing Data," The Bond Buyer (Nov. 16, 1992), at 1.

24. See Stamas, "MSRB Sets Jan. 21 to Launch Its Pilot Program For Improving Disclosure in the Secondary Market, " The Bond Buyer (Jan. 15, 1993), at 7.

25. See Letter from Gerald P. McBride, supra note 14, at 10.

26. See Roberts, "Preserve Integrity of Municipal Securities Market," Remarks delivered to the 1992 Bond Buyer Municipal Finance Forum, New York, New York (Oct. 22, 1992), at 14.

27. "Membership Survey Results," supra note 18, at 3. See Stamas, "Analysts Want More Disclosure In Bond Market, Survey Finds," The Bond Buyer (Oct. 22, 1992), at 1.