Remarks Of

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

Preserve Integrity of Municipal Securities Market

The 1992 Bond Buyer
Municipal Finance Conference
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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
450 Fifth Street, N.W.
Washington, D.C. 20549

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I. INTRODUCTION

I appreciate the opportunity to participate in the Bond Buyer's 1992 Municipal Finance Conference. Certainly public finance is an area that appears to be back in fashion. Among other things, the presidential election, the riot in Los Angeles, the flood in Chicago, and the hurricane in Florida have brought attention to the finance needs of state and local governments and thus to the need for an efficient public finance capital formation system.

I would urge those working in public finance to capitalize on this attention by encouraging Congress to reexamine some of its decisions in the tax area that have unnecessarily impeded the access to capital by state and local governments. I hope that in the upcoming Congress, our tax rules will be revised to increase the supply of bank-qualified bonds, to loosen even further the arbitrage requirements, to raise the bond volume caps, and to revise the alternative minimum tax provisions in order to encourage greater individual and insurance company investor participation in the municipal securities market.[1] While such a program would not directly provide the additional source of revenue that state and local governments so desperately need, it

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[1] See, e.g., Roberts, "Infrastructure Demands Underscore Need for Rescuing Bank Deductibility," The Bond Buyer (June 29, 1992), at 25; King, "Mutual Funds Tap Insurers As Holders of Tax-Free Debt," The Bond Buyer (Oct. 7, 1992), at 1.

would increase investor demand for tax-exempt bonds and would simplify the ability of state and local governments to access the tax-exempt capital market.

Notwithstanding the absence of necessary tax law revisions, the municipal securities market appears to be operating most efficiently. New-issue municipal bond volume reportedly grew over 40% through the first three quarters of 1992, rising to over $165.8 billion compared with about $118.4 billion in the same period last year. Municipal volume appears poised to break the $207 billion record set in 1985. At the current pace, full year volume would reach an all-time high of around $230 billion.[2] Refundings have accounted for most of the year's volume, jumping from approximately $33 billion in 1991 to over $80 billion through September.[3]

Low interest rates are the driving force behind the new issues and the continuing large number of refundings brought to market. The low interest rates have made many capital intensive projects less expensive and have encouraged municipalities with callable debt to refinance.

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2 "Muni Market Continues On Record Volume Pace," Investment Dealer's Digest (Oct. 12, 1992), at 32.

3 Hicks, "New Issues Up In 1st 9 Months; Most Growth Is In Refundings," The Bond Buyer (Oct. 1, 1992), at 1.

Although the market did choke on the large municipal bond supply for a brief interval several weeks ago, by and large, investor demand has kept pace with the record breaking volume of supply. Of course there are certain market aberrations that currently exist, such as the yield on short-term tax-exempt securities being higher than the yield of their taxable Treasury counterparts.[4] Thus, while there does not appear to be any indication of the advent of a liquidity crisis similar to that experienced in 1987, the municipal securities market does bear watching. However, to date, the municipal securities market is a national asset that has served both issuers and investors well. So long as this market maintains its liquidity and integrity, it will continue to do so.

II. ENFORCEMENT ACTION

During the two years that I have served on the Commission, I have spent a great deal of time attending to securities public policy issues relevant to the municipal securities industry. My major focus has been on what I consider to be potential threats to the integrity of this market.

The ability of thousands of municipal issuers to enter the market and service the needs of their communities depends upon the strength

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4 See, e.g., Mitchell, "Municipal Note Offerings Flood Market, Yield in Some Cases Top Taxable Issues, The Wall Street Journal (Sept. 23, 1992), at C1; Myerson, "Municipal Bond Yields Rival Taxed Issues," The New York Times (Oct. 1, 1992), at D19.

of the partnership that has been forged with investors. The relationship between issuers, dealers and investors is constructed on a foundation of trust that has resulted from the long history of municipal securities as "safe" investments. I believe it is fair to say that the municipal securities market thrives as a result of investor confidence, and the individual investor remains by far the predominant holder of municipal securities.[5] Thus, preserving the confidence of the individual investor in the integrity of the municipal securities market is central to its continued success.

I have always believed that the Commission, through its enforcement program, could play a more vigorous role in policing the municipal market and thereby could contribute substantially to the preservation of individual investor confidence in that marketplace. In the past, I have rather sadly remarked on several occasions that the Commission, in my view, had not focused enough attention in its enforcement program on the municipal securities market. I have stated that the Commission owes a responsibility to investors and to the securities industry to increase its enforcement presence in the

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5 See Hicks supra note 2.

municipal market so that the whole industry would not be tainted by the activities of a minority of its members.[6]

Happily I can report today that the Commission has focused more attention on its enforcement program on the municipal securities market. This increase in focus has been demonstrated in three enforcement actions undertaken in the Commission's 1992 fiscal year which just ended. I believe that each case is significant and breaks new ground in the enforcement area. I will touch upon each one briefly.

Last June, the Commission brought its first insider trading enforcement action involving municipal securities. In SEC v. Morse,[7] the former Secretary/Treasurer of the Kentucky Infrastructure Authority, N. Donald Morse, settled Commission charges that he traded in municipal bonds issued by the entity while in possession of material nonpublic information. Without admitting or denying the

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6 See, e.g., Roberts, "Perspectives on Municipal Disclosure," Remarks delivered to The National Association of Bond Lawyers, Washington, D.C. (Feb. 7, 1991), at 13; Roberts, "Improving Secondary Market Disclosure," Remarks delivered to the Government Finance Officers Association, Washington, D.C. (March 6, 1991), at 15; Roberts, "Regulatory Issues in the Municipal Securities Area," Remarks delivered to the Municipal Division Executive Committee of the Public Securities Association, Phoenix, Arizona (Feb. 29, 1992), at 12.

7 E.D. Kentucky, No. 92-64, June 23, 1992. See Stamas, "Bond Market Put On Notice As SEC Files Insider Charges," The Bond Buyer (June 24, 1992), at 1.

Commission's charges, Mr. Morse agreed to be permanently enjoined and to disgorge his profits.

According to the Commission's complaint, in June 1990, as part of his employment with the Authority, Morse was in charge of selecting certain term bonds of the Authority to be accepted for tender by the Authority. In selecting the bonds for tender, Morse solicited bids from bondholders to tender their bonds at or below the face value for the required redemption amount as set forth in the Bond Series Resolution. The bonds were to be accepted for tender on August 1, 1990.

On June 21, 1990, knowing that the Authority was lacking the required redemption amount, Mr. Morse purchased for himself certain bonds of the Authority. Morse selected his bonds for tender to the Authority at the highest price paid to any tendering bondholder. Morse's bonds were tendered to the Authority in the name of a local bank rather than in his own name. Morse failed to disclose to the Authority that he owned the bonds and that another bondholder had been willing to sell them at a lower price and hence the Commission's enforcement action.

In addition to demonstrating that the Commission was interested in pursuing securities law violations in the municipal securities market, the Morse case was important in that it reinforces the Commission's

view that the insider trading prohibitions do apply to municipal securities transactions. While there are those in the bar and in the securities industry that do not share that view, I have always been of the opinion that under the appropriate circumstances, the insider trading prohibitions do apply to transactions in municipal and other debt securities.[8]

In the second enforcement case, last August, the Commission filed a complaint, seeking a permanent injunction and other equitable relief, against Edward L. Scherer, formerly an analyst in the high yield department of Merrill Lynch.[9] Among other charges, the complaint alleges that Scherer engaged in fraudulent conduct by purchasing, through certain nominee accounts, municipal bonds supported by guaranteed investment contracts ("GICs") issued by Executive Life Insurance Company, while he was participating in the preparation of a favorable Merrill Lynch research recommendation concerning those bonds. The complaint charges that Scherer's conduct was fraudulent and deceptive in that Scherer failed to disclose or to cause disclosure of the fact that he had acquired a personal financial interest in the

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8 See Roberts, "Improving Our Debt Markets," Remarks delivered to the Investment Company Institute, Washington, D.C. (March 26, 1991), at 12; but c.f. Pitt & Groskaufmanis, "Insider Trading and Junk Bonds: Rule 10b-5's Latest Frontier?" 2 Journal of Corporate Disclosure and Confidentiality 272 (1992).

9 SEC v. Scherer, D.S. New York, Civil Action No. 92-6400, August 20, 1992.

GIC-backed bonds at the time he was participating in formulating the recommendation, and that he continued to hold an interest in the subject bonds at the time that the report was disseminated by Merrill Lynch. Additionally, the complaint charges that in purchasing the subject bonds prior to the issuance of the recommendation, Scherer misappropriated Merrill Lynch's proprietary information concerning the timing and content of the recommendation, which information was intended for the benefit of Merrill Lynch and its customers.

The Scherer case is currently in litigation. Interestingly enough, Scherer represents the first "scalping" case to be brought against an analyst for a broker-dealer involving municipal securities.[10]

Finally, in the third enforcement case, Donaldson, Lufkin & Jennrette ("DLJ") last month settled Commission charges that it failed adequately to review the questionable business dealings of Matthews & Wright for which it conducted an initial public offering.[11] DLJ

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10 In scalping, an investment adviser personally invests in a security before recommending it to a customer but fails to disclose that fact to the customer. Then the adviser sells the security as a result of his recommendation.

See Ferris, "The SEC's 'Scalping Case' Make Clear Its Targeting Insider Trading in Bonds," The Bond Buyer (Aug. 31, 1992), at 30' Stamas, "SEC Cautions Bond Analyst On Secretive Muni Trading," The Bond Buyer (Aug. 27, 1992), at 1.

11 In the matter of Donaldson, Lufkin & Jennrette Securities Corp., SEC, Administrative Proceeding File No. 3-7863, (Aug. 22, 1992). See Stamas, "SEC Censures Donaldson Over Disclosure in Cashless Closings," The Bond Buyer (Sept. 23, 1992), at 1.

agreed to a censure and to a permanent cease and desist order without admitting or denying the charges. In the order instituting administrative proceedings, the Commission alleged that DLJ did not have a reasonable basis to believe that the representations in the registration statement concerning certain municipal transactions involving Matthews & Wright were accurate and complete. Given its vital role and responsibilities in the transaction as underwriter for the offering, according to the order, DLJ was reckless since it knew that the registration statement would fail to state material facts by failing to disclose that a major portion of Matthews & Wright's revenues derived from bogus closings of municipal bond offerings in 1985 and in 1986.

With the Morse "insider-trading" case, the Scherer "scalping" case, and the DLJ "due diligence" case, a clear pattern has emerged. The Commission's Division of Enforcement has focused more attention on the municipal securities market.

Municipal securities participants, if they were not already, should be aware of this increased enforcement attention and should tailor their behavior accordingly. Securities law violations in the municipal area, when uncovered, will be pursued diligently by the Commission, and the Commission is exercising extra effort to discover such violations.

I applaud the increased focus of the Commission's enforcement program on the municipal securities market. This program now appears intent on maintaining the integrity that the municipal securities market has long enjoyed. Such a development will only benefit the vast majority of the issuers, dealers, and attorneys involved in the municipal securities offering process who strive to provide investors with necessary, accurate disclosure. An active Commission enforcement program is particularly warranted in the municipal securities area since unlike its involvement in the corporate markets, the Commission does not review filings, or come into contact daily with issuers, underwriters, and their counsel, as municipal bond offerings are being prepared for sale to the public.

III. SECONDARY MARKET DISCLOSURE

Another area where, in my judgment, the integrity of the municipal securities market could be and should be enhanced is in the area of secondary market disclosure. The general economic problems experienced by municipal issuers today are a reflection of the difficulties facing all segments of our economy. Nevertheless, one cannot overlook the fact that these economic problems will place stress on the financial markets. This highlights the need for accurate disclosure, so that important financial information is available to

investors at the time that they buy or sell securities in the secondary market.

The simplest way to achieve effective secondary market disclosure would be the adoption of a regulation that requires municipal issuers to provide secondary market disclosure to investors. At present there is no clear Commission jurisdiction to promulgate a rule applying directly to municipal issuers. I suspect that the Commission, through its existing jurisdiction and through its regulatory agility, could indirectly require secondary market disclosure. More importantly, while in the past I have identified what I believe is a need to revisit the application of the federal securities laws to limited portions of the municipal market to determine if the level of protection offered investors in the 1990s is adequate,[12] I do not believe that a regulation mandating municipal issuer secondary market disclosure is necessary at present, even assuming clear Commission jurisdiction to do so. I say this in recognition of the voluntary efforts on the part of many participants in the municipal securities market to improve secondary market disclosure.

The efforts of the Government Finance Officers Association ("GFOA"), the American Bankers Association's Corporate Trust Committee, the National Federation of Municipal Analysts ("NFMA"),

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12 See Roberts, "Perspectives on Municipal Disclosure," supra note 5, at 12.

and the Public Securities Association ("PSA"), to name a few, have been the catalysts for continued improvement in secondary market disclosure. I wish to praise the PSA and the NFMA for encouraging issuers to disclose, at the time of sale, the extent, if any, of their commitment to provide secondary market disclosure. I particularly wish to congratulate the NFMA for its ongoing project to recognize exemplary disclosure efforts by the issuer community. I believe that such an initiative is an outstanding example of a voluntary effort to improve secondary market disclosure.

I know that the GFOA encourages its members to participate in the NFMA's Certificate of Recognition program. I noticed that the GFOA recently bestowed its 1992 Award for Excellence in the debt management category to the City of Tallahassee for its 1991 Annual Report to Bondholders, which was designed to respond to secondary market disclosure needs. My congratulations to Bob Inzer, the Treasurer of the City of Tallahassee. I suspect that most issuers, with a little effort, would discover that like the City of Tallahassee, providing secondary market disclosure through their annual report to bondholders makes sense and serves the issuer's own best interest.[13]

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13 Inzer & Klein, "Responding to Secondary Market Disclosure Needs. Tallahassee's Annual Report to Bondholders," Government Finance Review (August 1992), at 23.

I have also noticed that after some initial reluctance, the Investment Company Institute has formed a task force to develop suggested secondary market disclosure guidelines for tax-exempt money market funds and for long-term bond funds.[14] These and other industry initiatives, combined with the Municipal Securities Rulemaking Board's ("MSRB") effort to create a central repository for secondary information, which was finally approved by the Commission, should move municipal disclosure further along the road toward an efficient secondary market for municipal securities.

The only discordant note that I will sound in the secondary market disclosure area is that I have been disappointed with the reaction of the legal community to voluntary secondary market disclosure initiatives. While I too wear tasseled loafers, it often seems to me that lawyers are against everything and for nothing. I must say that the reaction of the securities bar is so consistently negative towards anything advanced by regulators that their comments are often discounted, other than in the technical arena. I challenge the municipal securities legal community to adopt an open, positive mind with respect to secondary market disclosure.

I do not view the voluntary, organized presentation of information to the secondary market as a source of greater liability for

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14 Stamas, "Investment Company Panel Will Draft Secondary Market Disclosure Guidelines," The Bond Buyer (July 1, 1992), at 1.

issuers than they already encounter. If there are liability issues that need to be addressed, those issues should be placed in their proper perspective and should not become an impediment to improving voluntary disclosure efforts.

While I do not believe that a regulation to require secondary market disclosure is warranted at the present, this decision should be reevaluated over time. I am aware that the NFMA is frustrated by the low level of secondary market disclosure and apparently would now support Commission action to enhance such disclosure.[15] However, I am prepared to give the voluntary efforts underway more time. To paraphrase Vicki Westall's quote which appeared in today's Bond Buyer, "[I] would obviously prefer to see the industry move on its own towards a policy of more complete disclosure. . . . [I] believe that the market itself provides an incentive to do so in the form of increased interest costs for those issuers who don't provide timely secondary market disclosure."[16]

Cost effective secondary market disclosure is an idea whose time has come. Many municipal issuers have recognized the value of secondary market disclosure and voluntarily provide information to the market. In addition, some municipal issuers must make available

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15 Stamas, "Analysts Want More Disclosure In Bond Market, Survey Finds," The Bond Buyer (Oct. 22, 1992), at 1.

16 Id., at 19.

annual reports to satisfy state law requirements, and more limited periodic information may be required by the rating agencies.

I believe that it is important for everyone to continue moving forward to implement a voluntary secondary market disclosure program. It should be obvious to everyone that the integrity of the municipal securities market could only be enhanced by such a program, which in turn should contribute positively to the continued success of the municipal securities market.

IV. SUITABILITY

I wish to spend the remainder of my time today focusing on what I believe is the need to protect retail investors from broker-dealer recommended purchases of high-risk municipal bonds when such a purchase is clearly an unsuitable investment. I have in the past recommended that the Commission adopt a rule requiring broker-dealers to make an express written suitability determination when recommending transactions in certain municipal securities to retail customers.[17] However, if there exist other less intrusive methods of reducing risks to investors, then I am more than willing to consider those alternatives.

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17 See Roberts, " Regulatory Issues in the Municipal Securities Area," supra note 6, at 4; Roberts, "Proposals to Improve the Integrity of the Municipal Securities Market," Remarks delivered to the Bond Club of Virginia, Irvington, Virginia (June 13, 1992), at 7.

On this same subject, Bill Heyman, the Director of the Commission's Division of Market Regulation, last May requested by letter that the MSRB consider strengthening its customer suitability requirements in connection with transactions in certain types of municipal securities.[18] In response to this request, the MSRB has embarked upon an extensive study of problems in the municipal securities market to determine those areas which may need additional rulemaking or modifications to existing rules. In furtherance of that goal, the MSRB has recently published a notice entitled "Customer Protection in the Municipal Securities Market" requesting comment from all interested parties on potential problem areas in the municipal securities market and requesting suggestions for how customer protection could be improved.[19] I understand that the PSA is also attempting to determine what customer protection problems currently exist in the municipal securities market. I do wish to encourage the members of this audience to review the MSRB's notice and to provide the benefit of your comments.

I am proud of the leadership that the MSRB has exhibited thus far in what has to be considered as a sensitive area for the securities industry. I view the MSRB's customer protection study as an

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18 Letter from William H. Heyman to Christopher A. Taylor, Executive Director, MSRB, dated May 8, 1992.

19 MSRB Reports (September 1992), at 3.

excellent opportunity for the municipal securities industry to maintain the credibility it has long enjoyed with individual investors. At a minimum, as I have stated in the past, I am of the view that the MSRB should delete the "no reasonable grounds" provision of its suitability rule, MSRB Rule G-19.[20]

It appears to me that in too many instances, retail investors have inappropriately been sold high-risk municipal bonds. This often occurs in a yield-hungry environment. Many investors may have made a conscious choice to accept the high-risk, but inevitably, some did not. While I am aware that the municipal securities industry does not welcome additional regulatory burdens, the investor suitability abuses must stop or be stopped.

V. CONCLUSION

While an active Commission enforcement presence, an efficient secondary market disclosure program, and the elimination of investor abuses in the suitability area will not solve all of the problems existing in the municipal securities market, those developments will contribute substantially to the continued success of that market.

I know that each of you are interested in not only preserving but in improving the integrity of the municipal securities market, and I look forward to working with you toward such an objective.

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20 See Roberts, "Public Finance and Tax-Exempt Market Concerns," Remarks delivered to the Midwest State Treasurers' Conference, Minneapolis, Minnesota (August 24, 1992), at 2.