
Remarks Of

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Washington, D.C.

# "Proposals to Improve the Integrity of the Municipal Securities Market"

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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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## Introduction

The municipal securities market is a national asset that has served investors and issuers well for many years. I believe that it will continue to do so in the future. Of course, given the infrastructure problems faced by state and local governments in the 1990s, everyone hopes that it will continue to do so. However, the municipal securities market can and should be improved, particularly its integrity. After discussing some complaints that I have received regarding banks violating certain tying restrictions with respect to municipal securities offerings, it is my intention to focus today on possible measures to improve the integrity of the municipal securities market in the area of suitability. Among other things, I will expand upon the concept of a specific written suitability requirement for dealers selling unrated or conduit bonds to retail investors that I had suggested to a Public Securities Association audience some three months ago.

## II. Bank Tying Restrictions

From time to time, I receive complaints alleging that banks are unfairly competing for municipal securities underwriting business by

tying their credit enhancements to their role as underwriter. These complaints emanate from a variety of sources, which causes me to take them seriously, although I am unable to state with certainty that they are valid.

Federal banking law imposes a number of prohibitions and restrictions on banks concerning tying arrangements and other noncompetitive practices in connection with bank securities activities. "Tying" generally is defined as any arrangement in which a bank requires a customer that desires one service, such as credit, to purchase other services or products from the bank or its affiliates as a condition of receiving the first service. In addressing this issue, it is necessary to discuss the two principal means by which banks are permitted to engage in securities activities.

First, under Section 16 of the Glass-Steagall Act, banks are permitted to underwrite and deal in "bank-eligible" (generally U.S. government and municipal) securities, but only in a "separately identifiable department or division" ("Bank Department"), which is a

unit under the supervision of officers designated by the bank's board of directors.

Second, under Section 20 of the Glass-Steagall Act, bank holding companies ("BHCs"), with the prior approval of the Board of Governors of the Federal Reserve System ("Board"), may establish nonbank securities subsidiaries to engage in underwriting and dealing in "bank-ineligible" (corporate equity and debt) securities, provided that such subsidiaries are not "engaged principally" in such activities (over 10% of a subsidiary's gross revenues). Thus, although Section 20 subsidiaries may underwrite and deal in bank ineligible securities, they must underwrite and deal predominantly in bank-eligible securities, including municipal bonds. Unlike Bank Departments, Section 20 subsidiaries must register with the Commission as broker-dealers and are thus subject to the full range of regulatory requirements imposed on broker dealers under the Exchange Act.[1]

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[1] State-chartered banks that are not members of the Federal Reserve System or subsidiaries of BHCs may establish direct subsidiaries to underwrite and deal in bank ineligible securities. (continued...)

The Bank Holding Company Act ("BHCA")[2] prohibits a federally-insured bank from requiring a customer to purchase any other product or service from the bank or its affiliates, or to refrain from purchasing products or services from a competitor, as a condition of obtaining credit or any other service from the bank. This anti-tying provision applies to both Bank Departments and banks affiliated with Section 20 subsidiaries. The Board has extended this prohibition by regulation to BHCs and their nonbanking subsidiaries.[3]

Section 16 Bank Departments of national banks are required to follow the rules of the Municipal Securities Rulemaking Board

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[1](...continued)
12 C.F.R. § 337.4. These also must be registered as broker-dealers.

[2] Section 106(b) of the Bank Holding Company Act Amendments of 1970. 12 U.S.C. § 1971.

[3] 12 C.F.R. § 225.4(d). Tying arrangements also may violate federal antitrust laws, including Section 3 of the Clayton Act, Section 1 of the Sherman Act, and Section 5 of the Federal Trade Commission Act. 15 U.S.C. §§14, 1, 45. Unlike plaintiffs alleging violation of the antitrust laws, plaintiffs alleging violations of the BHCA do not have to establish the economic power of a bank and specific anticompetitive effects of tying arrangements as a condition to relief.

("MSRB"). In addition, national banks are required to operate in accordance with the principle of "safety and soundness," and examiners may look with special attention to credit arrangements and securities transactions with a single borrower. All records relating to the bank's municipal securities dealer activities must be separately maintained in the Bank Department, and all securities activities must be supervised by Bank Department management assigned specifically to that area.

Despite these limitations on tying arrangements, I have been informed that banks frequently link credit extensions to an issuer, or enhancements to an offering, to use of the bank or its affiliate as an underwriter of the offering. In practice, private actions are rarely, if ever, brought for violations of these limitations. In part, this is due to problems of proof; in part, it is due to a reluctance to alienate substantial issuers and lenders. For whatever reason, enforcement actions are rarely brought by regulators.

It should be noted that in 1974 the Commission proposed Exchange Act Rule 10b-20, which would have prohibited broker-

dealers from explicitly or implicitly demanding from their customers any payment or consideration in addition to the announced offering price of any security. In 1988, the Commission withdrew the rule ir view of the substantial period of time which had elapsed since its proposal and the fact that "tie-in" arrangements may be reached under existing antifraud and antimanipulative provisions of the federal securities laws. As a practical matter, in fact, this may not be the case.

While it is my understanding that federal banking regulators are contemplating the regulatory elimination of many of the firewalls between banks and their Section 20 affiliates in reliance on the general bank tying restrictions, such a step would place even greater importance on bank compliance with these general restrictions. In my judgment, this is an area that should be monitored carefully to insure that conflict of interest abuses are not imperiling the integrity of the municipal securities market. If it becomes clear to me that banks are continuing to violate these restrictions, then I am of the opinion that the Commission should

consider reproposing Rule 10b-20.

## III. Suitability

I wish to spend the remainder of my time today focusing on some alternative proposals to protect retail investors from inappropriate purchases of high-risk municipal bonds. One such proposal, which I have suggested previously, would require an express written suitability determination by broker-dealers who recommend transactions in certain municipal securities to retail customers. Potentially, all the proposals that I will discuss today could contribute to the continued integrity of the municipal securities market.

### A. Background

In recommending securities transactions to customers, broker-dealers already have an obligation under the general antifraud provisions to determine that the transactions are suitable for each customer. In addition, suitability provisions are contained in the rules of the National Association of Securities Dealers ("NASD") and

the MSRB.[4] MSRB rule G-19 requires that the broker-dealer, at or prior to the recommendation, must "inquire" as to the customer's financial background, tax status, investment objectives, and "similar information." This rule requires that the broker-dealer must either: (i) have reasonable grounds to believe that the recommendation is suitable in light of such information that it knows, or (ii) have no reasonable grounds to believe that the recommendation is unsuitable for the customer if all of such information is not furnished or known. MSRB Rule G-8 requires that any such information that is obtained be retained in the firm's records.[5]

The NASD and MSRB provisions do not specify the manner in which the suitability determination should be made, and they do not require that the determination be made in writing. The absence of a more explicit requirement may in some circumstances cause confusion on the part of broker-dealers and create problems of proof where questions concerning suitability are raised.

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[4] NASD Rules of Fair Practice, Art. III, Section 2, NASD Manual (CCH) ¶2152; MSRB Rule G-19, MSRB Manual (CCH) ¶3591.

[5] Rule G-8(a)(xi)(F), MSRB Manual (CCH) ¶3536.

Exchange Act Rule 15c2-6 addresses suitability concerns with respect to transactions in low-priced equity securities that are designated securities, as defined in that rule. In general, Rule 15c2-6 requires that, prior to recommending the sale of designated securities to a customer, a broker-dealer must: (i) obtain information concerning the customer's financial situation, investment experience, and investment objectives; (ii) reasonably determine, on the basis of such information and any other information known by the broker-dealer, that transactions in designated securities are suitable for the customer and that the customer has sufficient financial sophistication to understand the risks involved; (iii) deliver to the customer a written statement containing the basis for the firm's suitability determination; and (iv) obtain from the customer a signed and dated copy of the written statement.

In considering alternative regulatory approaches to improve the integrity of the municipal securities market, the primary issues are: (i) which municipal securities would be covered, and (ii) what

kind of regulatory action might be taken.

Analysis of these alternative approaches is hindered by a lack of information concerning current market practices. Although I have been provided with reports of investors being sold unrated or conduit municipal bonds that are inappropriate investments for these investors, I do not have a factual record indicating the source of the problem. For example, I do not know whether firms selling conduit or unrated bonds to retail investors are failing to make suitability determinations, whether these determinations are made but are based on insufficient information or are not properly documented, or whether investors are appropriately informed of potential risks involving these bonds and still choose to buy the bonds. Moreover, I do not know whether these concerns arise in the context of initial offerings, secondary trading, or both. The answers to these questions would govern which, if any, of the regulatory alternatives that I will subsequently describe should be pursued.[6]

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[6] An alternative or supplemental approach is enhanced (continued...)

B. Securities to be Covered

(1) Unrated or Low-Rated Securities

The nature of the municipal market precludes the use of criteria, such as price or the absence of exchange trading, that were used in defining designated securities subject to Rule 15c2-6. However, the application of a municipal securities suitability rule could be linked to the ratings assigned to the municipal security, or the failure to obtain a rating, by a nationally recognized statistical rating organization ("NRSRO"). Of course I am sensitive to the difficulties in linking regulatory requirements to such ratings in the

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[6](...continued)

enforcement of current rules. I do not know whether enhanced enforcement of current rules would fully address my concerns. For example, as discussed above, part of a salesman's obligation when recommending a security is to have a reasonable basis for that recommendation. This is, of course, closely related to the suitability requirement. If the salesman is not provided with, or is unable to obtain, adequate issuer-related information, it is unlikely that this reasonable basis requirement is being satisfied, or that an appropriate suitability determination can be made. The problem of broker-dealers recommending bonds on the basis of inadequate information may not be uncommon in the municipal market.

absence of clearly defined criteria for qualification as an NRSRO.[7] However, given the importance of NRSROs in making credit determinations in the municipal market, I preliminarily believe that ratings may provide the best way to identify securities likely to raise investor protection concerns.

If ratings are used, a proposed rule could apply to securities that are unrated, or, in addition to unrated securities, to those that are rated in a "junk" category. It is my understanding that certain small, regional issuers that are well-known locally may not apply for a rating because of the cost involved. It would be difficult to exclude these securities by definition. However, general obligation bonds of established communities could be excluded altogether in order to minimize any interference with the ability of municipal issuers to raise funds for public purposes. For example, when proposing a suitability rule, the Commission could request comment

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[7] I am aware that Kemper Securities recently has created a rating system for unrated municipal debt securities and makes these ratings available to its customers. It is my understanding that the staff of the Commission would not recognize as an NRSRO any system that does not provide ratings that are freely and publicly available.

concerning the volume of these securities, whether the market for the securities is primarily institutional or retail, and the additional costs to issuers that would result from such a suitability requirement.

(2) Conduit Securities

In my presentation to the PSA, I noted the disproportionate default rate of conduit bonds, including nursing home and hospital issues.[8] In lieu of or in conjunction with a ratings test, a rule could apply to bonds the proceeds of which are used by private or commercial enterprises, including developers of raw land in special assessment districts. This approach would reduce the problems identified earlier that are associated with the sole reliance on ratings.

The problems that I see with this approach are partly

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[8] Over the past five years, industrial revenue bonds, housing bonds, and nursing home and hospital bonds yearly have accounted for roughly three quarters or more of the total dollar amount of payment defaults of all municipal securities. Source: Bond Investors Association.

definitional and partly objective. The application of Rule 131 under the Securities Act of 1933 ("Securities Act"), which applies to financings involving a "lease, sale, or loan arrangement, by or for industrial or commercial enterprise," has over time raised many difficult definitional questions. Nonetheless, a suitability rule could be crafted in such a way as to clearly cover issues relating to enterprises such as nursing homes and hospitals, whether or not operated by a nonprofit corporation, where the enterprises are designed to generate profit for a private party. Also, the definition could be stretched to include special district issues, where the repayment obligation lies with the district, but the district is dependent on the success of a single entity, such as a land developer, in generating enough tax revenues to repay the bonds.

C. Alternative Proposals

There are a number of alternative proposals worth considering. As I noted previously, MSRB Rule G-19 requires that municipal securities broker-dealers seek to obtain information bearing on suitability, but the rule does not require that this information be

obtained in all cases prior to a transaction. Because of the MSRB's authority to prescribe sales practice requirements for municipal securities dealers, a regulatory response to suitability concerns could be accomplished either by Commission or by MSRB rulemaking. The Commission historically has deferred to the MSRB in developing rules for municipal securities dealers, except where the MSRB lacks the will or the authority to act.

(1) Require Written Information Related to Suitability

The Commission, or the MSRB by amendment to Rule G-19, could impose an affirmative obligation to obtain specified information prior to a recommended transaction. By operation of Rule G-8, this information would be required to be retained in the firm's records. This represents the least intrusive proposal.

(2) Require Written Suitability Determination

In addition to requiring that specified information be obtained, the Commission or the MSRB, as I have advocated, could require that broker-dealers record in writing their determination that transactions in covered securities are suitable prior to each trade.

This requirement would focus the attention of the salesperson on suitability concerns at the time of the trade and would facilitate compliance reviews.

Further, such a rule could follow the Rule 15c2-6 approach of requiring that the customer sign and return the written suitability statement prior to the trade. This has proven to be the most difficult operational aspect of Rule 15c2-6 for broker-dealers. Although this approach would create a "cooling-off" period that might prove useful, it may go further than is required to address suitability concerns involving low-credit municipal securities.

(3) Risk Disclosure

In conjunction with or as an alternative to a written suitability requirement, broker-dealers could be expressly required to inform customers of special risks related to the security prior to the trade. This approach might provide information to allow the customer to protect himself, rather than relying only on suitability determinations. However, the retail customers for whose benefit

any rulemaking would be proposed may not be capable of fully understanding the potential risks.

(4) Preliminary Official Statement Disclosure

The Commission could require broker-dealers to provide a preliminary official statement to a customer 48 hours in advance of selling certain newly issued securities to the customer. This alternative is based on Rule 15c2-8 under the Exchange Act, which requires that broker-dealers participating in an initial public offering provide preliminary prospectuses to investors at least 48 hours before confirming trades in the securities. This alternative would be consistent with the Commission's tradition of disclosure remedies, although it would break new ground in the municipal realm. However, this alternative would not address any abuses that may exist with respect to secondary market transactions.

(5) Registration for Conduit Bonds

As I have discussed publicly, the Commission could propose legislation to remove the Securities Act registration exemption for all or certain types of conduit bonds. This alternative would

provide direct Commission oversight of offerings that pose the same types of risks that are present in corporate bond offerings, and it would improve disclosure relating to covered securities. In addition, this would effectively divorce the Securities Act registration exemption from the tax exemptions of the Internal Revenue Code. However, a legislative solution might not affect bonds such as the Colorado special district issues or many nursing home and hospital issues, which would be excluded by the Section 3(a)(4) exemption for securities issued by Section 501(c)(3) organizations.

V. Conclusion

Finally, to update you on developments in this area, Bill Heyman, the Commission's Division Director of Market Regulation, has recently written Kit Taylor, the Executive Director of the MSRB, suggesting that the MSRB consider strengthening its customer suitability requirements in connection with transactions in certain types of municipal securities. In this regard, everyone should recognize that the MSRB was established by Congress to serve as a self-regulatory organization for municipal securities dealers --- on

the grounds that self-regulation, where feasible, may be more useful in some cases than direct governmental control. Kit has recently written Bill in response and stated that the MSRB would discuss Bill's suggestions at its next board meeting. I look forward to following the MSRB's progress on this matter.

In conclusion, I am aware that the municipal securities industry does not welcome additional regulatory burdens. However, there do appear to be numerous instances where retail investors are being inappropriately sold high-risk municipal securities. These abuses must stop or be stopped. I know that each of you are interested in preserving and improving the integrity of the municipal securities market, and I look forward to working with each of you toward such an objective. I also look forward to hearing your comments concerning the alternative regulatory proposals that I discussed today.