



**Remarks Of**

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**Education and Secondary Market Disclosure  
Will Help Preserve Growth  
of Municipal Securities Market**

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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**

I appreciate the opportunity to participate in this Public Securities Association's ("PSA") Annual Meeting. Certainly public finance is an area that appears to be back in fashion. Among other things, the advent of the Clinton administration has brought attention to the finance needs of state and local government 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 current Congress, our tax rules will be revised to accomplish some of the following suggestions: (1.) increase the supply of bank-qualified bonds, (2.) loosen even further the arbitrage requirements, (3.) raise the bond volume caps, (4.) ease the private-loan bond restriction, (5.) ease the rules that prohibit governmental bond issuers from advance refunding their post 1985 bond issues more than once, and (6.) revise the alternative minimum tax provisions in order to encourage greater individual and insurance company investor participation in the municipal securities market.

While these suggestions would not directly provide the additional source of revenue that state and local governments so desperately need, they 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. I realize that all of these suggestions, more or less, reduce the supply of scarce federal dollars and that Congress does not appear to be in a spending mood. Thus, the public finance community must pick from these suggestions and target its resources carefully in order to be successful.

I have always been partial to the suggestion of increasing the bank interest deduction for carrying costs associated with tax-exempt debt.<sup>1</sup> For whatever reason,

since the Tax Reform Act of 1986, it is clear that Congress has discouraged banks from assisting in meeting public infrastructure needs.

In a survey released last month by the American Bankers Association, bank holdings of tax-exempt bonds as a share of total assets apparently fell to 9% from 14% by the end of 1992.<sup>2</sup> Unfortunately, these survey results are in line with recent data from the Federal Reserve indicating that bank holdings of tax-exempt bonds fell by over \$3 billion in 1992.<sup>3</sup> I am of the view that our Tax Code should be amended to return the bank tax-exempt deductibility provision to at least pre-Tax Reform Act of 1986 status. The resulting increased capital and additional liquidity provided to the municipal securities market should result in lower borrowing costs, which, in turn, should help state and local governments tackle their infrastructure needs.

Notwithstanding the absence of necessary tax law revisions, the municipal securities market appears to be operating most efficiently. Municipal bond issuance volume was apparently \$81.2 billion for the first four months of 1993, which exceeded expectations.<sup>4</sup> Of the \$81.2 billion in issuance volume, apparently 33% was for new funding and 67% for refunding. While 1993 municipal volume is not expected to break the record 1992 volume, it may be larger than some predicted.

Low interest rates of course 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.

By and large, investor demand continues to keep pace with the large volume of supply. Households and mutual funds continue to invest heavily in the municipal market, which has more than made up for the declining investment appetite on the part of commercial banks and property and casualty insurance companies.<sup>5</sup> In fact, the demand for municipals on the part of individual investors is expected to continue to

rise. For example, almost 60% of investors who own or plan to buy stocks or bonds this year indicated that they are considering municipals as part of their portfolio mix, according to a survey released last month by Municipal Bond Investors Assurance Corp.<sup>6</sup>

## II. EDUCATION

In addition to the growth of individual investor interest in the municipal securities market, the municipal securities market has witnessed the rapid proliferation of complex derivative products.<sup>7</sup> Most of these products have been developed in an environment of falling interest rates and relatively favorable returns for municipal bonds with a view to leveraging market risks in order to achieve even higher returns. The liquidity of some of these products, if current market trends reverse and interest rates begin to climb, is unknown.<sup>8</sup>

The combination of the increase in retail investor interest with the flood of derivative products with complex features has raised concerns regarding investor protection, investment suitability, and market liquidity in the municipal bond market. I know that the Municipal Securities Rulemaking Board ("MSRB"), through its ongoing customer protection study, is scrutinizing current market practices with these concerns in mind. I suspect that the MSRB rules presently governing sales practices probably require revision in order to keep pace with the development of derivative municipal securities.

The continuing education effort currently underway by the MSRB and five other self-regulatory organizations may also help alleviate the concerns in this area to some extent. The development of a continuing education program for securities industry registered representatives and principals should help ensure the clear, understood communication of the risks of derivative products to investors seeking both higher returns and safety. Certainly as securities firms expand sales activity in the area of

derivative municipal securities, the need for special training and qualification standards, sales and supervisory procedures, and adequate disclosure to investors becomes much greater.<sup>9</sup>

Through the inspection and enforcement process, both the Commission and the National Association of Securities Dealers ("NASD") can assist the MSRB with its municipal securities industry continuing education efforts. I suspect that there is nothing more educational than an examination or an enforcement inquiry. The Commission and the NASD are already apparently increasing their scrutiny of municipal securities firms because of the surge in municipal bond sales to individual investors.<sup>10</sup>

By continuing to educate the industry, it will be much easier to educate potential investors, which should help avoid substantial future problems. As Leo O'Neill, the president of Standard & Poor's stated in a recent editorial entitled "New Investors Are Entering the Bond Market, Educate Them Now to Avoid Disruption Later," with respect to the current municipal securities combination of increasing individual investor interest with the proliferation of complex derivative products:

**So what's the fuss all about? Well, the fuss is not about what can go wrong from a credit standpoint or even about subpar bond performance. Rather the fuss is about potential investment or fund illiquidity created by sharp and unexpected losses that could cause investors to lose confidence in other investments that are perceived to have similar risks. Potentially, therefore, it is about a major market disruption.**

**Do I think this will happen? Not if the securities industry pays heed to the fundamental shift that has occurred in bond and bond fund ownership and redoubles its efforts to disclose the actual risks to investors.**

**Realistic expectations should be set and communicated as to potential returns available to bond investors in a volatile interest rate environment where the next major price move may be downward.**

**The time is appropriate for the industry to reaffirm a fundamental market caveat: Higher-than-average returns always involve higher-than-average risk whether it be credit or market. We shall see.<sup>11</sup>**

### **III. SECONDARY MARKET DISCLOSURE**

**It is interesting to note that as a part of the MSRB's customer protection study comment process, the PSA, in its comment letter, identified improved secondary market disclosure as the solution for most of the suitability problems which currently exist in the municipal securities market.<sup>12</sup> A similar conclusion was reached by the National Federation of Municipal Analysts ("NFMA") in its comment letter.<sup>13</sup> These comment letters accurately identify the need to redouble efforts to achieve adequate secondary market disclosure in the municipal securities marketplace.**

**While adequate secondary market disclosure will not eliminate defaults, it will enable investors to better understand some risks taken and the compensation available for those risks. By reducing uncertainty, the owner and the potential municipal bond buyer in the secondary market will have greater liquidity, dealers can more readily determine whether there is a reasonable basis for recommending particular securities, and the municipal securities market will be more efficient. A more efficient municipal securities market should be beneficial to all the participants in this marketplace, including governmental issuers.**

**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 investors. The integrity of the municipal securities market, which is central to this relationship and central to the success of that market, can only be enhanced by the existence of adequate secondary market disclosure. Municipal securities have historically been viewed by investors as a relatively "safe" investment, and I believe that everyone wishes for that view to continue, particularly with the recent influx of new investors.**

**Many municipal securities market participants have been working diligently to achieve adequate secondary disclosure and have been making some progress. For**

example, it is my understanding that the Government Finance Officers Association ("GFOA") is now working with the NFMA on an Illustrations and Examples of Disclosure publication, which, among other things, in its second phase will provide examples of, and worksheets for, secondary market disclosure for general obligation, revenue, and special district bonds.<sup>14</sup> This publication should be a useful supplement to the NFMA's Disclosure Handbook for Municipal Securities, the NFMA's 1992 Update, and the GFOA's Disclosure Guidelines for State and Local Government Securities.

While I encourage the NFMA and the GFOA to continue to work diligently on this project, I also wish to encourage the NFMA and GFOA to work together to publish one consolidated set of disclosure guidelines rather than two disparate ones. This would help municipal securities disclosure practitioners immensely in my judgment.

Since I have mentioned the NFMA, any accolades concerning secondary market disclosure progress should include the NFMA's outstanding Certificate of Recognition program. This program, introduced in January of last year, rewards municipal securities issuers that provide ongoing, audited financial statements and other information relevant to their outstanding securities. It is my understanding that this program is increasing in issuer acceptance.

For another example, there is 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 financial and credit information. I predict that the NFMA pledge will eventually trigger a market pricing and demand reaction to issuers who are forthright in their voluntary dissemination of future credit information.

In fact, 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.<sup>15</sup> 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."

For secondary market disclosure initiatives to work, the disclosure provided must be designed to inform investors and must be cost-effective. The usefulness of this information to investors depends upon its reliability, relevance, and accessibility. In terms of cost-effectiveness, frequent issuers will receive more benefits and experience lower marginal costs from providing disclosure to the market than will infrequent issuers. Likewise, for many small issuers that go to market infrequently, the economic benefits obtained from providing secondary market disclosure may not justify the costs.

One key will be to find the right balance of disclosure that will satisfy investors and will not impose excessive costs on issuers. That is why the joint GFOA/NFMA project designed to provide issuers with standardized methods of providing secondary market disclosure information is so important. Along these lines, I noticed that in January, the NFMA approved the first standardized format for tax-exempt bond issuers and trustees to use to provide the municipal securities secondary market with disclosure information.<sup>16</sup> Hopefully, improved, cost-effective, and more frequent secondary market disclosure by the appropriate issuers will be the result of these efforts.

Another key to the development of adequate secondary market disclosure is the presence of a national, central repository system that makes that information readily available to investors. Unlike the municipal securities market, in the corporate market,

secondary market disclosure practices are aided by the discipline of mandated periodic reporting. The absence of an effective repository system in the municipal securities market has been used as an excuse to forego continuing disclosure practices. Fortunately, the MSRB has started the operation of its secondary market disclosure pilot system, which may solve this repository problem.<sup>17</sup>

Obviously, submissions to the pilot system are voluntary. The American Bankers Association's Corporate Trust Committee and the PSA have been active in their support of the MSRB's system. While it is apparently off to a slow start, I remain optimistic that the MSRB's system, if given time, will go a long way toward providing the necessary repository system to make secondary market disclosure information readily available.

The lack of secondary market disclosure will continue to be an impediment to the liquidity and efficiency of the municipal securities secondary market. While this problem remains a long way from being solved, there are indications that the heightened awareness caused, among other things, by the study comment letters has accelerated the progress of the improvements beginning to take place in the municipal securities secondary market disclosure area.<sup>18</sup> Hopefully, with time, secondary market disclosure in the municipal securities market will improve dramatically through voluntary means.

I do wish to point out that 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.<sup>19</sup>

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, which I expect to be soon, hopefully such a requirement will be present in the proposal.<sup>20</sup> 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.

#### IV. CONCLUSION

I am certain that everyone here desires to retain the current investor flow into the municipal securities marketplace. I believe that the evolution of an efficient secondary market disclosure program and the appropriate handling of the concerns raised by the combination of increasing individual investor interest with the rapid proliferation of complex derivative products could help preserve the recent growth experienced by the municipal securities market. Education of the securities industry and of the investing public can help alleviate to some extent the latter concerns.<sup>21</sup> It would also be helpful if the appropriate regulatory authorities would take sufficient measures to maintain investor protection and to articulate adequate suitability criteria for investment in complex derivative municipal securities products.

## ENDNOTES

1. See, Roberts, "Infrastructure Demands Underscore Need for Rescuing Bank Deductibility," The Bond Buyer (June 29, 1992), at 25.
2. See Davies, "House Panel Wants To Hear SEC Views On 'Cherry Picking' Practices by Dealers," The Bond Buyer (April 1, 1993), at 1.
3. Id.
4. Fuerbringer, "Corporate Issues Drop Off in April," The New York Times (April 27, 1993), at D16.
5. See King, "Mutual Funds Top Insurers As Holders of Tax-Free Debt," The Bond Buyer (Oct. 7, 1992), at 1; and King, "Continued Rise Seen For Municipal Stakes Held By Households And Mutual Funds," The Bond Buyer (Dec. 18, 1992), at 1.
6. "Majority of Investors Considering Municipals, MBIA Survey Reports," The Bond Buyer (April 6, 1993), at 2.
7. For example, Wall Street firms apparently are at work on tax-exempt, mortgage-backed derivative securities, using single-family housing mortgage revenue bonds rather than ordinary mortgage loans. Pressman, "Housing Bonds Take the Place of Mortgages In Derivatives Planned by Wall Street Firms," The Bond Buyer (April 30, 1993), at 1.
8. One development in the derivatives liquidity area is the recent announcement of Standard & Poor's to explore the possibility of providing ratings on derivative products to assess risks other than credit risk. See Pressman, "Standard & Poor's May Offer Extensive Ratings On Derivatives Products," The Bond Buyer (March 26, 1993), at 3.
9. For example, in a March 19, 1993 memorandum, the PSA expressed concern regarding the adequacy of market disclosure in bond issues involving detachable call options. The PSA memorandum suggested that dealers selling bonds with detachable call options should disclose that feature through pricing wires. See Stamas, "PSA Proposes Dealers Disclose Detachable Calls on Pricing Wire," The Bond Buyer (April 6, 1993), at 1.
10. See Stamas, "SEC Intensifies Muni Inspections As Sales Increase To Individuals," The Bond Buyer (March 9, 1993), at 1, and Stamas, "NASD Tells Staff To Look Closely At Bond Sales To Retail Buyers," The Bond Buyer (April 30, 1993), at 1.
11. O'Neill, "New Investors Are Entering the Bond Market; Educate Them Now to Avoid Disruption Later," The Bond Buyer (April 19, 1993), at 26.

12. Letter from Gerald P. McBride, Chairman, Municipal Securities Division, PSA, to Harold L. Johnson, Deputy General Counsel, MSRB, dated January 8, 1993. ("We however believe that the most serious problem in the area of customer protection continues to be secondary market disclosure.")
13. Letter from Victoria Westall and Richard Ciccarone, Chairperson of the NFMA Board of Governors and the NFMA Standards & Practices Committee, respectively, to Harold L. Johnson, Deputy General Counsel, MSRB, dated December 16, 1992 ("NFMA Letter").
14. See "Muni Issuers, Analysts Join Forces On Secondary Mkt Info.," Wall Street Letter (Sept. 14, 1992), at 6.
15. See Stamas, "Issuers' Intentions on Secondary Disclosure Are Starting to Appear in Official Statements," The Bond Buyer (Dec. 14, 1992), at 1.
16. See Stamas, "Analysts Group Approves Standardized Disclosure Format," The Bond Buyer (Feb. 1, 1993), at 5.
17. See Stamas, "MSRB Sets Jan. 21 to Launch Its Pilot Program For Improving Disclosure in the Secondary Market," The Bond Buyer (Jan. 15, 1993), at 7.
18. For example, J.J. Kinney Co. has recently signed an agreement with Bloomberg Financial Markets to provide municipal bond price quotes and other financial information via Bloomberg's global electronic new network. See King, "J.J. Kinney to Transmit Muni Data Via Bloomberg Network," The Bond Buyer (March 24, 1993), at 4.  
  
See also Stamas, "PSA Proposes Dealers Disclose Detachable Calls on Pricing Wire," infra note 9. See generally Roberts, "Continue Secondary Market Disclosure Progress," Remarks delivered to the Government Finance Officers Association's Committee on Governmental Debt & Fiscal Policy, Washington, D.C. (Jan. 20, 1993).
19. See ICA Release No. 18177 (May 31, 1991).
20. There appears to be a growing need for the Commission to consider proposing amendments to Rule 2a-7 for tax-exempt money market funds. See "Here Come the Muni Funds -- Caveat Emptor," The New York Times (April 25, 1993), at F13, and King, "As Tax-Exempt Mutual Fund Numbers Grow, Retail Investors' Appetite Remains Healthy," The Bond Buyer (April 29, 1993), at 1.
21. See King, "Individual Investors Need to Brush Up On Bond Market, Say Muni Officials," The Bond Buyer (April 28, 1993), at 1.