Remarks Of

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Improving Secondary Market Disclosure

Government Finance Officers Association

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

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I. INTRODUCTION

On the way out this morning, I had the chance to reflect on the subject matter that is on the agenda for today's conference. It is striking to note that among the many conferences and seminars on securities disclosure that will take place this year, this will be one of the few, if any, that does not have as a central part of its program the explanation or interpretation of Commission requirements.

The fact that we can have a conference like this, devoted to industry efforts to improve disclosure, is remarkable. Today's conference is a tribute to the hard work of the Government Finance Officers Association ("GFOA") and specifically the individuals that over the past fifteen years have been responsible for preparing the Disclosure Guidelines. Moreover, these individuals were not content simply to prepare the Guidelines as a memorial to what good disclosure might be in a theoretical or abstract fashion. They have been preaching to the masses and have had great success winning converts.
To a large degree, the GFOA directly has been responsible for the great improvement that has occurred in primary market disclosure. I applaud your efforts. Even if some one else has already done so, I would like to take this opportunity to commend those who are responsible for this most recent edition of the Guidelines.

However, the job is only half over, and there are even those that would argue that you have repaired the wrong part of the market first. Some would contend that you should have first focused your efforts on making sure that accurate, current information was made easily accessible to investors in the secondary market.

II. TODAY’S BOND MARKET

I would like to talk for a few minutes about the municipal markets themselves. The importance of the market for municipal securities is reflected in its growth over the last twenty years. Over $800 billion in municipal securities were outstanding in 1990. More than 2,700 dealers are registered with the Municipal Securities Rulemaking Board ("MSRB"). Moreover, in 1990, $161 billion in new issues of securities were brought to market.
While commercial banks and some other institutional investors steadily have been reducing the amount of municipal debt they own, individual investors, including money market funds and other mutual funds, have steadily been increasing their level of investment. About two-thirds of all municipal bonds currently are either held directly or indirectly by individual investors.\(^1\) Moreover, confronted with increasing taxes, individual investors now have additional incentives to continue to invest heavily in tax exempt securities.

III. HEADLINES

I am concerned, however, that the industry is not keeping pace with disclosure developments elsewhere in the securities markets and will suffer as a result. As you are aware, among sophisticated investors, there is growing dissatisfaction with the lack of secondary market information. In addition, we are confronted daily with headlines in newspapers and magazines that decry the demise of

\(^1\) Source: Public Securities Association.
credit quality in the municipal markets and ask whether municipal securities will be the junk bonds of the 90's.²

We know that traditionally municipal defaults have significantly lagged corporate defaults. However, partly as a result of the explosive growth in the high yield debt markets in the 1980's and the recent economic slump, default levels in both the corporate and municipal markets are approaching record highs. In 1990, the Bond Investors Association reports that total defaults in the municipal markets will be at their highest level since the unprecedented default of the Washington Public Power Supply System's Project 4 and 5 bonds in 1983.

It is impossible to ignore the problems facing thousands of unsophisticated investors that purchased special assessment district bonds, nursing home bonds, and housing bonds that now are in default. More troublesome, yet, are reports in the press concerning

the problems of large governmental issuers that are apparently looming on the horizon. The fact that municipal securities generally are safer than corporate bonds will be little solace to many of the small investors in municipal securities that have lost their life savings.

I do not mean to suggest that the general economic problems experienced by municipal issuers today are the result of fraud or have any general correlation with the quality of disclosure provided to investors. The problems in most cases are a reflection of difficulties facing all segments of our economy, including the financial institutions that provided credit support for municipal bonds. Nevertheless, one cannot overlook the fact that these economic problems will place stress on the financial markets. They highlight 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.

IV. PROBLEMS WITH SECONDARY MARKET DISCLOSURE

In efficient markets, such as we have for corporate securities traded on our national exchanges or in the NASDAQ over-the-counter
markets, the price of a security theoretically reflects all the information that is known about a company at a particular point in time. It is not necessary that each company personally deliver the information to investors to achieve this efficiency. Instead, the information simply is filed with the Commission. There, the information immediately is disseminated to the public through private disclosure services. Interested analysts, market makers, and investors sift through and distill the vast number of filings that arrive each day. And through osmosis, even those investors that do not participate directly in the process benefit from the more efficient pricing of securities that results.

While the municipal market rivals the corporate bond market in terms of size and complexity of products, there is far less information readily available to investors. Investors in municipal bonds do not have easy access to the same information that is available to corporate investors. In addition, when information is provided by the issuer, investors must create redundant databases and issuers often respond to repeated requests for the same information. The result is
that the municipal markets operate in a fashion that is less than optimal.

As taxpayers, we all are interested in making sure that state and local governments finance their operations as inexpensively as possible. I am here today to advocate greater efficiency in the municipal markets - through improved continuing disclosure. I start, however, as you must, with the realization that any secondary market disclosure must be cost-effective. And while we often use the term "voluntary" in connection with secondary market disclosure, in an economic world, I think that issuers will volunteer to make disclosure in the same way that enlisted men "volunteer" for assignments in the Army. There must be either a carrot or a stick - an economic incentive to encourage disclosure or a regulatory requirement.

Although currently there are no federal regulations that require municipal issuers to provide secondary market disclosure, many do so anyway. While many municipal issuers have recognized the value of secondary market disclosure and provide information to the market out of "enlightened self interest," a large number of issuers must
make available annual reports to satisfy state law requirements.

In the absence of a federal regulatory requirement that issuers provide periodic secondary market information, I would like to focus briefly on why I believe it will be necessary for the industry to improve disclosure. Obviously, the preparation and dissemination of secondary market information entails costs. But looking at the balance sheet for the disclosure debate, we need to start with the realization that even if the industry makes no changes, does nothing, it already bears the costs that result from the absence of disclosure.

Among these costs, I would include diminished liquidity, reduced market access, and what I think of as disclosure intermediation - reliance on rating agencies and the use of credit enhancements. Not all of these costs are unique to municipal bonds, however. I think to some degree, there is room for improvement in both the municipal and corporate debt markets.

A. Liquidity Premiums

To begin with, it is widely recognized that sophisticated investors purchasing securities that cannot easily be traded will command a
"liquidity premium." Among the universe of investment opportunities available, including corporate bonds and Treasury securities, a rational investor in municipal bonds will demand a higher yield to compensate for the risk that there will not be adequate current information to support a resale of the bonds in the secondary market. Or, the investor may choose not to invest, or to invest elsewhere.

B. Inaccurate Information

In addition to simply not being able to obtain the information necessary to effect a transaction, the market suffers from misinformation. While municipal bonds traditionally have had a far lower default rate than corporate bonds, issuers and investors absorb other, more specific, costs that result from inadequate disclosure. For example, as I mentioned earlier, most of you are aware of the defaults among special tax districts in Colorado that have been reported in the press. The problems that are experienced by these issuers extend well beyond the direct investors in defaulted securities. Without adequate secondary market information, investors are less able to distinguish among issues, and reports of troubles may unfairly impair
the liquidity of many sound Colorado issuers as well. More disturbing yet is the possibility that news reports about the disclosure problems in the industry will cause retail investors to leave the municipal bond market and migrate to other markets that are perceived as having greater integrity. All municipal issuers will bear the costs of reduced demand if this happens.

3. Other Costs

Other economic costs that are imposed on the market as a result of inadequate disclosure would include increased reliance on bond insurance;³ inability to use efficient financing techniques, such as shelf offerings or so-called "wire deals"; and fewer bids for competitive issuances. For example, corporate issuers that provide continuing disclosure are able to use the so-called shelf-registration procedures under Rule 415 of the Securities Act. Theoretically, the Commission's periodic reporting system captures current information about an issuer

³ Unlike life insurers who make decisions largely on an actuarial basis, bond insurance is arguably the result of credit analysis. Because only creditworthy issuers can obtain bond insurance, it imposes cost on those issuers that present the least credit risk to investors. To the extent that bond insurance becomes the norm for creditworthy issuers it results in an unnecessary charge to investors that are interested in and capable of performing their own credit analysis.
that is equivalent to the information that would be provided in a prospectus. Consequently, the market is familiar with the financial condition of these issuers, and they rapidly can meet interest rate windows by disseminating an abbreviated disclosure document that provides information about the particular offering and "incorporates by reference" current information that already is known to the market.

In the municipal market, some of the largest issuers already engage in so-called "wire-deals" that rely upon the same philosophy. But whether or not an issuer intends to use shelf-financing techniques, more current information should result in additional bids, and lower interest rate costs, even in traditional competitive offerings.

V. IMPROVING SECONDARY MARKET DISCLOSURE

A. Compromises

Although I have mentioned some of the economic reasons why I believe that issuers might find it to their advantage to provide secondary market disclosure, there are many others. As I noted earlier, however, we need to also be sensitive to the fact that production of disclosure documents does entail costs. Milton Cohen,
a dean of the Chicago Bar, pointed out:

Ideally, ... the objective of full disclosure would best be served by having (1) as many issuers as possible (2) disclose as many facts as possible (3) as completely as possible (4) on a fully current basis (5) with perfect accuracy and objectivity (6) in such form as to be most readable and accessible by all interested investors.4

Mr. Cohen also recognized, as we all do, that there have to be compromises. The information that is provided to the secondary market should be reliable, relevant and easily accessible. Frequent issuers will receive more benefits and experience lower marginal costs from providing disclosure to the markets than infrequent issuers. Moreover, for many small issuers, the benefits obtained from providing secondary market disclosure will not justify the costs. The key will be to find the right balance of disclosure that will satisfy investors and will not impose excessive costs on issuers.

B. Disclosure Guidelines

I think that the members of this industry, and particularly issuers and investors, are in the best position to strike the right balance: to determine what disclosure is necessary to achieve greater efficiency

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in the secondary market. The efforts of the GFOA, the American Bankers Association's Corporate Trust Committee, the National Federation of Municipal Analysts, and the National Association of Bond Lawyers, to name a few, will be the catalysts for improvement in secondary market disclosure. Although the GFOA already has done an excellent job of developing guidelines for continuing disclosure, we need to redouble cooperative efforts to create relevant disclosure guidelines for trustees and specialized segments of the market.

C. **Increased Accessibility**

We also need to recognize that simply preparing continuing information is not worthwhile, if it is unavailable to the market. Greater attention needs to be devoted to assuring that the information is readily accessible. A recent report by the National Association of State Auditors, Comptrollers and Treasurers ("NASACT") indicates that 41 states currently collect information about certain issuers, in the form of annual reports and financial statements. To be truly effective, however, information has to be collected at central repositories, known
to investors and easily accessible, whether the repositories are operated by private vendors or the MSRB.

D. Role of Investors

Individual investors have the most important role to play in bringing about change in the municipal markets. In my view, large investors, those with the clout to compel disclosure, need to become more active. We certainly have seen evidence of the demise of the "Wall Street Walk" in other areas, and I think that institutional investors need to be more militant in the municipal markets as well. The letter to dealers from Loews Corporation, indicating that the company would not purchase bonds that do not offer a covenant to supply periodic disclosure, and the provisions required by investors in last year's Massachusetts Water Resources Authority offering, demonstrate that investors can have a role in influencing disclosure.

Ideally, the marginal costs of providing disclosure to the secondary market will be surmounted by the premium that the market will command if adequate information is not available. In other words, in the future, I would like to see a world where issuers will not ask
"what discount will I receive for providing continuing disclosure?" - the question will become "what premium will investors demand if I do not offer the continuing disclosure that is expected?"

E. **Role of the Commission**

Finally, I want to mention that the Commission also must play a greater role in insuring the reliability of information that is provided to the market. In the municipal markets, unlike the corporate markets, we do not review filings, or come into contact daily with issuers, underwriters, and their counsel as offerings are being prepared for sale to the public. Instead, we rely on the members of the GFOA and others who draft the documents, perform the investigations, and write the disclosure opinions.

One of my predecessors at the Commission, Justice William O. Douglas, stressed the importance of voluntary efforts, but added that the Commission kept a well oiled shotgun behind the door. While the vast majority of the issuers, dealers and attorneys involved in the offering process strive to provide investors with necessary, accurate disclosure, with the tools that the Commission has available, we have
not focused enough attention in our enforcement program on the municipal securities markets.

In the past, the Commission's enforcement role in the municipal markets has been far more circumscribed than in the corporate markets. Although the staff's Washington Public Power Supply System and the New York City investigations cited numerous disclosure problems, as many of you are aware, the Commission chose not to bring enforcement action against any of the participants in the offerings. Despite the fact that annual issuances of municipal securities have surpassed $100 billion in recent years, during the last decade I can cite only one enforcement case in which the Commission alleged that an underwriter did not provide adequate disclosure in an offering of securities.

Without the deterrent effect of an active Commission enforcement program, some issuers, dealers and their counsel have not had a full appreciation of their obligations under the law. The Commission also owes a responsibility to investors and members of the industry to increase our enforcement presence in the municipal
markets so that the whole industry is not tainted by the activities of a minority of its members.

VII. CONCLUSION

In conclusion, I want to emphasize that the municipal bond industry has proven that within the framework of the general antifraud provisions of the federal securities laws, it is capable of creating an effective alternative to the line item disclosure requirements applicable to primary offerings of registered securities. The key to the continued success of an unregulated disclosure process will be the ability of the industry to police itself and to produce the changes necessary to improve the secondary market. As an industry, it is important for you to be aware that the alternative to industry led efforts to improve secondary market disclosure may be regulation.

I would invite everyone in this audience to let me know of your views - not only on the issues that I have touched upon today, but also on other areas in which you believe the Commission can play a greater role in improving the municipal markets.