



Remarks Of

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Continue Improving Our Debt Markets

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

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I. INTRODUCTION

Thank you for inviting me here today. I believe that this is a particularly propitious time for the members of this Institute to be gathering to discuss investors' rights in the debt markets. As some of you may recall, last spring I had the privilege of participating in another Institute conference concerning the need for reform in our debt markets. Among other things, I mentioned the need for additional transparency in the secondary market for corporate, municipal and government debt securities and the need to improve access to current information concerning municipal issuers. Prophetically, in the wake of recent scandals in the government securities market, I questioned the notion, reflected in some of the Commission's rules, that the market for high quality debt securities moved solely on interest rate changes.

Today I wish to follow up on some of the same themes that I mentioned last spring. Specifically, I will discuss recent industry efforts and a growing sensitivity within the Commission to the need for further study of the operation of the corporate, municipal and government markets.

II. OVERVIEW OF THE DEBT MARKETS

Over the past thirty years, the attitude of American corporations on the use of leverage has changed significantly. The average debt to total long-term financing ratio of all non-financial corporations has increased steadily, rising from 15% to almost 40%. Ignoring the large private placement market, rated, publicly issued, long-term corporate debt outstanding now totals nearly \$800 billion. By far, the fastest growing segment of this market in the 1980s was non-investment grade debt, which now accounts for over \$200 billion.

The other component of the public market that grew rapidly in the 1980s consists of asset-backed securities, and in particular, private label mortgage-backed securities. These products, which in some cases did not exist even ten years ago, accounted for over \$140 billion in issuance last year, and the industry already has greatly eclipsed that mark in 1991. Moreover, there is an estimated \$2.5 trillion in outstanding mortgage debt that presumably could be securitized some day.

As a taxpayer, it is striking for me to note that at the end of 1990, long-term debt of state and local government issuers came to nearly \$650

billion. Further, during the last decade, U.S. government debt has grown at a rate of approximately 13% annually to almost \$3 trillion. And the diversity of products and financing techniques used today in the public securities markets exceeds anything that could have been imagined in the 1970s.

As our fixed income markets have grown in importance, the character of our securities market has been changing as well. In addition to a panoply of new products and markets, retail participation in the markets has shifted significantly to surrogates, such as investment companies and pension plans. Furthermore, the line between debt and equity products also has become blurred with the creation of products like REMICs and money market preferred stock - and with attempts by some major issuers to diminish the investor franchise that has long characterized equity participation in a corporation. In fact, although most of our notions of corporate control under the federal securities laws are keyed to equity holders, the so-called "vulture capitalists" have demonstrated that the destiny of many corporations can be more easily controlled by acquiring their debt.

Along with this staggering growth, our debt markets, which once were a quiet backwater of the financial system, now have captured the attention of our press. Through the general news media, we all are made keenly aware of the events that have conspired to bring us here today. We daily are confronted with the legacy of the highly leveraged buyouts and acquisitions of the 1980s and the financial problems of our major cities (as well as the special tax districts in particular states).

III. Commission Efforts

A. Surveillance and Enforcement

Although there are obvious differences between the equity markets and the debt markets, and we may never achieve the same level of information and efficiency in both markets, efforts are underway within the Commission to encourage improvements. I increasingly sense an awareness at the Commission of the need to focus more attention on improving our debt markets.

In addition to the financial problems of some corporate debt issuers and of our cities and states, the recent problems manifest in the government securities market are inescapable. There also are reports in

the press that insider trading is rampant in the debt market: retail investors in municipal bonds are being "picked off" prior to refundings;¹ and there has been active trading in certain high yield corporate bonds prior to the announcement of material events.² These reports demonstrate to me that the absence of direct, meaningful surveillance of the fixed income markets by the Commission and our self regulatory organizations has induced a casual attitude in the minds of some market participants toward their responsibilities under our federal securities laws.

The recent Congressional hearings on the government securities market highlighted the need for additional oversight in that market. In addition, I can tell you that the Commission recently has directed the New York Stock Exchange ("NYSE") and the National Association of Securities Dealers ("NASD") to undertake efforts to develop surveillance programs specifically tailored to the corporate debt markets and to make a review of debt transactions a routine part of broker-dealer examinations. Finally,

¹ Tom Herman, "When Bond Buyers Call, It Pays to Stall," Wall Street Journal, p.C1 (December 27, 1990); Donald Yacoe, "Two in Kentucky Indicted for Using Insider Information in Agency Bond Sale," The Bond Buyer, p.5 (November 5, 1990).

² George Anders, "Is Insider Trading Widespread in Junk Market?," Wall Street Journal, p.C1, (January 31, 1991); Matthew Schifrin, "Sellers Beware," Forbes, p.36 (January 21, 1991).

the Commission's own enforcement staff has under active investigation a number of cases that involve fraudulent practices in fixed income securities.

B. Price Transparency

Beyond surveillance, and the enforcement of existing rules, the Commission also has been examining the need for structural reforms. The development of a National Market System for equity securities has been a major undertaking of the Commission for over the past 20 years. Trade price reporting and current quotes have fostered competition among market participants and allowed investors to monitor execution of their transactions. Although there are significant differences in the markets for debt and equity, I am pleased to note that there has been movement within the past few years to increase the price transparency in the corporate debt and government securities markets.

1. Corporate Bonds

At Chairman Breeden's urging, the NASD, for example, has recently developed a prototype trading system, the Fixed Income Prototype System called FIPs, that would provide trade and quote reporting in the corporate

debt market. The system would offer the analytical data that also is available from many private vendors and could conceivably operate like NASDAQ and other NASD systems, providing current dealer quotes, offering same-day comparison of trades, and automatically routing transactions reported through the system to the appropriate clearing agencies and depositories.

The NASD's system would not be the first to provide this service to the market, however. Already, the NYSE operates an Automated Bond System ("ABS") that allows dealers to trade the debt of major corporations at the touch of a finger. While it has been in existence for many years, the ABS system has not attracted a significant amount of the volume in publicly traded corporate debt. In my view, neither the NYSE's ABS system nor the NASD's FIPs system will be truly successful in the future, so long as they must compete in a market that allows professionals to choose between opacity and transparency. To make these systems truly effective, the Commission may need to consider the implementation of transaction reporting for publicly traded corporate debt.

2. Government Securities

In the government securities market, I believe that it is important to mention that the Public Securities Association recently has begun operating a pricing system that may finally break the monopoly on price information that historically has been maintained by primary dealers. The Government Pricing Information System, Inc. ("GOVPX") is the result of a joint venture of primary dealers and interdealer brokers in the government market. For the first time, on a current basis, investors now can have available a composite picture of dealer activity showing executed trade prices, volume, best bid and offer, and yield in U.S. government securities. However, the GOVPX system is not perfect. The current system does not include information on that portion of the government securities market, the market for Agency debt, where traditionally greater abuses have existed.

I also must note that the Commission recently has recommended to Congress legislation that would, among other things, give the Commission standby authority to implement improvements in the market for government securities, in the event that industry initiatives alone are not

satisfactory. Among other things, this authority could be used to further promote transparency in the Treasury market and to encourage the reporting of quotes and transactions in certain Agency securities. Finally, I wish to mention that the Municipal Securities Rulemaking Board ("MSRB") and the Public Securities Association ("PSA") recently have indicated that they will be studying similar transparency problems in the municipal market.

IV. Industry Participation

In addition to market structure issues, I believe that it now is time for us to revisit the manner in which we view the substantive rights of public debt investors under our federal securities laws. As you are aware, bondholders are viewed under state corporate law as contract claimants to whom no fiduciary duty is owed by a corporation's directors. In theory, debt investors may negotiate the terms of the indenture and preserve their rights by requiring protective covenants in the bond contract. Thus, some courts have said that the responsibilities of directors to bondholders are defined precisely by the terms of the contract, and not by the general

notions of fiduciary duty or fairness that govern the relationship between shareholders and directors.³

In private placements, institutional investors, in fact, can demand covenants that require borrowers to maintain minimum net worth; to limit asset sales or the issuance of senior debt; and to require reports or access to financial statements that afford investors the opportunity to monitor their investments. The same opportunities are not available, however, to many investors in publicly offered debt, including many of the funds represented by members of this audience.

Small public investors interface with the market only through intermediaries and lack the economic clout to negotiate the terms of publicly offered debt instruments. Moreover, even among large mutual

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

funds, with substantial economic clout, the desire to chase yields, or to acquire the securities necessary to meet the demand for the creation and sale of new bond funds, may cause less attention to be placed on protective covenants.

Some would argue that investors in publicly offered debt swap the ability to negotiate covenants for additional liquidity. I wonder, however, whether it is not time to give more thought to the rights of public debt holders under our federal securities laws. Public investors in debt securities currently are not afforded the same substantive protections under our federal securities laws as equity investors. Before closing, I wish to mention two industry efforts that I believe, have the potential to improve our debt markets.

A. Fidelity Proposal

Last Fall, the Commission received a rulemaking petition from Fidelity Management requesting that the Commission address the recent practice of coupling tender offers for debt securities with "exit consents": solicitations that seek to strip the bonds held by non-tendering investors of their protective covenants.

As you know, debt tender offers are not subject to many of the significant regulatory protections that accompany offers for equity securities. For example, the Commission's rules do not impose any filing or disclosure requirements for cash deals. Proration, withdrawal, all-holders, and best price protections do not exist. The only requirements are that the issuer comply with general antifraud measures and observe minimum offering periods.

The Fidelity proposal would make some of the same disclosure safeguards currently available to equity investors, also available to bondholders. Debt holders would be required to receive notice of the results of the solicitation and thus information regarding the exact terms of the security they are being asked to surrender, before having to decide whether to tender into the offer.

I can assure you that the Commission is taking a serious look at that petition, as well as the general area of debt buybacks, to see if additional regulatory measures are appropriate. Where debt tenders are coupled with consent solicitations, among other things, the Commission may wish to consider: Whether all offering materials should be required

to be filed with the Commission, even in cash deals? Whether proration should be required throughout the minimum 20 day offering period?

Whether a bidder making a discriminatory tender offer should be required to send copies of the offering materials to all debt holders, so that everyone will have notice of the potential change in the value of their securities? Whether the outcome of the consent solicitation should be required to be announced at least 10 days prior to the termination of the offer?

B. National Federation of Municipal Analysts.

Another area in which I have noted a great deal of investor activism has been in encouraging secondary market disclosure in the municipal market. As you are aware, issuers of municipal securities are not subject to the periodic reporting requirements of the Securities Exchange Act of 1934. In the absence of specific Commission disclosure requirements, however, some mutual funds that invest in municipal bonds are beginning uniformly to demand covenants in indentures that will require issuers to provide them with necessary secondary market information. In addition, the National Federation of Municipal Analysts, many of whose members

work for the same firms represented by this Institute, proposed that municipal issuers uniformly indicate to investors whether or not they will provide the periodic information necessary for investors to monitor their investment and to support liquidity in secondary market transactions.

I believe that the willingness of an issuer to provide secondary market information, or to indicate sources from which it may be obtained, should be significant to funds investing in municipal securities. The need for current information in the secondary market was highlighted for me by the problems experienced by tax-exempt money market funds holding variable rate demand notes that were insured by Mutual Benefit Life Insurance. Upon seizure of the insurer, which had provided credit support for over \$244 million in variable rate demand notes, funds operating under Rule 2a-7 were required to divest themselves of these securities. Nevertheless, without information concerning the current financial condition of the underlying issuers, there were significant problems in valuing the securities for resale.

I have mentioned the demand notes insured by Mutual Benefit Life Insurance to illustrate liquidity and pricing problems that can result when

sufficient secondary market information is not available. I believe that receipt of current information also is critical, however, for remarketing agents, who must have a reasonable basis for recommending demand notes to their customers, and for the Boards of Directors of tax-exempt money market funds that must monitor the credit quality of their portfolios.

In my view, the proposal of the National Federation of Municipal Analysts is a very positive one. I also intend to recommend that the staff of the Commission give some thought to the importance of current information concerning issuers of variable rate demand notes as they consider amendments to the regulations governing tax-exempt money market funds.

V. Conclusion

In conclusion, I believe that it is time for both the Commission and the industry to focus more attention on the operation of our debt markets and on the protections offered public debt investors. Scandals, such as those which I have alluded to earlier, often are the catalyst that animates regulators to implement necessary reforms. However, they also can

produce excessive regulation that may add unnecessary and unjustified friction to our markets.

As the Commission considers reforms in the debt markets, it will be very important to have more input from investors. To some extent, insurance companies, pension funds, and mutual funds have become a proxy for individual investor participation in our capital markets. Increasingly, the "Wall Street Walk" is taking a back seat to shareholder activism in the equity markets. It is common, therefore, for the Commission to receive comments from the United Shareholders Association or individual pension and mutual funds that stress the interests of equity investors. The Fidelity petition, the efforts of the National Federation of Municipal Analysts, and this conference illustrate that the same phenomenon can occur in the debt markets.

As I stressed last spring, the ICI often participates in the debate about matters affecting mutual funds at the Commission. But your perspective, to date, largely has been as issuers of securities subject to the regulatory requirements of the 1940 Acts. I encourage you to have a stronger voice for debt investors as a means of improving our fixed

income markets. With approximately \$870 billion of debt under management, there is probably no group more capable of presenting the view of debt investors than the ICI.