Remarks Of

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"Municipal Market Reforms"

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"Municipal Market Reforms"

I. Introduction

The municipal securities industry has experienced extraordinary scrutiny in recent months, 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. There are, however, 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, and the lack of information available to the marketplace regarding syndicate practices. These are the areas in which I will primarily focus my remarks today.

II. Mark-Up Disclosure on Customer Confirmations

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.

Although developments to improve transparency in the municipal securities market are in an early stage, regulations now exist that, if applied to transactions in municipal securities, would make key pricing information much more accessible to investors. The need for easier access to such information has become more important as more retail investors enter the municipal securities market, and as more complex products continue to evolve.

The Commission's confirmation rule, Rule 10b-10 of the Exchange Act,[1] is a disclosure mechanism designed to convey certain minimum levels of information to investors. Broker-dealers effecting transactions in municipal securities, however, are excluded from the requirements of the Rule. MSRB rule G-15 (the MSRB's confirmation rule) requires certain disclosures in municipal securities transactions. Among the information required to be disclosed by MSRB rule G-15 is the existence of early redemption and put features, information about the taxability of interest, commission charges (when a broker, dealer, or municipal securities dealer acts as agent), and yield calculations.[2]

While these factors are important, no rule currently requires brokers, dealers, and municipal securities dealers to disclose mark-up and mark-down information in riskless principal transactions in municipal securities.[3] Of course, riskless principal trades are transactions in which a broker-dealer acts as principal and, after receiving an order to buy or to sell from a customer, makes a contemporaneous purchase or sale of a security from or to another person to offset the sale or purchase to or from the customer.[4] In other words, riskless principal trades are those in which there is a commitment on both the buy and the sell sides of a transaction.

A. Riskless Principal Transactions

For riskless principal transactions, Rule 10b-10 requires broker-dealers (who are not market makers in the particular securities) to disclose their mark-ups or mark-downs on "non-reported" equity securities.[5] Approximately 15 years ago, the Commission proposed requiring similar disclosures for transactions in municipal securities.[6] Commentators strenuously opposed this requirement, arguing that such disclosures generally would be inappropriate and unnecessary because no abuses had occurred in the municipal securities market requiring redress. Moreover, opponents of the rule change stated that, because yield is the most important aspect of a transaction in this market, additional disclosure regarding mark-ups or mark-downs would be meaningless to investors.

Commentators also asserted that mark-up disclosure would be meaningless because it would neither take into account the varying degree of diligence needed to execute transactions, nor the varying degree of difficulty of such transactions. Others contended that mark-up and mark-down disclosure would be detrimental to the long-term liquidity of the municipal securities market.[7] Faced with such opposition, in 1982, the Commission dropped this proposal.[8]

B. Need for Mark-Up Disclosure

During the intervening 15 years, the municipal securities market has changed a great deal. Experience has demonstrated that disclosure of mark-up information allows investors to monitor their transaction costs and to compare these costs between broker-dealers. Moreover, investors need to know their transaction costs in order to accurately assess the yield of their investments. Although yield is critical to investors -- and is required to be disclosed -- mark-up costs that affect yield are not disclosed. I am inclined to be of the view that investors need this mark-up information as well as the yield information.

The Commission has continued monitoring the municipal securities market over the past 15 years and has brought a number of enforcement actions against broker-dealers charging excessive mark-ups, particularly in recent times.[9] Since the municipal securities market lacks the fundamental information that can be provided from real-time, last-sale reporting, it is susceptible to abusive sales practices. Disclosure of mark-up information may alert investors when a broker-dealer has charged an excessive mark-up. In addition, requiring mark-up disclosure would assist the enforcement programs of the Commission and the self-regulatory organizations, alike.

Recently, Chairman Levitt, in testimony before Congress,[10] and the staff, in its municipal market report to Congress,[11] agreed that customer confirmations should include mark-up disclosure when a broker, dealer, or municipal securities dealer effects a municipal securities transaction on a riskless principal basis.[12] I agree as well with this approach, and the Commission may propose a new rule, modeled after Rule 10b-10, requiring such disclosure. I suppose an alternative approach would be to request the MSRB to propose a new rule or to amend its existing confirmation rule, G-15.

C. Feasibility of Implementing This Rule

Although some may see difficulties in disclosing mark-ups and mark-downs in a market that not only differs from the equity market but also lacks transparency, I am inclined to believe that this disclosure all the same is feasible. Because riskless principal transactions do not involve holding securities in inventory for any appreciable length of time, the calculation of a broker-dealer's mark-up or mark-down is relatively straightforward (and may, in fact, be accomplished by comparing order tickets for the sale and purchase involved). Thus, to comply with this requirement, a broker-dealer would disclose the difference between the customer's price and the dealer's contemporaneous purchase or sale price.[13] This calculation is generally done by broker-dealers anyway, in order to determine if they are in compliance with the MSRB's mark-up policy.

While questions may arise concerning what type of trade is considered "riskless," in general, transactions structured to offset a contemporaneous purchase or sale by a customer are considered riskless, regardless of the manner in which the purchase and sale are sequenced.[14] Moreover, a covering transaction consummated the same trading day as the initial customer transaction is generally considered to be a contemporaneous purchase or sale.[15]

I understand that Commission staff intends to seek industry input to determine the costs of implementing this disclosure requirement and to determine what changes, if any, will be necessary to tailor such a disclosure rule to the municipal securities market. I look forward to your comments on this matter.

D. Disclosing That Bonds Are Unrated

Further, the Commission is considering plans to include or to encourage the MSRB to include in any new confirmation rule, a provision requiring brokers, dealers, and municipal securities dealers to disclose whether the municipal bond being traded has not been rated by a nationally recognized statistical rating organization. This has been a pet recommendation of mine for several years now.

While the fact that a bond is nonrated does not necessarily mean that it is inferior or more prone to default, statistics do reveal that nonrated municipal bonds -- which make up approximately one-third of the market -- in the aggregate have a higher default rate than do rated bonds.[16] In my view, investors should be informed that the higher yields that they expect from nonrated bonds may be coupled with a higher credit risk. Requiring disclosure on the customer confirmation that a bond is nonrated should ensure that investors will receive this information.

I acknowledge that requiring the disclosure of additional information on the confirmation may not prove to be a very effective method of communicating to investors subsequent to the implementation of a T+3 settlement date in the municipal securities market. I understand that the MSRB is contemplating the introduction of another document to serve as something of a disclosure substitute for the confirmation in a T+3 settlement environment, and I suspect that the additional disclosure matters which I am discussing today would then need to be shifted over to that document.

Having stated the foregoing, I recognize that playing the game of ifs, ands, or buts is indeed a dangerous one and that it is probably wiser to stick to today's circumstances.

III. Syndicate Selection Practices

While not as much of a concern to individual investors as mark-up disclosure, the ways in which bond underwriting syndicates are formed -- and the increasing involvement of issuers in this formation process -- impact everyone in the municipal securities market. The extent to which an issuer is involved in selecting the members of an underwriting syndicate varies depending upon whether the issue is competitively bid or marketed through a negotiated sale.

In a competitive sale, the issuer generally has less involvement in selecting syndicate participants. While the issuer may state that it only will consider bids from syndicates having a member firm meeting certain criteria (such as minority- or woman-owned firms, or firms located in the issuer's geographic area), other decisions concerning syndicate composition ordinarily are made by the lead underwriter.

In contrast, I understand that it is common practice in the municipal securities industry for the issuer in a negotiated sale to select most, if not all, of the syndicate participants. Moreover, the issuer most likely will choose the bond counsel and the underwriter's counsel, as well as the other professionals necessary to complete the offering. While there is nothing intrinsically wrong with this level of issuer involvement, it does raise questions concerning issuer motivation for the desire to be involved in such micro-management. These concerns are heightened by the current increased level of negotiated transactions as opposed to competitively bid transactions.

A. Issuer Involvement in the Process

Exploring issuer involvement in the syndication designation area is difficult, in part because issuers differ greatly in the extent to which they substantiate their choices. While many issuers routinely document the process through which they select underwriters and other syndicate members (for reasons of state law or otherwise), others are not as thorough. For example, I understand that California issuers routinely produce elaborate paper trails in making decisions regarding the selection of underwriting syndicate members and other professionals.[17] In contrast, the New Jersey Turnpike Authority acknowledged last May that it had no documentation explaining how it selected the 48 firms that handled its $2.9 billion in refundings in 1991 and 1992.[18]

Presumably, members of underwriting syndicates are chosen for their strengths and abilities, alone and in combination with other syndicate members, to augment the success of an offering. Among the factors that may be considered are a firm's financial resources, its marketing abilities, its reputation, and its fiscal probity.[19] Other criteria could include whether the firm sells primarily to institutional or to retail clients, whether the firm has related experience, and whether the firm is particularly innovative.[20]

Syndicate members, however, may be selected at least in part on non-merit based criteria. Although the primary goal of municipal issuers in an underwriting is to raise funds at the lowest possible net interest cost, these issuers often have to balance the cost factor with other important interests. For example, some issuers wish (or are required by local law) to use public financing as a way of advancing certain social or regional goals. Such issuers may require minority-owned or local firms to be included in the syndicates distributing their securities. In these issuers' view, the public interests advanced by selecting syndicate participants for such reasons offsets any increase in the cost of the issue that may result.

In addition, municipal issuers, like non-governmental issuers, may prefer working with certain firms for reasons of past performance or loyalty. Such issuers also may have more faith in syndicate participants with whom they share a common history. These are all valid factors for municipal issuers to consider. When factors other than cost are determinative in selecting syndicate participants, however, it is my view that these additional factors should be disclosed.

B. Syndicate Manager's Responsibilities

MSRB rule G-11 addresses some of the responsibilities of the senior syndicate manager in operating the underwriting syndicate. Among other things, the rule provides that the senior syndicate manager must, before the first offer of the securities is made, give the syndicate members written notice of the priority provisions governing the distribution.[21] In addition, at the completion of the distribution, the rule requires the senior syndicate manager to inform the syndicate members of the syndicate's expenses and allocations.[22]

As a practical matter, issuers have a great deal of input in forming the priority provisions and may in fact dictate the priority provisions in full.[23] Similarly, issuers may impose the use of certain service providers, thus significantly affecting the final accounting statements given to syndicate members. Again, this issuer involvement is not necessarily evil. It should, however, be made known to syndicate participants, and thus to the marketplace and to investors in my judgment.

C. Disclosing the Selection Process

One way of ensuring such disclosure would be for the MSRB to revise its rule G-11 to require the senior syndicate manager to obtain and to disclose the information underlying the selection of syndicate members and of other offering participants, as well as the information underlying the establishment of priority provisions. In particular, the senior syndicate manager could be required to disclose:

- Who was employed in the issue, either as a member of the syndicate or otherwise? How much, and on what basis, were such persons compensated?
- On what basis were such persons chosen? Which persons were chosen by

someone other than the senior syndicate manager? Was it necessary to hire another person to supplement the work of a person not chosen by the senior syndicate manager?

Such a rule change would be consistent, in my view, with the MSRB's overall mission, in that it would remove impediments to a free and open market, and would promote just and equitable principles of trade by requiring that syndicate managers provide this information to the members of their underwriting syndicates.[24] I strongly encourage the MSRB either to consider revising rule G-11 in the manner that I described or to suggest to the Commission alternative methods of covering this territory.

In any event, to the extent the price at which bonds are sold is affected by the factors that I mentioned, the syndicate manager may already have an existing obligation under the federal securities laws to make such disclosures. In fact, I would argue that they do. However, in the absence of appropriate MSRB rulemaking, the Commission may wish to consider taking action under existing laws to encourage the industry to reveal its syndicate selection practices to the marketplace. This rulemaking action would probably only be applicable to negotiated financings and not to competitively bid ones.

V. Conclusion

Syndicate selection practices are likely to remain an issue for some time to come. However, regulators and market participants soon must begin addressing the problems stemming from the lack of transparency and the lack of mark-up disclosure in municipal securities transactions.

The municipal securities market in 1993 is immense -- and predominantly retail. These investors need the protections that greater transparency and that mark-up disclosure can provide them. I believe that the technology is available and affordable

to give investors in municipal securities somewhat similar protections to those which they receive in other securities markets, and it is my intention to provide these protections at a reasonable and appropriate level to municipal securities investors.

ENDNOTES

1. 17 CFR 240.10b-10.

2. MSRB rule G-15(a), MSRB Manual (CCH) ¶3571.

3. 17 CFR 240.10b-10(a)(8)(i)(A). Note that Rule 10b-10 requires the disclosure of this information for transactions in equity securities.

4. Securities Exchange Act Release No. 30608 (Apr. 20, 1992), 57 FR 18004, 18022.

5. 17 CFR 240.10b-10(a)(8)(i)(A).

6. See, Securities Exchange Act Release No. 15220 (Oct. 6, 1978), 43 FR 47538.

7. These opponents of the rule change argued that the cost of compliance would be such that small firms would leave the business Thus trading would be concentrated trading in larger firms with sufficient capital to maintain inventories of municipal securities.

8. Securities Exchange Act Release No. 18987 (Aug. 20, 1983), 47 FR 37919.

9. See, e.g., Investment Planning, Inc., Securities Exchange Act Release No. 32687 (July 28, 1993) (upholding NASD finding that mark-ups on certain municipal bonds were excessive, even though such mark-ups were below the NASD's 5% mark-up threshold); Donald T. Sheldon, Admin. Proc. File No. 3-6626 (Dec. 2, 1988)[available on LEXIS](undisclosed mark-ups in excess of 8% for municipal bonds were deemed excessive); Nicholas Codispoti, 48 S.E.C. 842 (1987) (mark-ups of 6.1% to 32.7% on municipal bonds trading in inactive market were deemed excessive); and Hanauer, Stern & Co., Securities Exchange Act Release No. 21313 (Sept. 11, 1984), 31 S.E.C. Doc. 483 (consent decree included findings of excessive mark-ups on municipal securities transactions).

10. Testimony of Arthur Levitt, Chairman, U.S. Securities Exchange and Commission, Concerning the Municipal Securities Market, Before the Subcommittee on Telecommunications and Finance of the Committee on Energy and Commerce, U.S. House of Representatives, Sept. 9, 1993.

11. Division of Market Regulation, U.S. Securities and Exchange Commission, Staff Report on the Municipal Securities Market, (Sept. 1993).

12. Id. at 16.

13. Moreover, failure to disclose a high mark-up may violate the antifraud provisions of Rule 10b-5 under the Exchange Act.

14. Letter regarding Buys-MacGregor, McNaughton-Greenawalt & Co. (Feb. 1, 1980), [1980] Fed. Sec. L. Rep. (CCH) ¶76,313. Moreover, even when a broker-dealer incurs risk, such as selling short to a customer and then going to market shortly thereafter to cover its position, the transaction would continue to be deemed riskless. Id.

15. Id. Thus, a transaction carrying over to the next trading day would not be contemporaneous for purposes of a riskless principal transaction.

16. Municipal Bond Defaults - The 1980's: A Decade in Review 1-2 (J.J. Kenny Co., Inc. 1993) ("Kenny Default Report"). According to this study, of the total municipal bond defaults between January 1, 1980 and December 31, 1991, 98 were rated issues and 628 were non-rated issues. Approximately 1.93 percent ($2.99 billion) of the total dollar volume ($155.31 billion) of non-rated bonds sold between 1980 and 1991 defaulted during that period, representing approximately 2.12% (522) of the total number of non-rated issues (24,603) sold during that period. In contrast, approximately 0.27 percent ($3.36 billion) of the total dollar volume ($1.24 trillion) of rated bonds sold during this period defaulted, or approximately 0.08% (53) of the number of rated issues (69,656) sold during that period. Id. at 1. Moreover, the study showed that the average time to default for rated bonds (90.61 months) was approximately 57 percent greater than the average time to default on non-rated bonds (57.83 months). Id.

    See also Public Securities Association, An Examination of Non-Rated Municipal Defaults 1986-1991 4 (Jan. 8, 1993) ("PSA Default Report"), showing that approximately 2 percent ($1.28 billion) of the dollar volume ($64.3 billion) of non-rated bonds sold between 1986 and 1991 defaulted. The conclusions of this study have been criticized, however, as being skewed toward finding fewer than actual defaults, in light of a finding by the Kenny Default Report that the average time of default for an unrated municipal security is slightly less than six years after issuance. See, e.g., B. Stein, Minus Munis - New Light is Shed on Default Rates, Barron's, May 31, 1979, at 22. The PSA Default Report itself seems to support this analysis, in that it shows a 6.2 percent default rate for bonds issued in 1986, compared to 2.7 percent, 2.2 percent, 1.8 percent, 0.5 percent, and 0.0 percent default rates for bonds issued in 1987, 1988, 1989, 1990, and 1991, respectively. PSA Default Report at 4.

    See also V. Stamas, "Markey Leaning Toward Ongoing Disclosure Bill," The Bond Buyer (Oct. 8, 1993) at 1 (In testimony before House subcommittee, six prominent industry representatives "agreed when asked whether the greatest disclosure problems and the highest risk of defaults have been with unrated bonds, particularly hospital, housing, special district, and industrial development bonds."); L. Spiro & K. Holland, "The Trouble With Munis," Business Week (Sept. 6, 1993) at 44) ("But owning unrated muni bonds, which make up nearly one-third of the total number of bonds in the market in 1991, can be risky. Investors often don't realize that higher yields on unrated muni bonds mean they are taking more credit, or default, risk.").

17. Among the documents produced by a California issuer are (a) a written analysis of the planned bond issue, specifying requirements and needs, (b) a record of the requests for qualifications ("RFQs") sent to potential syndicate members, (c) staff analysis of the RFQs, and (d) a ranking of the firms based on their qualifications. S. Dickson & A. Pressman, "N.J. Turnpike Has No Records on Choosing Refunding Team," The Bond Buyer (May 10, 1993) at 1.

18. Id. The New Jersey Turnpike Authority ("Authority") had sent out a detailed, 22-question request for proposal in early 1991, and had the firms' written responses on file. In addition, firms that were finalists for senior underwriting positions gave oral presentations to an Authority committee. When called upon to show how its underwriters were chosen, however, the Authority could produce nothing.

19. A. Pressman & S. Monsarrat, "SEC and State Board Are Now Scrutinizing New Jersey Turnpike Over Bond Refunding," The Bond Buyer (May 6, 1993) at 1.

20. S. Dickson & A. Pressman, "N.J. Turnpike Has No Records on Choosing Refunding Team," The Bond Buyer (May 10, 1993) at 1. For example, although not required by statute, the New Jersey Highway Authority maintains detailed records documenting its selection of underwriters. These records include a matrix ranking potential underwriters in six weighted categories -- innovative financing, marketing capability, marketing approach, knowledge of authority, relevant experience, and affirmative action. Id.

21. MSRB rule G-11(f). MSRB rule G-11(e) provides that a syndicate must establish "priority provisions" (provisions governing the allocation of securities to different categories of orders) and procedures for changing these provisions (if changes are to be allowed). While these provisions may permit the syndicate manger to use discretion in making allocations in individual situations, the priority provisions cannot solely provide that allocations will be made at the syndicate manager's discretion. Moreover, when allocations are made using the syndicate manager's discretion, the syndicate manager has the burden of demonstrating that the allocation was made in the best interests of the syndicate.

22. In particular, MSRB rule G-11(h) requires the senior syndicate manager to provide syndicate members with statements itemizing the nature and amounts of all expenses incurred on behalf of the syndicate, the related entities to which securities have been allocated, the persons submitting group orders to which securities have been allocated, and the aggregate par values and prices of all securities sold from the syndicate account.

23. C.f., C. Grigsby, "Priority Rules Often Ignored, But Shouldn't Be," Letter to the Editor, The Bond Buyer (Aug. 12, 1991) at 21 ("Typically, in current negotiated issue practice, Rule G-11(e) is ignored. Instead of the syndicate members establishing or agreeing to priority provisions, the priority provisions are determined solely by the senior manager.").

24. See Section 15A(b)(6) of the Exchange Act.