Remarks Of

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"Secondary Market Disclosure and Swaps"

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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 of the Commission.

U.S. Securities and Exchange Commission
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I. Introduction

I appreciate the opportunity to participate in this legislative conference. It is always a pleasure to be involved in a National Association of State Treasurers' ("NAST") gathering. Each of you currently are faced with the onerous task of causing each state dollar to generate more on the investing side and to stretch farther on the spending side. Good luck!

Fortunately, interest rates are historically very low, and the municipal securities market appears to be operating in an efficient manner. I noticed that both the January and February municipal issue volume for 1993 have set a new record high.[1] If marginal tax rates increase as expected, investor demand for municipal securities, particularly on the part of individual investors, should increase as well.[2] Certainly the debt markets, long considered the stepchild of our capital formation system, are now high profile. It is about time that the debt markets have acquired the visibility they deserve.

I intend to focus today on the topic of secondary market disclosure, which should be pertinent to you as an issuer of tax-exempt securities, and on the topic of derivatives, which should be relevant to you both as an issuer and as a purchaser of securities.

II. Secondary Market Disclosure

As everyone here is aware, the Municipal Securities Rulemaking Board ("MSRB") is in the throes of a study, among other things, of its suitability rules. The MSRB deserves to be congratulated for conducting a customer protection study. I suspect that it would have been much easier not to undertake such a project.

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 municipal investors. The integrity of the municipal securities market is central to this relationship and is central to the success of that marketplace.

I am of the opinion that the MSRB's study represents an opportunity to enhance the integrity of the municipal securities market, which, if capitalized upon, could only work for the benefit of state treasurers. Municipal securities have been viewed historically as "safe" investments, and I believe that everyone wishes for that view to continue.

The Public Securities Association ("PSA") identified secondary market disclosure, or the lack thereof, as the most serious problem in the area of customer protection for the municipal securities market in its comment letter to the MSRB in conjunction with the study. A similar conclusion was reached by the National Federation of Municipal Analysts ("NFMA") in its comment letter. I am inclined to agree with the thrust of these comment letters. While I will not recite the many projects and programs now underway, I do recognize that some voluntary progress is being made toward improving secondary market disclosure in the municipal area.

Although there does not exist at the present clear Commission jurisdiction to promulgate a rule requiring secondary market disclosure which would apply directly to municipal issuers, a failure or stalling of these 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 to improve secondary market disclosure, I am not advocating, with one exception, a regulatory or legislative approach that would effectively mandate such disclosure at this time. Of course, any decision to defer regulatory or legislative action in this area must be reevaluated over time, and it is thus important for all municipal securities market participants to continue to make progress with these voluntary initiatives.

I should point out though that there already exists those who would prefer immediate regulatory action to insure adequate secondary market disclosure for the municipal securities market. Almost 60% of the analysts surveyed last summer 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.[3] 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%.

Similarly, in its comment letter to the MSRB, Barre & Company expressed support for a mechanism "to force issuers to report quarterly to the public, financial data and any other pertinent information so that all issuers can be monitored."[4] Even the Government Finance Officers Association apparently is urging state and local governments to assert control over vendor and developer lease sales and to require the terms and risks of such deals to be disclosed to investors.[5]

I do encourage the NAST to give strong consideration to recommending that its members adopt 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 material financial and credit information. I believe that this NFMA pledge, if utilized, will eventually trigger a market pricing and demand reaction to issuers who are forthright in their voluntary dissemination of future financial and credit information and that those issuers who utilize the pledge will ultimately be rewarded.

The NFMA pledge and the issue of secondary market disclosure have received some additional impetus lately. 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.[6] 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 is one municipal securities area where I believe the Commission is justified in imposing secondary market disclosure requirements and that is with respect to tax-exempt money market funds.

Investment Company Act Rule 2a-7 provides an exception to the "daily mark-to-market" requirement for money market funds. In order to utilize this exception, a money market fund, whether taxable or tax-exempt, is required to purchase only those securities which, among other things, are U.S. dollar-denominated debt instruments that are determined by the fund's board of directors to be of minimal credit risk.[7]

I do not understand how a board of directors for a tax-exempt money market fund could determine that a security is of minimal credit risk, as is currently required, unless the issuer of the security is willing to provide material secondary market information. While this is not necessary for taxable funds since such information is already required to be filed with the Commission and made available to the public, such a requirement is necessary for tax-exempt funds in the absence of any similar filing requirement. It appears to me then that an explicit information requirement along the lines of the NFMA Model Language Resolution should be added to Rule 2a-7 for tax-exempt money market funds to assure the integrity of those funds. When the Commission considers proposing amendments to Rule 2a-7 for tax-exempt money market funds, if necessary, I will attempt to add such a requirement to the proposal. I believe that fund management needs access to current information in order to determine that a security is an appropriate investment for a money market fund.

Other than with respect to tax-exempt money market funds, I prefer to give the voluntary initiatives underway more time and to allow the NFMA pledge and the MSRB's continuing disclosure information pilot system to fully develop. In this voluntary fashion, I believe that the municipal securities 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 all municipal securities market participants, including the NAST, to continue to press forward with the secondary market disclosure projects and programs already underway. I also wish to stress that the Commission and the Congress will continue to follow the progress on these initiatives with interest.

III. Swaps

Moving on to topic number two, as everyone here is aware, the development of derivative products has been the focal point of most discussions concerning the direction of public finance for several years now.[8] I suspect that the majority of tax-exempt funds now hold, or have at some time invested in, synthetic securities.

These securities are not easily understood or, at least, not easily understood by me. Because of the complexity of these new financial instruments and their increasing popularity, there should be more intense scrutiny, in my judgment, of municipal derivative securities activity by the Commission. Regulators are often behind the industry in the learning curve with respect to new financial products and are often suspicious of these new products until they have demonstrated an ability to withstand market stress. Regulators also often hold the view that the securities industry tends frequently to understate or to ignore the risks of new financial products.

In an effort to close the gap in this learning curve, the staff of the Commission is now collecting a substantial amount of information on both taxable and tax-exempt derivative securities from the securities industry as a part of its risk assessment program pursuant to rules adopted by the Commission under the authority of the Market Reform Act. This exercise should enable the Commission to assess the current risk assessment policies of broker-dealers and to develop new risk assessment procedures if necessary. Hopefully, as an outgrowth of this exercise, the Commission will ultimately become more comfortable with these new financial products.

I also anticipate that before the end of the year, the Commission will propose amendments to its net capital rule setting forth the appropriate capital treatment for derivative securities. Of course this will involve making a determination as to the market risk of particular derivative securities, at least for net capital computation purposes. One challenge that the Commission will face in this regard is to determine how to require sensible capital treatment of derivative securities without forcing the transactions into unregulated affiliates or forcing the derivatives market off-shore. As Commissioner Carter Beese stated in a recent presentation on this subject:

> There is a fair argument to be made that segregating these risks in entities that do not hold

customer funds and securities is good policy. But I wonder if creating incentives to effect these transactions in unregulated entities where they are out of sight fulfills our obligation to protect investors. If we follow current practice, regulators will end up stubbornly standing guard over a shrinking core of the retail-related markets while ceding rapidly growing portions of institutional and cross-border finance to the unregulated area.[9]

One popular municipal derivative investment product that I am sure the members of this audience are familiar with is the interest rate swap. From a regulatory perspective, I know that particular concerns have been expressed in the swaps area with respect to the counterparty or credit risk involved.[10] Currently this credit risk is being concentrated in a few highly rated banks and securities firms, or in affiliates thereof. But as the swaps market continues to explode, the credit quality of the participants will inevitably decline which should exacerbate the credit risk on the table for a swapper. It has been suggested that in this event, a swapper could require its counterparty to provide assets as collateral in case the counterparty did fail.[11] Obviously this just complicates an already complex area. Further, concerns have been expressed about the liquidity of interest rate swaps in times when liquidity may be most needed.[12] No doubt liquidity has been a problem for new financial products in the past during times of market stress. It will be interesting to observe how regulators handle the issues presented by interest rate swaps in the years to come.

Under the right set of circumstances, I do understand that the use by governmental issuers of interest rate swaps can be an effective instrument for state and local debt management programs. However, I would caution all the issuers in this audience to exercise care and to be sure that the swap is designed properly in order that the risks attendant to the product do not outweigh the benefits. Some of the factors to consider, in addition to the counterparty risk, that have been pointed out to me are -- the certainty of legal authority, the leveraging involved, the length of the swap, the index used, the compensation paid to the counter-party, the break-even point, the ability to obtain comparable market quotes, and the political problems posed in the event of unanticipated payments under a swap agreement.[13] I suspect that these are considerations more appropriate for the marketplace and for governmental issuers, than for federal securities regulators. In any event, I am unaware of anyone at the Commission who is interested either in overregulating or in stifling innovative financial engineering.

IV. Conclusion

I know that each of you are interested in preserving and even in improving the integrity of the municipal securities market, as that will only make your job easier, and I do look forward to working with each of you toward such an objective. As I reflect upon the leadership that each of you have exhibited in the area of public finance, I am confident that in the future we can direct the municipal securities

market, new financial products notwithstanding, in a manner that will accomplish such an objective.

ENDNOTES

1. Hicks, "New Issues Hit $16.37 Billion, Setting Record For February," The Bond Buyer (March 2, 1993), at 1.

2. Vogel, "Munis Can See Further Gains, Say Managers," The Wall Street Journal (Feb. 22, 1993), at C1.

3. "Membership Survey Results," Municipal Analysts Bulletin, a newsletter published by the NFMA (Nov. 1992), at 3. See Stamas, "Analysts Want More Disclosure In Bond Market, Survey Finds," The Bond Buyer (Oct. 22, 1992), at 1.

4. Letter from David Glatstein, Barre & Company Incorporated, to Harold L. Johnson, Deputy General Counsel, MSRB, dated November 30, 1992 ("Barre Letter").

5. Hill, "Issuers Should Take Charge of Vendor Deals And Mandate Disclosure, Finance Officers Say," The Bond Buyer (Jan. 28, 1993), at 1.

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

7. See ICA Release No. 18177 (May 31, 1991).

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

9. Beese, "The Future Of The OTC Derivatives Market: Where Do We Go From Here," Remarks delivered at the Risk Magazine/CATS Software Symposium, London, England (Dec. 1, 1992), at 7.

10. See Hansell and Muehring, "Why derivatives rattle the regulators," Institutional Investor (Sept. 1992).

11. See "The ratings war," The Economist (Feb. 13, 1993).

12. See "Brady Warns Of Risks Posed By Swaps Market, Urges One Regulator," 24 BNA Sec. Reg. & Law Report 1888 (Dec. 25, 1992).

13. See Johnson, "As the Importance of Interest Rate Swaps Grows, So Does the Need for Issuers to Guard Against Risk," The Bond Buyer (August 10, 1992), at 29. The aforementioned article was adopted from remarks delivered by J. Chester Johnson, president of Government Finance Associates, Inc., to the

Institute for International Research, New York, New York, (June 29, 1992).