Remarks Of

Richard Y. Roberts
Commissioner*
U.S. Securities and Exchange Commission
Washington, D.C.

Improving Our Debt Markets

Investment Company Institute
March 26, 1991
Washington, D.C.

---

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

U.S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

I. INTRODUCTION

As most of you are aware, the Rule 2a-7 amendments were my first significant exposure to the Investment Company Institute ("ICI"). The process of cooperation and compromise that led to the recent amendments epitomizes the relationship that should exist between the Commission and industry organizations, but all too frequently is not present.

II. RULE 2a-7

Although commercial paper issuance declined in 1990, the commercial paper market has grown at an annual rate of approximately 19% during the past decade. Money market funds are undoubtedly a major contributor to this growth in the market. As a group, they were among the fastest growing categories of financial intermediaries in the 1980s. And money market funds' appetite for investment in high quality, short-term securities created a natural partnership with commercial paper issuers.

During the consideration of the proposed amendments to Rule 2a-7, a great deal of attention was focused on the growing importance of the commercial paper market and money market funds as an efficient alternative to traditional bank lenders. In addition, more fundamental questions were raised about the extent to which we should rely upon rating agencies as guardians of our nation's credit markets. Although these are important issues, I viewed the amendments very simply as an attempt by this industry to preserve a reputation for integrity that it has expended a great deal of resources to cultivate.

Twenty years ago, the mutual fund industry created a product that it called a "money market fund." While the term "money market fund" describes the type of instruments that these mutual funds invest in, it is also a term that in the minds of 20 million U.S. investors has acquired a secondary meaning. The term "money market fund" has become a trademark. To the investing public, and particularly retail investors, the term "money market fund" has acquired currency and meaning extending beyond its mere descriptive title. Partly due to the Commission's rulemaking, but also in large measure due to the responsible stewardship of the industry, an investor that purchases a money market fund share can know that he or she will receive at least one dollar for every dollar invested - and without the cost of a federal insurance program.

It is evident that the industry recognizes the value of its trademark. In the aftermath of defaults by Integrated Resources and Mortgage and Realty Trust, the ICI realized there was a possibility that some money managers would feel compelled to chase yields by purchasing riskier paper, or that a sudden, unexpected default by a single major commercial paper issuer could occur, in either case causing the first money market fund to "bust the buck." In such an event, all money market funds, even those not directly affected by defaults, would bear the cost of reduced investor confidence. By requiring greater diversification, by limiting investment in second tier paper, and by shortening the maturity of assets held by money market funds, the Commission's recent amendments to Rule 2a-7 should help insure that the value of the money market fund franchise is preserved and that investors are not confused by imitations.

III. Growth in the Debt Markets

The commercial paper market, and the activities of money market funds, however, are simply a constellation in the universe of the fixed income market that has also been expanding during the past decade. With the introduction of new financing techniques, the debt markets have become increasingly important. Notwithstanding their growing importance in this country, they have taken a back seat to the nation's equity markets. I would like to spend a few minutes discussing the need for bondholders, including mutual funds, to be more militant in preserving their rights under current state corporate law, and the need for the Commission to focus more attention on strengthening the integrity of our nation's 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 mortgage-backed securities. These products, which in some cases did not exist ten years ago, accounted for over $140 billion in issuance last year. 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 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.

While the fixed income markets have been growing in importance, the character of our world securities markets 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. 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. In light of these changes, I believe that it is time for all of us to undertake an assessment of the protections afforded debt investors.

IV. Bondholder Activism

As many of 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, 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.[1]

---

[1] 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 (continued...)

In a perfect world, with full disclosure, bondholders would write contracts to protect themselves from perceived risks or would demand a premium to reflect the risk. But today, in most cases, bond contracts are written largely by management and their counsel, perhaps with input from the rating agencies. Moreover, an investor in the secondary market has little opportunity to rewrite the bond contract. But if the sole recourse of bondholders under state corporate law is to enforce contractual rights under the bond contract, then investors need to be more militant, and they also need the protections of adequate disclosure and of a market that can transmit accurate, current price information, so that the value of the bond contract can be reflected in the price of the security.

V. The Federal Securities Laws

Beyond the fundamental distinctions that exist between bondholders and equity holders under state corporate law, there also is a distinction that is evident in the federal securities laws. Although it is very subtle, I

---

[1](...continued) 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).

believe that there is discrimination between shareholders, who are perceived as participating in the growth of our nation's capital, and bondholders, who are mere creditors. Many of the inherent safeguards, and many of the structural market protections, that are present in the equity markets do not exist for debt holders under our federal securities laws. And, until recently, the Commission's focus, in terms of investor protection, has largely been on the most visible segment of the securities markets - the equities market.

In 1975, for example, Congress added Section 11A to the Exchange Act and required the Commission to establish a National Market System for securities. In doing so, Congress found that, among other things, it was "in the public interest" to have (1) economically efficient execution of securities transactions, (2) fair competition among broker-dealers, (3) the availability of information with respect to quotations for and transactions in securities, and (4) the execution of investors' orders in the best markets. As a result of this Congressional mandate, the Commission and industry jointly have worked on the development of an efficient National Market System for equity securities. We now have an intermarket trading system and real time quote and trade reports that allow investors the chance to identify and access the most competitive markets for a particular security.

The fixed income markets, however, have largely been an "after-thought" in our regulatory scheme. The 1975 legislation that required the Commission to take a hard look at the way equity securities were traded, excluded governments and municipal debt, and there was little mention of the market for over-the-counter and exchange listed corporate debt. While the Commission has discussed for over twenty years the prospect of improving transparency in the fixed income markets, today, the corporate, municipal, government, and asset-backed markets have become too important to ignore. Nevertheless, these markets currently lack the disclosure and price discovery mechanisms that characterize modern efficient markets.

Although there are obvious differences between the equity markets and the debt markets, and efforts are underway to make improvements, which I will mention in a minute, with the technology and resources we now have available, additional attention should be devoted to improving the debt markets. To illustrate one of the problems that currently exists, The Wall Street Journal reported last week that a retail customer was quoted bids of $22 and $34 for a company's bonds by different market makers on the same day.[2] Current trade price reporting would reduce price disparities by enhancing competition among dealers in debt securities, and allowing customers to make more informed investment decisions.

The different level of regulatory protections afforded debt and equity investors is not only evident in our market structure. It also exists under the Commission's periodic reporting and tender offer regulatory scheme. In fact, in the municipal and high yield corporate debt markets, the absence of secondary market information may be the greatest impediment to increased efficiency. As you are aware, municipal issuers are exempt from the Commission's reporting requirements. Moreover, even for those municipal issuers that do produce periodic reports, there is no central, easily accessible source of information. For corporate issuers, secondary market information is required only if there are 300 or more equity

---

[2] Laurie Cohen, "Let the Small Investor Beware of Those Junk Bond Prices," Wall Street Journal, p.C1 (March 18, 1991).

investors, regardless of the number of debt holders the corporation may have.

Debt tender offers also 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.

These disparities in our regulation are all too apparent to investors. There have been debt tenders by public companies recently where issuers and affiliated parties have repurchased large amounts of their non-investment grade debt, as part of restructurings, without offering their debt holders the same basic disclosure protections received by equity investors. In addition, public companies recently have gone private and repurchased their debt at severe discounts when the absence of periodic reports greatly reduced liquidity in the secondary market. Finally, there are reports in the press that insider trading is rampant in the debt markets. I have read stories about retail investors in municipal bonds being "picked off" prior to refundings,[3] and I am aware of reports that active trading in certain junk bonds has occurred prior to the announcement of material events.[4] While we are confronted with some different legal issues when pursuing insider trading in the debt markets, among the legion of enforcement actions taken by the Commission, I cannot cite a single completed case involving insider trading in debt securities. Indeed, I also find surprising the notion reflected in some of our antifraud rules that bond prices solely are based upon changes in interest rates and therefore cannot be manipulated.

VI. The Future

Although the solution to some of the problems in the fixed income markets may need to come from federal and state legislators, it appears that progress already is underway at the Commission and in the industry. Bloomberg, Cantor, Reuters, Telerate, Bridge and others now provide

---

3 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).

4 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).

important market information about segments of the bond market that was not available ten years ago. In addition, in the 1990s, I increasingly sense an awareness at the Commission of the need to focus more attention to improving our debt markets. There already has been movement to increase the price transparency in the non-investment grade corporate debt and government securities markets.

The NASD, for example, has recently indicated that, in addition to its PORTAL system for Rule 144A securities, it may be willing to build and operate a system for trade and quote reporting in the high yield corporate debt market. The system would provide 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. To make the system truly effective, however, the Commission would need to play an important role in requiring dealers to participate and to submit transaction reports that will be made available to vendors.

In the government securities markets, the Public Securities Association also has recently announced the availability of a government securities pricing system that will 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 markets. Once the system is operational, investors will have available for the first time, on a current basis, a composite picture of dealer activity showing executed trade prices, volume, best bid and offer, and yield in U.S. government securities.

Finally, I am pleased to see the increasing activism of mutual funds in the fixed income markets. In the absence of specific Commission disclosure requirements, institutional investors in municipal bonds are beginning to demand covenants in indentures that will require issuers to provide them with necessary secondary market information. Moreover, 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 consent solicitations that seek to strip the bonds held by non-tendering investors of their protective covenants.

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 will take a serious look at that petition, as well as the general area of debt buybacks, to see if additional regulatory measures are appropriate.

VII. Conclusion

In conclusion, insurance companies and mutual funds have become a surrogate for individual investor participation in the debt markets. Increasingly, the "Wall Street Walk" is taking a back seat to shareholder activism in the equity markets. There is evidence of the same phenomenon occurring in the debt markets as investors become more active in demanding covenants that will protect the value of their investment.

While frequently bondholder protections are thought of strictly in terms of covenants that prevent the issuance of senior debt, they may also mean improved disclosure and better fixed income markets. 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 would like to 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.