Remarks Of

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"PUBLIC FINANCE AND TAX-EXEMPT MARKET CONCERNS"

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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 of the Commission.

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"PUBLIC FINANCE AND TAX-EXEMPT CONCERNS"

I. Introduction

I appreciate the opportunity to participate in this 1992 Midwest State Treasurers' Conference. While I am a poor substitute for Chairman Breeden, who was originally scheduled to participate, I am honored to be here and relish the challenge all the same. The "Reflective Leadership" theme is particularly appropriate in view of the multiplicity of challenges currently confronting those in public finance.

It is my intention today to focus primarily on two subjects -- (1.) a simple method to assist in a small way the battle to overcome the infrastructure crisis faced by every state and local government, and (2.) some operational concerns which, in my opinion, pose potential problems to the integrity of the municipal securities market.

II. Proxy Reform

As an aside, however, it is my understanding that many in the audience are interested in the subject of proxy reform; and I will spend a few minutes to briefly comment on that subject. The Commission proposed certain amendments to

its proxy rules under Section 14(a) of the Exchange Act in June of last year. Recently the Commission revised these original proposals and, at the same time, proposed several amendments to its executive compensation disclosure requirements. As originally proposed, and as reproposed, the proxy amendments were intended: (1.) to facilitate shareholder communications, (2.) to enhance informed proxy voting, and (3.) to reduce the cost of compliance with the proxy rules for all persons engaged in a proxy solicitation. I am confident that all the members of this audience agree that those objectives are laudable.

The proxy amendments were reproposed in response to the over 900 comment letters received by the Commission. While there were several revisions, as well as some new amendments, there should be no substantial surprises in the reproposal. It is my understanding that the staff has received approximately 500 comment letters to the proxy rule reproposal and the executive compensation disclosure proposal. I would encourage each of you to consider and to

respond to the proxy reproposal soon if you have not already done so, because the comment period expires at the end of August.

Chairman Breeden has indicated an interest in adopting proxy rule amendments in the fall. I hope the Commission adheres to that schedule in order that the amendments would be in place in time for the 1993 proxy season. I look forward to the Commission finally revising the current antiquated, burdensome rules impeding shareholder communication and shareholder participation in the corporate governance process, thereby furthering Congress' intent to assure fair, informed, and effective shareholder suffrage.

III. Help for Infrastructure Crisis[1]

Everyone here is painfully aware of the infrastructure problems faced by state and local governments in the 1990s. Any reasonable mechanism that could provide more capital and increased liquidity to the municipal securities market, and

1 This material is largely derived from a Guest Words column which appeared in The Bond Buyer. See Roberts, "Infrastructure Demands Underscore Need for Rescuing Bank Deductibility," The Bond Buyer (June 29, 1992), at 25.

thus result in lower borrowing costs for issuers, which in turn should free up more capital to meet infrastructure demands, should be considered. Of course the most help would come from a mechanism that would find substantially more funds for state and local governments. I will not be of much assistance in that regard.

News stories abound with large, even astounding, infrastructure investment needs for the United States.[2] Various political groups have claimed public capital shortfalls of hundreds of billions of dollars. While it is difficult to assess these infrastructure need claims, the flood in Chicago and the riot in Los Angeles underscore the fact that there exists a real infrastructure crisis.

Most municipal bond offerings are intended to supply proceeds to fund public infrastructure capital requirements. As was pointed out in the Report of the Anthony Commission on Public Finance, since 1917, the Tax Code has contained provisions encouraging banks to purchase the

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2 See, e.g., Hamilton, "Maintaining Nation's Infrastructure Just Gets Tougher," The Washington Post (April 18, 1992), at D10.

debt of state and local governments. The Tax Code recognized that since banks are supposed to be in the business of borrowing money to make loans, they should be exempt from the general requirement that borrowing costs associated with tax-exempt debt cannot be deducted from gross income. Further, these provisions recognized that banks are uniquely suited to purchase the securities of state and local governments in communities in which they are doing business because they understand both the issuer's needs and their creditworthiness. As a result of these provisions, until 1982, banks played a vital role in the tax-exempt market. However, in 1982, Congress began to limit the bank interest deduction for carrying costs associated with tax-exempt debt, reducing the deduction to 85 percent in 1982 and then to 80 percent in 1984 and finally eliminating it for most issuers in 1986. As we all know, the Tax Reform Act of 1986 limited the ability of banks to deduct 80% of the cost of carrying tax-exempt bonds so that the deduction

was available only for bonds that are purchased from an issuer that expects to sell no more than $10 million of bonds annually.

The impact of these Tax Code changes on the holding of tax-exempt bonds by banks has been staggering. In 1980, commercial banks held 41% of all tax-exempt securities, but by the end of 1991, bank holdings had dropped to only 9.6%. In particular, the Tax Reform Act of 1986 sapped the demand for tax-exempt bonds on the part of commercial banks. Commercial bank ownership of tax-exempt securities decreased by $128.1 billion from the end of 1985 to the end of 1991, a reduction of 33.7%.

For whatever reason, it is clear that Congress has discouraged banks from assisting in meeting public infrastructure needs. Revenue does not appear to be the reason, or, given the small numbers involved, at least not a sound one. The final estimate of the Joint Committee on Taxation forecasted only a $55 million revenue increase over

the first five years following the enactment of the provision in the Tax Reform Act of 1986 amending the bank deductibility limit.

Fortunately, a bill recently approved by the Senate Finance Committee attempts to encourage banks to invest in our national infrastructure as a means of alleviating, in a small way, our infrastructure crisis. The bill, which is principally involved in attempting to revitalize certain enterprise zones, increases from $10 million to $25 million the amount of governmental bonds that an entity may issue annually while qualifying those bonds for the small-issuer exception to the general bank interest disallowance rule. This provision would be effective for bonds issued in 1993.

Apparently the Joint Committee on Taxation has estimated that increasing the bank deductibility provision in this manner would result in a $100 million revenue decrease over 5 years. While it is difficult to correlate this $100 million revenue decrease estimate with the earlier $55 million revenue increase estimate concerning the limitation on the

bank deductibility provision of the Tax Reform Act of 1986, the numbers involved remain relatively small considering estimates of the magnitude of the infrastructure crisis.

While the Senate Finance Committee bill is a step in the right direction, it does not in my judgment go far enough. The 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.

By returning banks to a prominent investor role in the municipal securities market, banks can help meet our public infrastructure demands. Banks should be encouraged to contribute to the solution of the public infrastructure crisis. For certain, Congress should return the tax-exempt bank deductibility provision to its pre-Tax Reform Act of 1986 status. I know that all of the state treasurers here would be

very much in favor of permitting the securities that your employer issues to be bank-eligible.

IV. Tax-Exempt Concerns

A. Municipal Market Generally

I wish to focus the remainder of my prepared remarks today on some concerns that I have with the operation of the tax-exempt market that may be of interest to you. Obviously the members of this audience deal with that market everyday.

The municipal securities market is a national asset that has served both issuers and investors well for many years. It appears that it will continue to do so in the future. The tax-exempt issue volume for the first seven months of 1992 was approximately $120 billion, which, if that pace continues, would make 1992 either the first or second largest volume year ever. Despite the large volume and the skimpy yields, skimpy at least by traditional measures, there is no apparent slackening in demand. Judging from the cash flows into tax-

exempt funds, municipal bonds continue to appeal strongly to investors.

Trouble, however, does lurk behind these large volume numbers. Of the 1992 tax-exempt volume, almost one-half of the bonds were issued for refunding purposes, compared with 30% in 1991 and 22% in 1990.[3] Thus, there is not as much new supply in the bond market as one might think from the volume. This is all the more reason to increase the supply of bank-qualified bonds as an easy way to increase, in a small manner, the total new supply of municipal bonds and help in the battle to overcome our infrastructure crisis.

Also, as a result of the high levels of refunding, many investors are receiving their money back to be reinvested at interest rates far below what they have enjoyed for the past decade. Fortunately, despite the lower-interest rate environment, this money is presently being plowed back into municipal bonds. It is my understanding that the level of refunding will remain high for several years. If for some

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3 See, Vogel, "Municipals Maintain Their Allure," The Wall Street Journal (Aug. 10, 1992), at C1.

reason investors did not recycle this money back into the municipal market, there could occur a substantial market dislocation. Such a liquidity crisis did occur in the spring of 1987. However, there is no evidence to date that would indicate such a calamitous occurrence is likely.

As I previously mentioned, because of the refundings, investors are forced to reinvest money at much lower interest rates and are thus hungry for yield. Higher yields are difficult to find in today's municipal market without increasing risk. Apparently one investment approach is to extend maturities as a means of achieving more yield, but that entails incurring greater risk as one moves out the yield curve. Investors utilizing this approach should be aware of the risk behind the lure of the steep yield curve. Another approach is to take additional credit risk by buying higher yielding but lower rated or unrated bonds.[4] I wish to mention a concern that I do

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[4] See Lebherz, "Trying to Enhance Yields as Rates Fall," The Washington Post (July 5, 1992), at H5.

have which is an outgrowth of this second investment approach.

B. Reexamine Suitability Requirements

I do not believe that I should be concerned, as a federal securities regulator, with those investors who decide to seek higher tax-exempt yields by assuming greater credit risks. I do become concerned, however, when broker-dealers capitalize on this yield-hungry environment by recommending and selling to unsophisticated individual investors low-rated or unrated bonds that are clearly unsuitable investments. Such practices impugn the integrity of the tax-exempt market to the detriment of all issuers that access this market, even issuers such as the ones that you work for, that do not fall in the low credit category.

Unhappily, I must report that it appears that in too many instances retail investors have inappropriately been sold high-risk municipal bonds. It is difficult to discern whether the investors in those instances make these investment decisions

on their own, or whether the securities were recommended by broker-dealers in spite of suitability concerns.

In recommending securities transactions to customers, broker-dealers have an obligation to determine that the transactions are suitable for each customer. Also the Municipal Securities Rulemaking Board ("MSRB") Rule G-19 requires that broker-dealers, at or prior to a recommendation, must "inquire as to the customer's financial background, tax status, investment objectives, and similar information."[5] This rule requires that the broker-dealer must either: (i) have reasonable grounds to believe that the recommendation is suitable in light of such information that it knows, or (ii) have no reasonable grounds to believe that the recommendation is unsuitable for the customer if all of such information is not furnished or known.

I do not understand the necessity for the second part of MSRB Rule G-19. It appears to me that such a provision could undermine the purpose behind a suitability rule. One of

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[5] MSRB Manual (CCH) ¶ 3591.

the sales practice rules of the National Association of Securities Dealers ("NASD") requires that NASD members recommending securities transactions to their customers must, in each case, have reasonable grounds to believe that the recommendation is suitable for the customer based on information provided concerning the customer's other securities holdings, financial situation, and needs as provided by the customer.[6] There is not a "no reasonable grounds" provision in this NASD sales practice rule. However, by operation of Section 15A(f) of the Exchange Act, transactions in municipal securities are not covered by the NASD sales practice rules.[7] The MSRB presently is looking at this issue generally and is considering changes to its suitability rule. I am of the opinion that in order to reduce

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6 I acknowledge that this rule requires the broker-dealer recommendation to be suitable based only on the information provided by the customer, "if any." NASD Rules of Fair Practice, Art. III, Section 2, NASD Manual (CCH) ¶2152. However, Commission decisions involving this rule have held that a broker-dealer must determine the suitability of its recommendation based on what has been disclosed by the customer, and in the absence of disclosure, the broker-dealer cannot safely assume that a recommendation is suitable for a customer. Gerald M. Greenberg, 40 S.E.C. 133 (1960). In addition, disciplinary action under the NASD rule has been sustained over an objection that the customer failed to disclose complete information. Eugene Erdos v. SEC, 742 F.2d 507 (9th Cir. 1984).

7 15 U.S.C. 78o-3(f).

inappropriate recommended sales to retail investors of high-risk municipal securities, at a minimum, the MSRB should delete the "no reasonable grounds" provision of its suitability rule. This second clause of MSRB Rule G-19 provides, at the present, a potential suitability loophole. I hope that this loophole will be closed in the near future as a result of the MSRB's review.

C. Education of Regulators in Derivatives

Another outgrowth of efforts to increase yield, but reduce risk, have led to the development of new tax-exempt synthetic or derivative products. Of course, the development of new derivative products has been the focal point of most discussions concerning the direction of public finance for several years now.[8] According to a recent survey, 41% of tax-exempt funds hold, or have at some time invested in, synthetic securities.[9]

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8 See Chamberlin, "New Directions in Public Finance," Dean Witter Tax-Free Municipal Bonds Institutional Newsletter (March 30, 1992).

9 "Faced With Supply Problems, Many T-F MFs Turn to Synthetic Floaters," Money Market Insights (May 1991).

Synthetic securities are not easily understood or, at least, not easily understood by me. Because of the complexity of these new financial instruments and their increasing popularity, there should be more intense scrutiny, in my judgment, of municipal derivative securities activity by the Commission. It is not that derivative or synthetic securities are *per se* evil so much as that regulators do not at present fully understand the risks they pose. Regulators are often behind the industry in the learning curve with respect to new financial products and are often suspicious of these new products until they have demonstrated an ability to withstand market stress. Regulators also often hold the view that the securities industry tends frequently to understate or to ignore the risks of new financial products.

In an effort to close the gap in the learning curve, the staff of the Commission will be collecting a substantial amount of information on taxable and tax-exempt derivative securities from the securities industry as a part of its risk assessment program pursuant to rules recently adopted by

the Commission under the authority of the Market Reform Act. This exercise should enable the Commission to assess the current risk assessment policies of broker-dealers and to develop new risk assessment procedures if necessary. Hopefully, as an outgrowth of this exercise, the Commission will ultimately become more comfortable with these new financial products. I am unaware of anyone at the Commission who is interested in stifling innovative financial engineering.

On the municipal side, apparently one of the more popular derivative securities is a "synthetic" variable-rate demand note ("VRDN"). The wide-use of synthetic VRDNs underscores the need in my judgment for the Commission to propose additional amendments to Investment Company Act Rule 2a-7 to address issues unique to tax-exempt money market funds. The Commission has adopted amendments to Rule 2a-7 which primarily apply to taxable money market funds.

Synthetic VRDNs have complex structures. A credit risk probably exists with respect to each of the put providers involved in the arrangement. The Commission, in my judgment, should strongly consider proposing reasonable limitations on the ability of tax-exempt money market funds to invest in some synthetics which possess higher credit risks due to their complexity. There are other persuasive reasons as well, which I will not go into today, that should compel the Commission to propose amendments to Rule 2a-7 applicable to tax-exempt money market funds.

I am disappointed that the Commission has not to date proposed such amendments to Rule 2a-7. The money market fund industry apparently would support an appropriate set of amendments.[10] There are about 280 tax-exempt money market funds with approximately $100 billion in assets.[11] These funds are too large to be ignored in a regulatory sense. At a minimum, the Commission should consider limiting the

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10 <u>See</u> Kohn, "Stricter Rules on Tax-Exempt Money Market Funds," Investor's Business Daily (August 18, 1992).

11 <u>See</u> Hyatt, "Money Market Fund Assets Show $404 Million Rise," <u>The Wall Street Journal</u> (August 21, 1992) at C11.

exposure of tax-exempt money market funds to credit risks to reduce the likelihood that a fund will realize a loss of principal requiring it to reduce its price per share below its established stabilized price. "Breaking the buck" could be catastrophic for the money market fund industry and its investors regardless of whether a taxable or tax-exempt money market fund was the actor; and, while such an event is probably ultimately inevitable, it should be avoided as long as reasonably possible.

Another popular municipal synthetic investment product is the interest rate swap. Under the right set of circumstances, the use by government issuers of interest rate swaps can be an effective instrument for state and local debt management programs. However, I would caution all the issuers in this audience to exercise care and to be sure that the swap is designed properly in order that the risks attendant to the product do not outweigh the benefits. Some of the factors to consider that have been pointed out to me are -- the certainty of legal authority, the counter-

party risk, the leveraging involved, the length of the swap, the index used, the compensation paid to the counter-party, the break-even point, the ability to obtain comparable market quotes, and the political problems posed in the event of unanticipated payments under a swap agreement.[12] I suspect that these are considerations more appropriate for the market and for government issuers, rather than for federal securities regulators.

D. Secondary Market Disclosure

There are two other miscellaneous concerns I have with the present operation of the municipal market that I wish to mention briefly. The first is secondary market disclosure, or the lack of it in the municipal market. I know that everyone here is interested in a vibrant, efficient primary and secondary municipal securities market. Such a market must possess as some of its characteristics -- liquidity and

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12 See Johnson, "As the Importance of Interest Rate Swaps Grows, So Does the Need for Issuers to Guard Against Risk," The Bond Buyer (August 10, 1992), at 29. The aforementioned article was adopted from remarks delivered by J. Chester Johnson, president of Government Finance Associates, Inc., to the Institute for International Research, New York, New York, June 29, 1992.

integrity. I believe that an active secondary market disclosure program could only enhance the liquidity and integrity of the municipal securities market. This would benefit all the market participants -- issuers, underwriters, broker-dealers, trustees, bond attorneys, and investors. A number of industry associations have been working on various secondary market disclosure guidelines, including NASACT and the GFOA. The NFMA has been actively involved in a positive way for some time in the secondary market disclosure area. I notice that even the Investment Company Institute has recently initiated such a project. I wish to urge continued voluntary industry efforts to develop an effective secondary market disclosure program and further wish to encourage each of you here today to provide reasonable secondary market information, concerning your respective issuer, in a timely manner to the municipal securities marketplace.

E. Bank Tying Activity

The final concern is that I have received various complaints alleging that banks are "tying" their provision of credit enhancement in a municipal securities offering to a role as an underwriter in the offering. Two of the complaints are: (1.) a bank will have a credit policy that provides that credit enhancement for a municipal securities transaction will be offered only if the bank or its affiliate is also an underwriter in the transaction, and (2.) a bank will have a two-tiered pricing structure so that the price for providing credit enhancement is cheaper if the bank or its affiliate also is an underwriter in the transaction. While I take these complaints seriously, I am unable to state with certainty that they are valid.

I know that the issuers with whom you are employed are large enough and sophisticated enough to avoid being trapped into a "tying" arrangement. However, because of your active presence in the municipal market, you may be

aware of bank "tying" activities; and if so, please let me know.

As you are aware, "tying" in this context generally refers to any arrangement in which a bank requires a customer that desires one service, such as credit, to purchase other services or products from the bank or its affiliates as a condition of receiving the first service. Obviously federal banking law imposes a number of prohibitions and restrictions on banks with respect to tying arrangements and other anticompetitive practices in connection with bank securities activities. Even if the activity was not against the law, I believe that bank "tying" activities would rarely, if ever, be of benefit to an issuer. It is an activity that has no place in a market that depends upon its safety, soundness, liquidity, and integrity to attract capital.

V. Conclusion

I know that each of you are interested in preserving and improving the integrity of the municipal securities market,

and I look forward to working with each of you toward such an objective. As I reflect upon the leadership that each of you have exhibited in the area of public finance, I am also confident that in the future we can direct the municipal securities market in a manner that will improve our ability to confront and to solve our infrastructure crisis.