**Remarks Of**

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**Washington, D.C.**

# "Comments on Municipal Market Reforms and Rule 2a-7"

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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.

U.S. Securities and Exchange Commission
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## I. Introduction

The municipal securities industry has experienced extraordinary scrutiny in recent months, most of it negative, both from regulators and from the media. Much of this attention has been focused on two issues: the need for improved disclosure in the municipal market, particularly in the secondary market, and the use of political contributions by underwriters and other securities professionals to obtain municipal securities business. I wish to say something with respect to both of those issues. I also wish to say something with respect to potential Commission action forthcoming on proposed amendments to Investment Company Act Rule 2a-7 which will deal with tax-exempt money market funds.

There are, though, a number of other problems in the municipal market that warrant serious attention. Among these problems, in my view, are the lack of mark-up disclosure in municipal securities transactions, the need for bond purchasers to be informed of whether their bonds are rated, the lack of transparency, and the lack of information available to the marketplace regarding syndicate practices. While I will not say much more regarding these latter issues, nevertheless, they are important and should be mentioned. Of course, the Commission's recently issued Staff Report on the Municipal Securities Market ("Staff Report") contains recommendations with respect to all of these matters.

As Chairman Levitt has indicated recently on more than one occasion, the principal way to improve the integrity and fairness of the issuance and trading of municipal securities is with more information. More information about issuers so that investors can better evaluate their securities. More information about the market so that investors can obtain fair prices. And more information about transactions so that regulators can do their job better. Investors will benefit from greater knowledge and confidence in their investments by a more informed marketplace. Consequently, the public at large will benefit from a stronger and healthier source of funding for local governments.

However, before I begin my discussion today, I wish to point out some positive aspects about today's municipal securities market, and there are plenty. The municipal securities market continues to be an exciting and active one. The record-breaking municipal securities new issuance volume in 1992 of approximately $235 billion[1] has already been surpassed in 1993. In the first eleven months of this year, apparently a total of approximately $261 billion of new municipal securities were issued.[2] Almost two-thirds of these municipal issues were refundings.[3]

Low interest rates, of course, are the primary driving force behind the new issues and the continuing number of refundings brought to market. The low interest rates have not only made many capital intensive projects less expensive, but they have also encouraged municipalities to refinance their callable debt.

Further, at least until recently, investor demand continued to outstrip the ever-increasing supply. The anticipated continuing increase in individual tax rates appears to be the driving force behind the surge of individual investor interest. As a general proposition, the demand for municipals on the part of individual investors is expected to continue to rise,[4] particularly as tax rates continue to rise.

My point is that while the focus of the current scrutiny of the municipal securities market has been on the need to correct certain persistent problems, there is also a great deal of good occurring in this market. Everyone should not lose sight of that. Although I do believe that some municipal securities market reform is necessary, the reform actions should be measured, appropriate, reasonable, and cost-effective.

I recognize that the municipal securities market is not collapsing and that the reform necessary falls in the category of adjustment rather than reconstruction. There are a number of nagging problems which deserve attention, but the responses thereto should be balanced and tempered with the notion that this market is thriving and is fairly efficient. On the other hand, complacency is not the appropriate regulatory response in my view either.

The ability of thousands of governmental issuers to enter the municipal bond market repeatedly in order to finance 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 is central to this relationship and central to the success of that marketplace. Municipal securities have traditionally been viewed by investors as a relatively "safe" investment, and I believe that the Commission should adopt the appropriate, reasonable measures necessary to ensure that such a view continues.

## II. Political Contributions

There are two approaches which have been initiated as a response to the negative political contribution perception which exists in today's municipal securities marketplace. These approaches appear to me to complement each other. The first is the regulatory approach being developed by the Municipal Securities Rulemaking Board ("MSRB"). While I have not yet had the opportunity to review the MSRB's rule in print, I am encouraged by the reports that I have received. It appears that the MSRB has demonstrated strong leadership in this area and is in the process of developing a sound, responsible rule. I certainly commend the MSRB for moving aggressively and expeditiously.

Of course, the other approach is the voluntary ban approach which is not limited by constitutional or jurisdictional concerns. Many of our nation's largest securities firms are developing this approach initially and have already agreed in principle to discontinue the practice of making political contributions that attempt -- or even appear to attempt -- to influence the selection of the firm as an underwriter. While I am not privy to all of the developments, it appears to me that the actions by the large firms can indeed serve as a model, which I hope will be followed, if not already, by all of the municipal securities firms that may be represented here today.

I do encourage that some voluntary action be taken. I will be extremely disappointed if any of the municipal securities firms which may be represented here today elect to sit back and wait for the development of an MSRB political contribution rule. You can voluntarily do more than, and go farther than, the MSRB rule and should do so in my judgment. Many of you have indicated to me in the past that a ban is what you want and you now have the opportunity to establish one.

Although political contributions that express one's sincere support for a candidate are the lifeblood of our political process, contributions that coincide with business relationships can diminish respect for elected officials and for our markets and should therefore be discouraged.

I hope that whatever voluntary consensus may emerge, together with the proposed rulemaking by the MSRB, will serve as a model for developing the industry standards which will best protect the integrity of the municipal securities marketplace in the future. The two approaches appear to me to work hand in glove together. All municipal securities participants deserve a fair and efficient marketplace where allegations of graft and corruption are the rare exception rather than the rule.

Apparently there has been some sense that the Commission's approach to the so-called Group of 17 voluntary initiative was meant to be limited to some Wall Street exclusive club. I wish to stress that the Commission's intention was always to be inclusive, not exclusive. I pledge that the Commission will continue to work with anyone and everyone to help pursue any appropriate voluntary consensus that develops.

III. Secondary Market Disclosure

Moving to the subject of disclosure, disclosure deficiencies have always existed in the municipal securities market. As a result of the WPPSS controversy, the

Commission attempted to remedy initial disclosure deficiencies in this market through the promulgation of Exchange Act Rule 15c2-12.[5] Although initial disclosure deficiencies continue to persist and further improvements remain necessary, primary disclosure practices have improved considerably; and I believe that Rule 15c2-12 has been relatively successful. The gaping disclosure deficiency which currently exists in the municipal securities market is in the secondary market.

Earlier this year in a letter to the MSRB, the Public Securities Association ("PSA") indicated that the lack of secondary market disclosure poses one of the more serious customer protection problems in the municipal securities market.[6] I agree. The present lack of adequate secondary market disclosure is a problem for brokers when recommending municipal securities to retail investors, for municipal bond funds when they attempt to mark their securities to the market daily, and for investors when they attempt either to buy or to sell municipal bonds in the secondary market. These problems will become even more exacerbated if municipal bond trading increases in the future as expected, and it is already estimated that municipal securities trading averages $3 billion per day by dollar amount.[7]

Fortunately, there are both rulemaking and legislative alternatives now under active consideration to deal with the lack of secondary market disclosure in the municipal securities market. These alternatives were discussed in the previously mentioned Staff Report.

Of course, in order for any secondary market disclosure initiative to work, the disclosure provided must be designed to inform investors and must be cost-effective. The usefulness of this information to investors will depend upon its timeliness, reliability, relevance, and accessibility. What may be necessary from many issuers is only the provision of a comprehensive annual financial report ("CAFR") within a reasonable length of time after the end of the fiscal year, which would include, among other things, an annual audited financial statement, and the timely dissemination of a notice upon the occurrence of a material event.

Concerning this latter point, the American Bankers Association ("ABA") Corporate Trust Committee in June of 1990 prepared a draft of disclosure guidelines for corporate trustees involved in tax-exempt transactions. This ABA list of sixteen items appears to me to represent a sound, reliable and relevant list of items that should be disclosed in a timely manner to the municipal secondary market. Most of the matters on the list should already be in the possession of the trustee and should require little additional work on the part of issuers. I am not as keen on the ABA revised disclosure guidelines issued in September of 1991, which are merely a watered down and effectively useless version of the 1990 draft.

In terms of cost-effectiveness, frequent issuers will receive more benefits and experience lower marginal costs from providing secondary market disclosure to the market than will infrequent issuers. Moreover, for many small issuers that go to market infrequently, the economic benefits obtained from imposing secondary market disclosure may not justify the costs.

So far as accessibility is concerned, it appears to me that secondary market disclosure should be provided to a national repository. If states desire that such disclosure be provided to a state repository as well, I see no problem with such a requirement. However, at a minimum, investors need for the disclosure to be transmitted to a national repository in a timely manner.

Although I acknowledge that there are a number of exemplary voluntary secondary market disclosure initiatives underway, the Staff Report indicated that reliance only on a voluntary approach to achieve adequate municipal securities secondary market disclosure has not worked to date and that legislation would serve as the only comprehensive solution. The Report stated:

**Although these voluntary efforts should be encouraged, by their very nature, they are insufficient to address the inconsistencies in the quality of disclosure in the municipal securities market. In the Staff's view, comprehensive improvement of the existing system would require Congressional action.** Congress, for example, could provide the Commission with direct statutory authority to set mandatory disclosure requirements for municipal issuers and authorize specifically the Commission to require continuing financial disclosure by municipal issuers. Congress could even rescind the exempt status of municipal bonds under the Securities Act and the Exchange Act, thereby subjecting them to the registration and continuous reporting obligations applicable to corporate and foreign government bond issuers. The system for corporate and foreign government bond issuer reporting could not be adopted wholesale, but would need to be adjusted to take into account the unique characteristics of the municipal securities market.[8]

Chairman Levitt further stated in his testimony at the congressional hearing that a legislative approach was the only meaningful way to ensure comprehensive disclosure both on an initial and continuous basis.[9] However, in almost the same breath, Chairman Levitt indicated that the passage of such legislation was unlikely.

When the Securities Act was enacted in 1933 and the Exchange Act in 1934, Congress made the decision that the regulatory burden in the municipal securities market was to be placed on the broker-dealer industry. That view was reaffirmed with the passage of the Tower Amendment in 1975. It is unlikely that this view will change in the near future. Thus, as attractive as the legislative alternative is to me, I am not optimistic that such an approach will work.

This brings us to the regulatory alternatives. Rather than wring their hands and whine about their lack of jurisdiction, the Staff in their Report also explored

Commission rulemaking alternatives in the event that the legislative approach was not followed. The Staff Report set out that:

> If Congress chooses not to provide the Commission with full authority to address the adequacy and consistency of disclosure in this market, the Staff believes that the Commission could explore ways to improve initial and secondary market disclosure under its existing authority. Specifically, the Staff will prepare a memorandum and draft release recommending that the Commission use its interpretive authority to provide guidance regarding the disclosures required by the antifraud provisions of the federal securities laws. Similarly, the Staff will recommend amending Rule 15c2-12, or adopting similar rules, to prohibit municipal securities dealers from recommending outstanding municipal securities unless the municipal issuer makes available ongoing information regarding the financial condition of the issuer of the type required in initial offerings. . . .

Although awkward, the Commission interpretive and rulemaking approach recommended by the Staff has merit and is attractive to me. It is my understanding that the Staff has been working furiously to develop the interpretive release mentioned in the Staff Report with an eye toward Commission action no later than February of next year. This release is expected to include a provision dealing with the issue of secondary market disclosure.

Among other things, the Staff has been involved in a virtual endless series of meetings with various municipal securities market participants to better understand the structure and needs of the municipal marketplace. I look forward to reviewing the Staff recommendations in this area in the near future.

In any event, I am inclined to support the Staff proposed interpretive and rulemaking approach. I recognize that others, including the PSA, consider part of this approach draconian in nature and rather impracticable. Specifically, I understand that the PSA opposes the adoption of a rule that prohibits municipal securities dealers from recommending outstanding municipal securities unless the municipal issuer makes available certain ongoing information. The Commission could partially mitigate the PSA's concern by inserting a grandfather clause and thereby make the rule prospective only. This makes sense, although such an approach does pose both drafting and operational hurdles.

The PSA, in objecting to this approach, also probably resents the unfairness of placing an additional regulatory burden on the broker-dealer industry. While the municipal securities market is lightly regulated (and does not need much regulation for that matter), I acknowledge that broker-dealers are very heavily regulated already. However, Congress made the decision years ago that broker-dealers are the appropriate party to bear this burden, and Congress does not appear at the present to be likely to change that view.

Apparently the PSA does support a rule requiring the underwriter for each issue of municipal securities: (i) to explain to the issuer the significance and importance of continuing disclosure in the secondary market; and (ii) to recommend that the issuer undertake a commitment to provide continuing disclosure for the issue being underwritten. The MSRB may also favor such a rule.

While joining the PSA in opposing the Staff's suggested rule, the MSRB apparently is willing to go farther than the PSA and seemingly would be inclined to support a rule requiring all dealers to make certain written disclosures to customers purchasing municipal securities. The disclosures would: (i) indicate to the customer whether the issuer of the securities has made a commitment to provide continuing disclosure for the issue; and (ii) explain to the customer the effect that the lack of continuing disclosure information may have on the ability of the customer in the future to obtain an accurate valuation of the securities and to find a ready market for the securities if they are sold prior to maturity.[10]

While there may be variations in the specific approach taken, the foregoing discussion indicates that there does appear currently to exist a consensus among the Commission, the MSRB, and the PSA that some rulemaking action is necessary to complement the planned interpretive release. I am comforted by this consensus, and it will be interesting to see what rulemaking approach ultimately carries the day.

IV. Rule 2a-7

Before closing, I do wish to point out that there is another municipal securities area where I believe the Commission is justified in imposing limited secondary market disclosure requirements, and that area is tax-exempt money market funds. The Commission may consider proposing amendments to Investment Company Act Rule 2a-7 dealing with tax-exempt money market funds before the end of the year.

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.[11] At the outset, I should point out that it appears to me that for tax-exempt money market funds, the present minimal credit risk requirement of Rule 2a-7 should be modified to make it clear that this determination should be an ongoing matter and is not limited to one initial determination.

However, I do not understand how a board of directors for a tax-exempt money market fund could determine that a security presents minimal credit risks, even as is now required, unless current material secondary market information on the security is available, under certain circumstances. Thus, I believe that money market fund management should have access to some current information, under certain circumstances, in order to determine that a security is an appropriate investment for a tax-exempt money market fund.

Two examples, both of which have occurred during my Commission tenure, reaffirm my belief that an appropriate continuing information requirement should appear in the upcoming Rule 2a-7 proposal. I will walk through each example.

The majority of securities held by municipal money market mutual funds are variable-rate demand notes ("VRDNs"), which are long-term municipal bonds that have puts attached, and whose rates reset periodically (typically daily or every seven days). Most VRDNs have credit enhancements provided by a bank or an insurance company. The most important credit questions about VRDNs and other credit-enhanced securities center on the creditworthiness of the current letter of credit ("LOC") provider, and not on the creditworthiness of the issuer. Neither trustees nor issuers are currently required to notify bondholders about changes in circumstances affecting the securities, including such critical credit-related facts as a change in the identity of the LOC provider, and in fact many issuers and trustees apparently feel no obligation to disclose this information when they are asked to do so. I am of the view that this circumstance should be changed.

The first example obviously is that it is my understanding that some money market fund portfolio managers, in the past, have encountered uncooperate bond trustees and issuers who have been unresponsive to a request for notice of a letter of credit substitution. While LOC provider substitutions apparently do not occur frequently, even one substitution of a high credit quality provider with a lower credit quality provider could cause a municipal money market fund severe problems and possibly could even cause a fund to "break a buck." This result may not only economically adversely effect the fund's shareholders but could do irreparable harm to the credibility of both taxable and tax-exempt money market funds.

I argue that even in the circumstance where a high quality LOC provider is substituted for another high quality LOC provider, the tax-exempt money market fund needs timely notice of the substitution. Such notice is necessary because securities backed by LOC providers apparently trade in the municipal secondary market very differently even if the LOC providers are rated identically. Thus, the marketplace values the securities differently even if the rating agencies do not, and tax-exempt money market funds need timely notice of any LOC substitution in order to be alerted to the prospect that the securities they hold may now need to be priced differently.

The second example demonstrating the need in my view for a limited tax-exempt money market fund continuing information requirement was the seizure of Mutual Benefit Life Insurance ("MBLI") by the New Jersey Insurance Commission. MBLI insured, and provided liquidity for, approximately $110 million of VRDNs held by at least eleven money market funds. MBLI was placed into "rehabilitation" by the New Jersey Insurance Commission in July 1991, following a "run" on the company by policyholders. Subsequently, MBLI did not honor its put obligations, and the advisers of the funds that held the MBLI-backed VRDNs either purchased the VRDNs from the fund or arranged, on a temporary basis, for alternative put providers.

Because most tax-exempt issuers are state and municipal governments and agencies, they are not subject to the reporting requirements of the Exchange Act and thus may not provide much in the way of secondary market information. Although tax-exempt money market funds today rely principally on the quality of the LOC provider in evaluating the safety of the investment in a VRDN, they are dependent upon the quality of the underlying municipal issuer if the LOC provider's credit suddenly declines.

This limited need for current information about the underlying issuer was illustrated by the MBLI default on its guarantees. As a result of a lack of market information, quotes for (unguaranteed) securities of the underlying issuers varied significantly. Funds could not determine how accurately to price their securities, and the Commission could not determine whether a fund would be required to break a dollar if it continued to hold these securities.[12] Funds could not find permanent substitute put providers, in part because prospective credit enhancers could not determine the nature of the obligation they would be assuming. (More important factors, admittedly, were the rapidity of MBLI's decline and the connection between MBLI and the partnerships that issued the instruments.)

While the previously mentioned two examples do not represent the largest regulatory problems to be addressed by the upcoming Rule 2a-7 proposal and should not overshadow the more important provisions which will undoubtedly appear in this proposal, it appears to me that the proposal should offer a solution for the future in order to ensure that these problems of the past, minor though they may be, are not repeated in a more magnified and worrisome fashion.

A solution to the MBLI example may be to include in the Rule 2a-7 proposal a limited continuing disclosure requirement concerning the underlying issuer under certain circumstances, such as when the credit quality of the LOC provider deteriorates, which was the case in the MBLI example. There may exist a more appropriate solution to this problem, and I know that the Staff is presently working hard on this matter. It will be interesting to see what the Staff develops.

However, the larger problem may be the first example. It may be crucial that any Rule 2a-7 disclosure requirement focus on the credit quality of the provider of the credit enhancement and on the structure of the enhancement arrangement, and secondarily on the underlying issuer. Therefore, any such disclosure requirement may need to include something along the lines of an issuer or trustee covenant to notify money market funds by registered mail prior to the effective date of any potential LOC substitution event which may be provided for in the financing documentation. Again, there may be a more appropriate solution to the problems posed by this first example, and I know that the Staff is working on this matter as well.

I acknowledge that my recommendations in the tax-exempt Rule 2a-7 area have not been warmly received by the bulk of the fund industry in the past. However, as a regulator, I find little solace in the industry answer to date that these problems are small, are unlikely to be repeated, and do not merit a regulatory response. My concern is that total reliance on this answer may later prove to be an irresponsible regulatory approach.

Some apparently also have viewed my past recommendations in this area as some plot to get around the Tower Amendment. That is not my motivation. My recommendations are prompted by the extraordinary importance that I place on the safety and integrity of money market funds, whether taxable or tax-exempt.

I recognize that it is awkward and clumsy to place a limited secondary market disclosure requirement in Rule 2a-7, even if tailored specifically for certain tax-exempt money market fund problems. I challenge the money market fund industry today to design a better solution. I believe that they can. I have always found a positive, constructive approach to be more useful and more successful than the somewhat mindless series of "nos" that I have received from the tax-exempt money market fund industry on these matters to date.

## ENDNOTES

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

2. See Hicks, "Bond Volume Stalls in November; 11-Month Total Up 23% From '92," The Bond Buyer (December 2, 1993), at 1.

3. Id.

4. "Majority of Investors Considering Municipal, MBIA Survey Reports," The Bond Buyer (April 6, 1993), at 2.

5. Rule 15c2-12 requires underwriters to insist that municipal issuers make available official statements at a time when, and in quantities which, they might not otherwise be produced. The rule is purely procedural; it does not impose any requirements regarding the content of official statements. The content of these statements continues to be governed by the antifraud provisions. Nonetheless, the proposing and adopting releases for Exchange Act Rule 15c2-12 contained an interpretation regarding the due diligence responsibilities of underwriters under the federal securities laws that emphasized the importance of complete disclosure in the issuer's offering documents, and the underwriter's duty to review these documents for omissions or misstatements. See Exchange Act Release No. 26100 (Sept. 22, 1988), 53 FR 37778, 37785 ("Proposing Release"); and Exchange Act Release No. 26985 (June 28, 1989), 54 FR 28799 ("Adopting Release").

6. Letter from Gerald P. McBride, Chairman, Municipal Securities Division, PSA, to Harold L. Johnson, Deputy General Counsel, MSRB, dated January 8, 1993 ("PSA Letter").

7. See Staff Report, at 46 n.18.

8. See Staff Report, at 39.

9. See Testimony of Arthur Levitt, Chairman, SEC, Concerning the Municipal Securities Market, Before the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce (Sept. 9, 1993), at 6.

10. See Report of the Municipal Securities Rulemaking Board on Regulation of the Municipal Securities Market, Submitted to the House Committee on Energy and Commerce, 103rd Cong., 1st Sess. (Sept. 1993), at 73-4.

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

12. "Even as investors scramble to determine what their [MBLI backed] bonds are worth, they are finding the task extremely difficult due to the lack of financial disclosure in the $800 billion municipal bond market." "Caution Flags for Muni Investors," Wall Street Journal (July 22, 1991), at C1.