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HEADLINE: TESTIMONY ARTHUR LEVITT, JR., CHAIRMAN U.S. SECURITIES AND EXCHANGE COMMISSION CONCERNING THE STATE OF THE MUNICIPAL SECURITIES MARKET BEFORE THE SUBCOMMITTEE ON TELECOMMUNICATIONS AND FINANCE COMMITTEE ON ENERGY AND COMMERCE UNITED STATES HOUSE OF REPRESENTATIVES SEPTEMBER 9, 1993

BODY:

TESTIMONY OF

ARTHUR LEVITT, JR., CHAIRMAN

U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING THE STATE OF

THE MUNICIPAL SECURITIES MARKET

BEFORE THE SUBCOMMITTEE ON TELECOMMUNICATIONS AND FINANCE

COMMITTEE ON ENERGY AND COMMERCE

UNITED STATES HOUSE OF REPRESENTATIVES

SEPTEMBER 9, 1993

Chairman Markey and Members of the Subcommittee:

I am pleased to appear today to testify on behalf of the Securities and Exchange Commission regarding the challenges and opportunities facing the municipal securities market. It is indisputable that this vital market has been the subject of intense scrutiny in the past several months, and serious concerns have been raised regarding certain aspects of it, which I will comment on in a moment. The infusion of dollars from millions of individual investors seeking safe, tax-exempt investments calls for our scrupulous attention to this market. I commend you, Mr. Chairman, for holding this hearing so that attention can be focused on the concerns that have been raised and what steps should be taken to address them. The Commission looks forward to working with you and your colleagues on the critical issues relating to this important capital market.

While the Commission remains confident of the strength and effectiveness of the municipal securities market, we also share the Subcommittee's concern that investor confidence in its integrity may have been impaired as a result of recent serious allegations of abusive practices. This market, which has fueled the growth of America's infrastructure, has many positive attributes that should be fostered. Nevertheless, there also are certain negative aspects that work against investor interests, which must be reformed. I am convinced that the various entities that play a role in overseeing this market must work together

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to ensure that the municipal market is fair and efficient, while remaining mindful of the costs borne by market participants

In brief, I believe the key to reform of the municipal securities business is more hard information. More information about issuers so investors can better evaluate the value of their securities. More information about the market so investors can obtain fair prices; and more information about transactions so regulators can do their job better. I recognize that information gathering and dissemination imposes direct and indirect costs. Thus, we must ensure that such information is obtained and disseminated in a cost effective manner.

The Municipal Securities Market Today

It has been almost twenty years since Congress last enacted legislative reform to address problems in the municipal securities market. Since the 1975 Amendments, much has changed. Ownership of municipal bonds once was heavily concentrated in the portfolios of banks, insurance companies, and other institutions. Today, retail investors, holding both directly and through mutual funds and other intermediaries, increasingly depend on municipal securities to provide a secure, tax-exempt source of income. Households now account for the largest ownership share of any investor group in the market.

Increasingly, retail ownership has been accompanied by an explosion in volume. Investors now hold in excess of \$1.2 trillion in outstanding principal amount of securities issued by approximately 50,000 state and local issuers. In 1992 alone, volume reached a record \$235 billion, and this record is well on its way to being broken this year. The dealer segment has grown along with the rest of the market. Distribution and trading of municipal bonds is carried out by a network of approximately 2,600 brokers, dealers, and banks.

Along with these changes, new and increasingly complex securities are being introduced at an extraordinary pace, as issuers and dealers look for ways to respond to investor demand for products tailored to individual needs. Fundamentally, this is a welcome development that manifests the ability of the marketplace to devise creative financing solutions to meet demand. At the same time, as regulators, we must keep a careful eye on the possibility that more complex and volatile instruments will lead to investor confusion or marketing abuses.

The significance of the municipal market to the national economy, as well as to taxpayers and individual investors, cannot be overstated. Indeed, the municipal market finances a vast number of programs throughout the United States, which provide infrastructure, services, and community development opportunities at relatively low cost. While overall the municipal market functions effectively, the problems that have been highlighted in recent months have raised legitimate and serious concerns.

In response to the joint request of this Subcommittee and the Committee on Energy and Commerce, the Commission staff recently completed a report on the municipal securities market. I would like to discuss some of the problems identified in the report, and what the Commission intends to do to address those problems.

Municipal Broker-Dealer Market Practices

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In recent months, several separate incidents of alleged abusive practices in the municipal market have received significant publicity. Media reports describe how municipal securities dealers have allegedly paid political figures and other parties to obtain underwriting business in municipal offerings.

These reports are substantial enough to call into question not only the business practices of municipal underwriters, but also the integrity of the municipal securities market as a whole. Although our review has not been completed, we are carefully looking at these practices with a view toward enforcing existing laws. We believe strongly that something must be done by all interested parties -- market participants, regulators, and Congress -- to ensure that investor confidence in this market is reinforced. The MSRB recently has advanced thoughtful proposals to deal with these issues. Without commenting on their substance at this hearing today, we believe their approach represents a step in the right direction.

In addition, the Commission is studying the ways in which municipal bond offerings are underwritten. Competitive bidding, which used to be the norm, has been eclipsed by negotiated underwritings, which now account for approximately 75 percent of the aggregate dollar volume of long-term municipal bond offerings. Competitive bidding is generally believed to lower the overall cost of selling general obligation bonds, whereas the benefit of negotiated underwriting is that it may permit municipalities to fund needed projects that otherwise might not receive financing. My own view is that while negotiated underwritings serve an important function in the municipal market, issuers should take a hard look at competitive bidding before doing a negotiated offering. In my opinion, issuers should constantly evaluate the benefits of competitive bidding as they explore financing alternatives.

Of course, my views on this matter are reflective of my own experience with both negotiated and competitive transactions. What appears to differentiate municipal and corporate underwritings is that municipal issuers tend to control the flow of funds by selecting both managing underwriters and syndicate participants. To the extent to which issuers recognize political contributions by influencing the choice of syndicate members as well as managing underwriters, the potential for self-dealing becomes substantially greater. Accordingly, in its review of the municipal bond offering process, the Commission staff intends to consider how municipal bond issuers influence the composition of underwriting syndicates, and whether more disclosure of these practices is needed.

The Need For Increased and More Readily Available Information

Municipal Issuer Disclosure

The foundation for strengthening the efficiency and integrity of America's municipal securities market is improved issuer disclosure, both in initial offerings and on an ongoing basis. Under the present regulatory system, municipal securities are exempt from the registration and reporting provisions of the federal securities laws. This means that the extent of municipal issuer disclosure tends to be driven by the perceived level of demand for information from the buyers of municipal securities.

Over the years, the staff has investigated a number of bond defaults and near-defaults in which investors received inadequate disclosure. For example, in investigating the New York City fiscal crisis of the mid-1970's, the staff

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determined that the City had serious undisclosed financial problems at the time underwriters distributed over \$4 billion in short-term debt securities. A decade later, the staff found in investigating the default of securities issued by the Washington Public Power Supply System that the underwriters failed to conduct an examination of the issuer's disclosure to determine the substantial accuracy of statements to investors at the time that \$2.5 billion in revenue bonds were sold. As a result, some ill-informed investors purchased the bonds on the basis of an initial prospectus, with no updated disclosure from the issuer that construction on the underlying utility projects had been terminated, that there was ongoing litigation regarding the bonds' backing, that Moody's had suspended its rating on the bonds, or that Standard & Poors had placed the bonds on its CreditWatch list.

Allegations of inadequate disclosure in conduit bond issues also are too common to disregard. In one particularly egregious case, \$16 million in bonds were sold to finance the development and construction of a retirement center. After the bonds defaulted, it was found that investors were not informed of several significant facts, including the fact that the developer had been unable to obtain private financing for the project, and that the project's underwriters had a remarkably poor track record with municipal bond issues for health care facilities. In fact, at the time the bonds were issued, this project's underwriters were involved in 36 bond issues that were either experiencing financial difficulties or were in default. Of those issues, 30 were for retirement centers or nursing homes.

Voluntary organizations, led by the Government Finance Officers Association, have sought to encourage issuer disclosure. For example, the National Association of State Auditors, Comptrollers and Treasurers' Blue Ribbon Committee on Secondary Market Disclosure recently published its recommendations for enhancing information collection within the states. We expect that these self-regulatory efforts on the part of the states will improve disclosure procedures for all issuers of state and local governmental securities. Accordingly, we strongly encourage these efforts and welcome the opportunity to work with these and other groups to further improve the quality of disclosure in the initial and secondary markets for municipal securities.

Overall, the quality of disclosure has improved steadily over the years. There remains, however, a marked disparity in the quality of disclosure among issuers. At one end of the spectrum, there are large municipal issuers that provide comprehensive disclosure documents containing vital information. At the other extreme, there are small, less frequent issuers whose disclosures consist of a brief one- or two- page description and term sheet prepared by the managing underwriter for use in selling the offering. Such bare bones descriptions provide investors with little insight into the risks involved in purchasing a municipal security.

Once an offering is completed, periodic disclosure is even less common, and yet it is equally important for bondholders, subsequent investors, and dealers. Without ongoing disclosure, the liquidity and efficiency of the municipal securities market is impeded. Moreover, investors cannot be truly confident in their evaluations of bonds without updated disclosures.

Under the current regulatory structure, comprehensive disclosure in the municipal market can only be achieved through Congressional action by subjecting municipal issuers to registration and continuous reporting obligations. While

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we realize that a complete overhaul of the existing system may not be popular, and therefore may be difficult to accomplish, such an approach would be the only meaningful way to ensure comprehensive disclosure both on an initial and continuing basis.

At a minimum, the Commission believes that legislation is needed to require registration of all corporate obligations underlying municipal conduit securities. These securities are issued nominally by a public issuer but represent in reality an investment in a private enterprise. From an investment standpoint, they are identical to corporate bonds issued directly by the underlying obligor, except that the interest is tax-exempt. Investors in conduit bonds should receive the same initial and continuing disclosures regarding the underlying corporate obligor as they would receive for any other non-municipal entity.

In the meantime, the Commission is prepared to explore ways to improve disclosure under its existing interpretive authority by providing guidance to issuers regarding the disclosures required under the antifraud provisions of the federal securities laws. In addition, the Commission will consider proposing rules prohibiting municipal securities broker-dealers from recommending outstanding securities unless the issuer provides ongoing information about the financial condition of the issuer. While this approach would be indirect, and would by no means substitute for legislation setting comprehensive disclosure requirements, it would contribute to addressing the weaknesses in the current system.

Disclosure of Mark-ups

Another aspect of the market that needs to be addressed is the disclosure of broker-dealer compensation. The amount of the mark-up charged by municipal dealers currently is not required to be disclosed. In part, this is a result of a lack of trading history for many bonds that would serve to establish market price, and from a lack of public reporting, which I will discuss in a moment.

The lack of this disclosure makes municipal bond investors particularly susceptible to fraud and abuse. For example, in one case, the Commission alleged that municipal securities were marked-up 6 to 32 percent above the prevailing market price, based on the price the firm paid other dealers for the bonds no more than five business days before selling them to customers. In another case, the alleged undisclosed mark-ups on municipal securities ranged from 10 percent to an almost inconceivable 149 percent. This apparently was possible in part because the broker-dealer was able to take advantage of the customer's lack of knowledge of factors entering into the dealer's pricing decision. In an effort to address these types of situations, the Commission has directed the staff to find ways to improve confirmation disclosure in this area.

Transparency

To some observers, the most significant flaw in the municipal securities market is the lack of trading information available to investors and market professionals. Many of the problems, both real and perceived, in the municipal market would be alleviated if the level of publicly available information dissemination were greater. Retail investors and regulators need better trade and quote data to assess the fairness of the prices that municipal securities broker-dealers charge their customers.

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Disclosure in the municipal securities market is not comparable with disclosure in the equity markets, or even with that in the corporate bond market. Particularly in the case of unrated issues, investors may be operating in an environment in which they have no independent way to judge the true market value or suitability of their bonds.

Of course, an individual walking into a broker's office to purchase a municipal bond may be able to get a quote for that security. What he or she cannot get, however, is a real market price with which to compare the quoted price. Even for professionals, price information may not be available, or may be unreliable. The price at which one dealer will sell a bond to another dealer or to an institutional investor frequently differs from the price at which another dealer will sell the bond to a retail investor.

The MSRB has proposed a pilot program to collect and publish on a delayed basis, information on inter-dealer transactions in municipal securities. While this is a constructive first step, I believe that the Commission and the MSRB should work together to make available, at least for actively traded securities, more complete and timely price information for municipal securities in a cost effective manner.

Audit Trails

Improved quote and trade reporting should go hand-in-hand with better audit trail and surveillance systems. This, in turn, would allow greater monitoring and enforcement of municipal broker-dealer activities. A better audit trail would, for example, increase the NASD's ability to examine and enforce the existing customer protection rules of the Commission and the NASD.

Although the municipal securities market appears to have had a relatively low level of proven sales practice abuses, this should not lead Congress, regulators, or the investing public to believe that all segments of the municipal securities market are safe from abuse. Regulators need better tools if they are to address the elements of the municipal market that prey on unsophisticated investors. A state-of-the-art surveillance system of the type that exists in the stock and options markets today is the logical point to begin closing this gap in the regulatory system.

Conclusion

The municipal securities market is essential to our country. It provides an efficient means of financing local governmental needs, and on the whole it provides safe, sound, and reliable investments for millions of bondholders. The municipal market, however, is radically different from what it was in 1975, when Congress set up the current regulatory system.

As I have indicated, the Commission, working together with market participants, the Congress, the MSRB, the NASD, and other regulators, is prepared to take the initiative to ensure that America's municipal securities market remains a strong and healthy source of funding for local government, and a safe and fair market for investors. To that end, the Commission will work to ensure that investors receive more information about this market.