**TESTIMONY OF**

**ARTHUR LEVITT, CHAIRMAN**
**UNITED STATES SECURITIES AND EXCHANGE COMMISSION**

# CONCERNING THE MUNICIPAL SECURITIES MARKET

**BEFORE THE COMMITTEE ON COMMERCE**

**U.S. HOUSE OF REPRESENTATIVES**

**JANUARY 12, 1995**

U. S. Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

## EXECUTIVE SUMMARY

**STATEMENT OF ARTHUR LEVITT, CHAIRMAN**
**U.S. SECURITIES AND EXCHANGE COMMISSION**
**CONCERNING THE MUNICIPAL SECURITIES MARKET**
**BEFORE THE COMMITTEE ON COMMERCE**
**JANUARY 12, 1995**

The municipal securities market is of vital importance to American investors, to the state and local governments that need access to the municipal securities market in order to provide financing for public works and services, and to state and local taxpayers who stand behind municipal issuers. For this reason, the Commission has been engaged in a broad-ranging effort to improve municipal securities issuer disclosure and price transparency, and to end "pay-to-play" practices. Likewise, the events surrounding the bankruptcy filing of Orange County, California, and the effect of those events on our nation's securities markets, are important to American investors. This statement will (i) review the public record concerning the Orange County "pools"; (ii) discuss our initiatives over the last eighteen months to improve the municipal securities market; and (iii) make preliminary observations on state and local governments as investors in the securities markets.

Orange County Investment Pools and Bankruptcy. The Orange County Treasury managed money for 187 separate local governmental agencies. By the beginning of December 1994, these participants had deposited approximately $7.5 billion in the Orange County Treasury. The Orange County Treasurer, Robert L. Citron, managed investment pools for the participants. A significant portion of the pools were invested in interest-rate sensitive instruments. In addition, Citron employed a strategy of leverage utilizing reverse repurchase agreements that was predicated on interest rates continuing to remain low. Increases in short-term rates throughout 1994 had a dramatically negative effect on the pools' portfolios, eventually precipitating a cash-flow squeeze and the bankruptcy.

Initiatives to Improve the Municipal Securities Market. Over the last eighteen months we have undertaken a number of initiatives to enhance the transparency and integrity of this vitally important market. In that time, the Commission:

* Issued in March 1994 an interpretive release addressing the application of the antifraud prohibitions of existing securities laws to the municipal securities markets. The release noted, among other issues, the Commission's views about municipal issuers' disclosure practices with respect to their derivatives activities, both as issuers and end-users; and reminded municipal issuers that the antifraud provisions apply to their statements that can be reasonably foreseen to affect the secondary market for their securities;

* Adopted extensive revisions to existing rules applicable to municipal securities brokers and dealers that will facilitate better annual disclosure of financial information and timely disclosure by municipal securities issuers of material events that affect the value of municipal securities;

* Took steps to improve price transparency for the municipal securities and other debt markets; and

* Encouraged industry initiatives and approved MSRB rule G-37 eliminating "pay-to-play" practices from the municipal bond market.

State and Local Governments as Investors. The range of permissible investments for state or local governmental entities is controlled by state or local law. The Commission, as part of the President's Working Group on Financial Markets, has begun working with representatives of state and local governments to promote sound investment practices. In addition, we strongly encourage all end-users, including state and local governments, to take definitive steps toward ensuring the proper understanding and effective management of derivatives risk.

TESTIMONY OF

ARTHUR LEVITT, CHAIRMAN

U.S. SECURITIES AND EXCHANGE COMMISSION

CONCERNING THE MUNICIPAL SECURITIES MARKET

BEFORE THE COMMITTEE ON COMMERCE

U.S. HOUSE OF REPRESENTATIVES

JANUARY 12, 1995

Chairman Bliley and Members of the Committee:

I appreciate the opportunity to provide the Committee with an update on the activities of the Securities and Exchange Commission ("SEC" or "Commission") in the municipal securities market, as well as a discussion of the events surrounding the bankruptcy filing of the County of Orange, California ("Orange County"). These issues are of vital importance to Americans who invest in the municipal securities market, to the state and local governments that need access to the municipal securities market in order to provide financing for public works and services, and to state and local taxpayers who stand behind municipal securities issuers.

My statement will (i) review the public record[1] concerning the so-called Orange County "Pools"; (ii) discuss our initiatives over the last eighteen months to improve the municipal securities market; and (iii) make preliminary observations on state and local governments as investors in the securities markets. Though the Municipal Securities Rulemaking Board ("MSRB") will be testifying on its own behalf, I will mention briefly some of the initiatives that the SEC and the MSRB are working on together.

When I became Chairman of the Commission, I placed reform of the municipal securities market at the top of my agenda. I did so in the belief that a formerly institutional market had been transformed into a primarily retail one, without the full protections of disclosure, transparency and the assurance, as far as possible, of complete integrity in the offering process. Outstanding issues in the municipal bond market now exceed $1.2 trillion.[2] Individual investors, including those investing through mutual funds and money market funds, held approximately 76% of municipal debt outstanding in 1993, compared with 44% in 1983.[3] Over the last eighteen months, we have undertaken a number of initiatives to enhance the transparency and integrity of this vitally important market. In that time, the Commission:

* Issued in March 1994, an interpretive release addressing the application of the antifraud prohibitions of existing securities law to the municipal securities markets. The release noted, among other issues, the Commission's views about municipal issuers' disclosure practices with respect to their derivatives activities, both as issuers and end-users; and reminded municipal issuers that the antifraud provisions apply to their statements that can be reasonably foreseen to affect the secondary market for their securities;

* Adopted extensive revisions to existing rules applicable to municipal securities brokers and dealers that will facilitate better annual disclosure of financial information and timely disclosure by municipal securities issuers of material events that affect the value of municipal securities;

* Took steps to improve price transparency for the municipal securities and other debt markets; and

* Encouraged industry initiatives and approved MSRB rule G-37 eliminating "pay-to-play" practices from the municipal bond market.

With these measures, we have created significant new tools that will allow the

Commission to vigorously enforce the high standards we envisioned eighteen months ago.

## I. The Orange County Bankruptcy and Related Effects.

On December 6, 1994, Orange County, California, and the "Orange County Investment Pools, an instrumentality of the County of Orange" filed for bankruptcy under Chapter 9 of the federal Bankruptcy Code.[4] These filings began the largest municipal bankruptcy in our nation's history. The full effect of these proceedings may not be known for some time. Today, however, we can safely say that the consequences are broad reaching, affecting not only the citizens of Orange County, but residents in other communities and their bond holders as well. Although additional facts come to light daily, we can provide at this time a brief description of the circumstances in which Orange County and approximately 187 local government entities invested public monies using a strategy that has resulted in an estimated loss exceeding $2 billion.[5]

### A. The Orange County Investment Pools.

#### 1. Pool Participants.

The Orange County Treasury managed money for 187 different and separate governmental agencies (the "Participants").[6] By early December 1994, the Participants had deposited approximately $7.5 billion in the Orange County Treasury.[7] As described by the Treasurer, the Participants included approximately

> 28 cities in Orange County and 6 cities outside of Orange County, 32 school districts, 5 community college districts and 53 special district accounts, of which four are outside of Orange County . . . 31 different agencies that are governed by [the Orange County Board of Supervisors] . . . also very large sums of money that are sent to [the County Treasury] by the municipal and superior court systems throughout Orange County until needed.[8]

At least one city, Fullerton, as well as Orange County, enabled its employees to place their retirement accounts with the County Treasurer.[9] Districts and agencies within Orange County apparently were required to place funds on deposit in the County Treasury.[10] Other local agencies "that have their own treasurer and are not required by law to invest with the County Treasurer"[11] elected to deposit monies with the Orange County Treasurer.[12] As a result of judicial proceedings, approximately 400 individuals deposited funds with the Treasurer that were invested in the Pools.[13] Some local agencies, including Orange County as well as several school districts, apparently issued one-year notes solely to invest the borrowed funds in the Pools. Orange County borrowed $600 million in July 1994 to invest in the Pools, and five school districts each borrowed in excess of $50 million to invest in the Pools.[14]

### 2. The Pools' Investment Strategy.

Until December 5, 1994, Robert L. Citron ("Citron"), the elected Treasurer of Orange County, California, managed the Pools.[15] Citron had been the Treasurer of Orange County for over 20 years. Until the recent bankruptcy filings, Citron's investment strategy was to use reverse repurchase agreements[16] in "a strategy that utilizes leverage and . . . the use of structured or floating interest rate securities that enabled an approximate leverage figure of 2 to 1."[17] This strategy, as characterized in a September 1993 report to the Orange County Board of Supervisors, was "predicated on interest earning rates [continuing] to remain low for a minimum of the next three years."[18] Citron reported a return of 8.5% for fiscal year 1993, and 7.74% for fiscal year 1994.[19]

A significant portion of the Pools appears to have been invested in four-year notes and structured notes issued by federal government sponsored entities ("GSEs"), such as Fannie Mae and Freddie Mac.[20] Some of these securities were "structured" to provide a rate of return that was equal to a fixed rate less a multiple of a floating rate index, commonly called "inverse floaters."[21] This rate feature makes the market value of the inverse floaters much more sensitive to interest rate fluctuations than traditional fixed or floating rate obligations. If interest rates decrease or remain stable, the inverse floaters provide a high rate of return. In the few years of declining rates prior to early 1994, this would have contributed to the high rate of return achieved by the Pools. When rates increase, however, the interest return is reduced sharply, causing a corresponding drop in the market or "liquidation" value of the note.

The numerous increases in short-term rates throughout 1994 had a dramatically negative effect upon rate-sensitive structured notes.[22] Orange County's problems were compounded by the fact that it had entered into reverse repurchase agreements, at short-term rates, to take relatively long-term rate positions which combined with the structured notes to produce a portfolio highly sensitive to interest rate movements. By December, 1994, an estimated $7.5 billion in deposits with the county treasurer had been leveraged to over $20 billion.[23]

As rates increased, the returns on long-term obligations no longer exceeded the cost of funds used to acquire them and their market value declined, as did the market value of the inverse floaters. Where long-term obligations were used as securities subject to reverse repurchase agreements, the decline in market value required additional commitments of securities (similar to posting additional collateral) subject to reverse repurchase agreements. Requests for withdrawal of deposited funds, combined with the negative interest return under the reverse repurchase agreements, apparently generated a cash-flow squeeze which precipitated the Orange County bankruptcy.

### 3. The Assets of the Pools as of December 1, 1994.

At the beginning of December 1994, the Orange County Treasurer had received approximately $7.5 billion in deposits from various government agencies within and outside the County.[24] In addition, the Pools had outstanding approximately $12.5 billion in reverse repurchase agreements to which approximately $14 billion in securities were subject, boosting the total securities holdings to approximately $20 billion.[25] Of the estimated $14 billion, approximately $10 billion apparently were fixed rate obligations, mostly GSEs.

### 4. The Pools' Losses and the County's Bankruptcy.

On December 1, 1994, Orange County publicly disclosed that the Pools had suffered a "paper" loss of approximately $1.5 billion. On December 6, Orange County did not meet a substantial obligation under a reverse repurchase agreement with CS First Boston ("First Boston"), and First Boston proceeded to liquidate approximately $2.6 billion of securities it held subject to reverse repurchase agreements with Orange County. Reportedly, other firms began to sell securities subject to reverse repurchase agreements with Orange County. Later that day, Orange County and the Pools each filed a petition for bankruptcy under Chapter 9 of the Bankruptcy Code ("Chapter 9"). By Friday, December 9, a substantial part of the securities underlying Orange County's reverse repurchase agreements were reported to have been liquidated by the counterparties.[26]

The bankruptcy of a local government with a substantial amount and diversity of outstanding municipal bonds presents a host of important issues. The Orange County bankruptcy proceedings are the largest ever commenced under Chapter 9.[27] The previous filings did not begin to approach the level of complexity presented by Orange County. Consequently, many of the provisions of Chapter 9 have yet to be interpreted and applied in the context of a large municipality with a substantial amount of outstanding municipal bond debt. Furthermore, the approximately 187 local agencies invested in the bankrupt Pools also are, in many instances, issuers of municipal bonds. Decisions affecting deposits in the Pools by local agencies also may have an effect on holders of their municipal bonds.

Because many issues under Chapter 9 affecting certainty of payment on a wide variety of municipal securities may be addressed for the first time, decisions made in the bankruptcy proceedings will be watched very closely by the municipal bond market, and potentially will have a significant effect. These decisions will concern the community of municipal bondholders in general, as well as holders of the bonds of Orange County and the roughly 187 local agencies. The Commission, exercising its statutory right under Section 1109 of the Bankruptcy Code, has entered an appearance in the Orange County bankruptcy proceeding to monitor the legal proceedings related to liquidation of the securities subject to reverse repurchase agreements and other issues, and we will take action as appropriate to ensure safe, orderly markets.

**5. Rating Agencies' Assessment of Orange County's Debt.**

Both Standard & Poor's Corporation ("S&P") and Moody's Investors Service, Inc. ("Moody's") rated debt that was issued by Orange County, and other municipalities that participated in the Pools. Prior to Orange County's disclosure that the Pools had large unrealized losses, Orange County's short-term debt was rated in the highest category, and its long-term debt was rated very highly, by both S&P and Moody's.[28] Following Orange County's bankruptcy filing on December 6, 1994, S&P downgraded its short-term debt rating of most Orange County obligations to "speculative," and most of its long-term debt to "CCC."[29] Moody's also reacted by initially suspending its ratings of all Orange County debt, and then on January 6, 1995, by reinstating and lowering its long-term ratings on certain of Orange County's obligations to Caa[30] and its ratings on various short-term obligations to "speculative grade" and "not prime."[31]

**B. Issues Concerning Securities Subject to Reverse Repurchase Agreements.**

The Orange County bankruptcy petition raised several issues under the Bankruptcy Code with respect to the ability of Orange County's creditors to close out their repurchase agreements with the County. During the days immediately following the filing of the petition, rumors circulated about the County's intention to sue its repurchase agreement counterparties, and perhaps others, if the counterparties sold the securities subject to the repurchase agreements.[32] On December 13, 1994, Orange County sued Nomura International Securities, Inc. for liquidating the $900 million of government securities it held under repurchase agreements with the County[33] arguing that those sales violated the automatic stay provisions of the Bankruptcy Code.

In general, under Bankruptcy Code Section 559, parties to a standard repurchase agreement can liquidate their repurchase agreement positions with the counterparty. Section 559 was added in 1984 in order to prevent gridlock in the financial markets due to the bankruptcy of a major repurchase agreement participant.[34] While Chapter 9 does not specifically incorporate Section 559, Section 559 states that it operates independently of any need for incorporation. Nonetheless, due to the rarity of large municipal bankruptcy proceedings under Chapter 9, how Section 559 actually will be applied to proceedings under that Chapter is not certain.

Because uncertainty about the effects of bankruptcy can increase costs throughout the financial system as a whole, the Commission, as part of the President's Working Group on Financial Markets ("Working Group"),[35] also has been working to increase legal certainty in our financial markets.[36] Legal certainty in those markets is essential, because uncertainty inevitably creates disincentives to entering into transactions, potentially damaging market liquidity and causing systemic gridlock in times of market stress.

### C. Impact on Money Market Funds.

At the time that Orange County's financial problems began to be reported in the press, many money market funds held notes issued by Orange County or municipalities that invested in the Orange County Pools ("Orange County notes").[37] Money market funds generally seek to maintain a stable net asset value per share, typically $1.00. Money market funds must comply with the risk-limiting conditions of Rule 2a-7 under the Investment Company Act of 1940 ("Investment Company Act"), which require, among other things, that fund investments must be limited to securities that present minimal credit risk.[38] As a result of the decline in prices for Orange County notes that immediately followed the bankruptcy filing, some of these funds faced the prospect that they would not be able to maintain their $1.00 share price -- that is, they would "break a dollar."[39]

Money market fund advisers are not legally obligated to guarantee or otherwise maintain the $1.00 share price of the funds they advise, and funds must prominently disclose in their prospectuses and sales literature that there is no guarantee that this price will be maintained. Many advisers, however, when faced with the prospect of their funds breaking a dollar, have taken actions to support the funds' share price. To maintain their funds' net asset values at $1.00 in the wake of the Orange County bankruptcy, a number of fund advisers voluntarily have purchased Orange County notes from their money market funds.[40] Other advisers have obtained irrevocable standby letters of credit from unaffiliated banks for the benefit of money market funds to secure payment of principal and interest on the Orange County notes. Finally, many advisers have provided short-term "puts" for the Orange County notes.[41]

Many of these actions involve affiliated transactions between a fund and its adviser or a related party that are prohibited by Section 17 of the Investment Company Act unless the Commission issues an order approving the transaction. The Commission's Division of Investment Management, as it has done in the past in similar instances, granted oral "no-action" relief with respect to a number of transactions involving Orange County notes.[42]

As of December 31, 1994, 36 funds holding, in the aggregate, approximately $545 million of Orange County notes have received no-action relief from the Division of Investment Management in connection with the types of transactions described above. To our knowledge, no money market fund has broken a dollar as a result of the Orange County bankruptcy. If the prices of Orange County notes continue to decline, and a fund's adviser is unable or unwilling to provide support for the share price of a fund holding Orange County notes, however, the per share net asset value of the fund may fall below a dollar. The Commission is continuing to monitor closely the impact of Orange County's bankruptcy on money market funds.

## II. The SEC and Municipal Finance Transactions.

### A. Creation of the Orange County "Pools" Under California State Law.

The ability to commingle local government funds into investment pools and the manner of and limits upon their investment are matters covered by state law. California state law sets the framework for the deposit of local agency monies with the county treasurer for investment and authorizes the types of securities in which public monies may be invested. California law appears to provide statutory authority under which some cities, towns, and other local agencies may choose to deposit their monies with the county treasurer, while others are required to deposit their monies with the county treasurer, who may be authorized to invest the monies in certain financial instruments specified by statute.[43]

In California, counties are the largest political subdivisions of the state. They are governed by boards of supervisors, which have administrative, financial, and oversight powers. Certain financial matters, including the custody and investment of county monies, are administered by the county treasurer and reviewed by the county auditor, both of which are offices created by state statute. A board of supervisors creates districts, such as school, transportation and road districts, within the county, and the board has the power to issue bonds, when approved by the electorate.

California state law appears to require the deposit of certain monies with the county treasurer, such as monies of school districts,[44] and monies paid into or held by local courts.[45] California law also appears to permit probate courts to order that monies belonging to the estate of a minor or incompetent person be deposited with the county treasurer.[46] Local agencies that are not required by law to deposit their monies with the treasurer are permitted by California law to deposit excess monies, i.e. monies not immediately required, if their governing body authorizes the action.[47]

The range of permissible investments also are controlled by state law. California state law expressly requires "all money belonging to, or in the custody of, a local agency, including money paid to the treasurer . . . [to] be deposited for safekeeping in state or national banks, savings associations or federal associations . . . in the state," or invested in specified types of securities.[48] The state periodically has expanded this list by statutory amendment, adding reverse repurchase agreements in 1979 and, subject to a percentage limit, collateralized mortgage obligations, equipment lease-back certificates, consumer receivable pass-through certificates and other structured obligations in 1992.[49] The investment list contains quality requirements applicable to certain types of investment.

**B. Exemption from the Investment Company Act for Government Pools.**

The Commission generally does not have, nor does it seek, the ability to regulate investment decisions by municipalities or other end-users of securities.[50] Investors seeking higher than average returns generally undertake higher than average risks. That decision generally should be made by the investor. In the case of state and local public instrumentalities, investment decisions should be made with the guidance and oversight of state and local governments.

Section 2(b) of the Investment Company Act excludes from registration and regulation state and local governments and investment pools operated by one or more of these governmental entities.[51] The broad wording of this exclusion strongly indicates that Congress anticipated that state and local governments would establish and participate in investment pools as a means to effectuate government functions, and concluded that the federal government should not regulate those pools as investment companies. Consistent with the statutory language and purpose of Section 2(b), the exclusion has been construed broadly by the Commission staff.[52]

The Orange County Pools are not now, and to our knowledge have never been, registered under the Investment Company Act.[53] Presumably, the determination not to register under the Investment Company Act was made on the basis of the Section 2(b) exclusion.[54]

The Commission believes that state and local governments should have the authority to manage their cash reserves and monies in government custody either individually or collectively. Further, the Commission believes that state and local governments or the pools created to serve this function should be able to rely on the exclusion in Section 2(b) of the Investment Company Act. State and local governments are in the best position to regulate the manner in which municipal funds are managed. In the Commission's view, absent special facts, requiring municipal entities to operate in compliance with the Investment Company Act would represent unnecessary federal intervention into state and local affairs. If it determines that the Commission should regulate these pools, Congress would have to amend the Investment Company Act to give the Commission the necessary authority and provide additional resources.

### C. Offers and Sales of Municipal Securities.

#### 1. Overview.

On March 9, 1994, the Commission initiated a broad-ranging program to improve the quality of and access to municipal securities disclosure in the secondary market by (1) issuing a release interpreting existing disclosure obligations applicable to municipal securities ("Interpretive Release");[55] (2) issuing a release proposing rule amendments obligating municipal securities brokers and dealers to obtain assurances that issuers have agreed to provide continuing disclosure;[56] and (3) proposing a rule requiring disclosure of mark-ups in riskless principal transactions.[57] This past November 10, the Commission adopted the rule amendments regarding continuing disclosure, that, when in full effect one year from now, will provide annual financial disclosure and material event notification in the municipal securities market. On November 9, 1994, the Commission approved an MSRB initiative to improve price transparency that, once fully implemented, will provide price reporting for all retail transactions in municipal securities on a same-day basis or sooner. In addition, the Public Securities Association ("PSA") initiated a program, that would publish a model yield curve and establish a "900" number, which investors could call to obtain price information regarding particular municipal securities.[58]

#### 2. Municipal Securities Disclosure.

The market for municipal securities has been largely unregulated at the federal level. Both the Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act") were enacted with provisions containing broad exemptions[59] for municipal securities from their provisions, except for the antifraud provisions. Municipal securities received special exemptions at that time due not only to considerations of federal-state comity, but also to the absence of perceived abuses in the municipal securities market as compared to the corporate market. Furthermore, the typical investors in municipal securities in the 1930s were institutional investors.

In the past few decades, however, this situation has changed. In the 1970s, in response to abusive practices by dealers in municipal securities, as well as to the increasing number of retail investors in this market, Congress established a limited regulatory scheme for the municipal securities market. The Securities Acts Amendments of 1975[60] included provisions for the mandatory registration of municipal securities brokers and dealers and the creation of the MSRB.

### 3. Rule 15c2-12.

In 1989, acting in response to consistently slow dissemination of information in connection with municipal securities offerings, the Commission adopted Exchange Act Rule 15c2-12,[61] which requires dealers to obtain and review issuers' official statements prior to selling bonds, and to provide official statements to customers and potential customers. Specifically, prior to recent amendments that I will discuss, Rule 15c2-12 required an underwriter of municipal securities (1) to obtain and review an issuer's official statement that, except for certain information, is "deemed final" by an issuer, prior to making a purchase, offer, or sale of municipal securities; (2) in negotiated sales, to provide the issuer's most recent preliminary official statement (if one exists) to potential customers; (3) to deliver to customers, upon request, copies of the final official statement for a specified period of time; and (4) to contract to receive, within a specified time, sufficient copies of the issuer's final official statement to comply with the rule's delivery requirement, and the requirements of MSRB rules.

Under provisions of Rule 15c2-12, underwriters must deliver final official statements to potential customers for a 90 day period after the close of the underwriting period. The underwriters' 90 day delivery obligation is shortened to 25 days if the final official statement can be obtained from a Nationally Recognized Municipal Securities Information Repository ("NRMSIR"). Therefore, under the rule as adopted, NRMSIRs essentially serve the function of disseminators of official statements on behalf of underwriters. In addition to accepting and disseminating final official statements, NRMSIRs provide, although they are not required to do so under Rule 15c2-12 as originally adopted, other current market information about municipal issuers to the primary and secondary municipal markets.[62] Currently, there are three private vendors that have been designated by the Commission as NRMSIRs through no-action letters.[63]

At the time of the proposal and adoption of Rule 15c2-12, the Commission also issued an interpretation concerning the due diligence obligations of underwriters of municipal securities.[64] Underwriters, of course, play an integral role in the distribution of information. In its interpretation, the Commission emphasized that underwriters of municipal securities have an obligation to have a reasonable basis for recommending municipal securities, and in fulfilling that obligation, to review the accuracy of the offering statements with which they are associated.[65]

### 4. The Staff Report on the Municipal Securities Market.

In 1993, at the request of this Committee, the Commission's Division of Market Regulation conducted a comprehensive review of the municipal securities market. Its findings, published in the September 1993 Staff Report on the Municipal Securities Market ("Staff Report"),[66] underscored the need for improved disclosure practices in both the primary and secondary municipal securities markets, notwithstanding voluntary industry initiatives to improve disclosure. The Staff Report cited the need for increased price transparency in the municipal securities market to enable investors and regulators to judge the fairness of the prices charged to customers to buy and sell bonds. The Staff Report further highlighted the need to address inappropriate political contributions and other forms of influence peddling, which undermine the integrity of the municipal securities market.

As a consequence of the Staff Report, participants in the municipal securities industry have worked with us every step of the way toward the important goal of enhancing investor protection.

### 5. The Interpretive Release.

The Interpretive Release, published in March 1994, provided the municipal securities market with an overview of existing disclosure obligations of market participants under the antifraud provisions of the federal securities laws in connection with both primary and secondary municipal market disclosure. The Interpretive Release was intended to encourage the ongoing efforts of market participants to improve disclosure practices, and provided guidance to assist market participants in meeting their obligations under the antifraud provisions.

As the starting point for its review of existing law, the Interpretive Release noted that the disclosure documents used by municipal issuers in primary offerings of municipal securities, such as official statements, are subject to the prohibition against false or misleading statements of material facts, including the omission of material facts necessary to make the statements made, in light of the circumstances in which they are made, not misleading.[67] While acknowledging significant improvement in disclosure practices in recent years as a result of voluntary initiatives, the Commission identified several areas of primary market disclosure that needed increased attention.

The Interpretive Release stated that municipal issuers must give greater consideration to disclosure issues arising from their activities as end-users of derivative products.[68] When either the issuer or the revenues securing an issue of municipal securities is exposed to investment related market risks, the disclosure documents need to discuss the market risks of such exposure, the strategies used to alter such risks, and the exposure to both market risk and credit risk resulting from risk alteration strategies.[69]

Offerings of municipal securities that carry a derivative feature also present concerns to which investors should be alerted. The Interpretive Release noted that investors need information about the nature and effects of each significant term of the debt, including credit enhancements and risk modifiers, such as inverse floaters and detachable call rights. Investors in these securities should be aware of their exposure to interest rate volatility, under all possible scenarios. In addition, any legal risk concerning the issuer's authority to issue securities with unconventional features needs to be disclosed.[70]

With respect to accounting disclosure, the Interpretive Release pointed out that sound financial statements are critical to the integrity of the primary and secondary markets for municipal securities, just as they are for corporate securities. The Interpretive Release encouraged the use of audited financial statements and an explanation of accounting principles followed in the preparation of financial statements, unless statements were prepared in accordance with generally accepted accounting principles ("GAAP").[71] In order to avoid providing investors with an outdated, and therefore potentially misleading, picture of the issuer's financial condition and results of operations, the Interpretive Release indicated that audited financial statements should be available as soon as practicable.[72] The Interpretive Release also stated that unaudited financial statements for the most recent fiscal year and other current financial information should be provided in the interim prior to completion of the audit.[73]

In addition, the Interpretive Release pointed out that narrative explanations of data may be necessary where a numerical presentation alone is not sufficient to permit an investor to judge the financial and operating condition of the issuer or obligor.[74] Moreover, issuers must assess whether the probable future impact of currently known facts mandates disclosure. Disclosure of such currently known conditions and their future impact is critical to informed decisionmaking.

The Interpretive Release also addressed questions of conflicts of interest, and noted that information about financial and business relationships and arrangements among the parties involved in the issuance of municipal securities may be critical to an evaluation of an offering.[75] Failure to disclose material information concerning such relationships, arrangements, or practices may render misleading statements made in connection with the offering process, including statements in the official statement about the use of proceeds, underwriters' compensation, and other expenses of the offering.[76]

The Interpretive Release reminded issuers of the application of the antifraud provisions of the federal securities laws to statements to the market, and emphasized the importance of municipal issuers' establishing practices and procedures to disclose material information subsequent to the initial offering on a timely and continuous basis, as a way of minimizing the risk of misleading investors with incomplete or outdated information that is otherwise made available by the municipal issuer. The Interpretive Release makes clear that when a municipal issuer releases information to the public, through public statements and the issuance of reports, which information is reasonably expected to reach investors and the trading markets, that information is subject to the antifraud provisions. The Interpretive Release recommended that issuers and obligors provide financial statements that are audited in accordance with generally accepted auditing standards ("GAAS") and prepared in accordance with GAAP; other pertinent financial and operating information (depending on the type of issuer and security sold); and a narrative discussion that analyzes the issuer's or obligor's financial condition and results of operations, as well as facts likely to have a material impact on the issuer or obligor.

In addition to periodic information, to assure that participants in the secondary market base their investment decisions on current information, the Interpretive Release called for timely disclosure of events that materially reflect on the creditworthiness of municipal securities issuers and obligors and the terms of their securities, including principal and interest payment delinquencies, as well as nonpayment related defaults; unscheduled draws on reserves or credit enhancements; matters affecting collateral; and rating changes.

**6. Amendments to Rule 15c2-12.**

Concurrent with the publication of the Interpretive Release, the Commission published a release that requested comment on proposed amendments to Rule 15c2-12,[77] designed to enhance the quality, timing, and dissemination of disclosure in the municipal securities market by placing certain requirements on brokers, dealers, and municipal securities dealers. On November 10, 1994, the Commission adopted these amendments in final form,[78] with modifications that had their origin in extensive cooperation from industry groups, and the thoughts and suggestions contained in over 390 comment letters.[70]

The amendments reinforce current market practices that generally have provided good quality official statements, and extend those practices to the secondary market. Specifically, the amendments require underwriters to reasonably determine that an issuer or obligor has undertaken to provide annual financial information; audited financial statements, when and if available; notices of eleven specified events, if material; and notice of a failure to provide annual financial information, with respect to those persons who are committed by contract or other arrangement to support payment of all or a part of the obligations on the municipal securities, and for whom financial or operating data is presented in the final official statement.

Underwriters will be required to reasonably determine that the undertakings specify the identity of each person for which annual financial information and notices of material events will be provided (either by name or by the objective criteria used to select such person), as well as the type of financial information and operating data to be provided as part of the annual financial information; the accounting principles to be used in the preparation of financial statements, including whether audited financial statements will be provided; the date on which annual financial information for the previous year will be provided; and to whom it will be provided.

The amendments rely on the parties to an initial offering of municipal securities to establish which parties will provide ongoing secondary market disclosure, and what information is material to an understanding of the securities being offered. Under the amendments, the financial information and operating data in the final official statement will determine the type of financial information and operating data to be provided on an ongoing basis pursuant to the undertakings, and the persons about which that data will relate. This approach is designed to provide meaningful secondary market disclosure under standards that are flexible, yet enforceable. The approach is consistent with that traditionally followed by the Commission with respect to official statement disclosure, which relies on market discipline and general antifraud considerations to ensure that disclosure provided is meaningful.

The undertakings will call for annual financial information to be provided to each NRMSIR and the appropriate state information depository, if any. In addition, notices of material events, including notices of a failure to provide annual financial information, will be provided to each NRMSIR or the MSRB, and to the appropriate state information depository.

**7. Information Repositories.**

As a result of the amendments to Rule 15c2-12, NRMSIRs will play an expanded role in the collection and dissemination of secondary market information. In addition to the collection and dissemination of final official statements, they will collect and disseminate annual financial information, as well as notices of material events. To implement these new standards, the Commission has determined that existing NRMSIRs should reapply to the Commission for recognition under the criteria to continue to function as NRMSIRs. The Commission envisions that existing NRMSIRs as well as potential newcomers to the area will be designated as NRMSIRs through a no-action letter process.

The Commission is sensitive to the need of NRMSIRs for flexibility in adapting to the new requirements of Rule 15c2-12. To ensure the technological and economic feasibility of its disclosure requirements, the Commission staff has been in contact with existing NRMSIRs throughout the process of adopting the amendments. Since the adoption of the 1994 amendments, the staff has conferred both with existing NRMSIRs as well as numerous vendors that are considering becoming NRMSIRs. Correspondingly, NRMSIRs and vendors that wish to become information gatherers and disseminators have demonstrated the technology they have developed to facilitate municipal securities disclosure to Commission staff and market participants. It appears that various vendors are developing technology to make available information mandated by Rule 15c2-12 as part of a complete information service for municipal securities. The interest expressed in NRMSIR designation as well as the technology that is being developed to collect and disseminate information on a rapid basis lead the Commission to believe that its efforts to enhance municipal securities disclosure have been well received by market participants.

Interest also has been expressed by states and private entities within states in being designated as State Information Depositories ("SIDs"). Under the amendments, a SID would be a depository operated or designated by the state that receives information from all issuers within the state, and makes this information available promptly to the public (including NRMSIRs) on a contemporaneous basis. The numerous inquiries concerning designation as a SID lead the Commission to believe that many states are seriously considering the possibility of establishing state based depositories. The interest expressed in designation as either a NRMSIR or a SID, and the active development of technology are an encouraging indication that NRMSIRs and SIDs will perform their anticipated role in making information available to market participants in the near future.

The amendments also prohibit brokers, dealers, and municipal securities dealers from recommending the purchase or sale of municipal securities to which the underwriting prohibition applied unless they have in place procedures that provide reasonable assurance that they will receive promptly any notices of material events regarding these securities. For example, a dealer could rely on a vendor system that electronically reported all material events to the dealer when they occurred, if these reports were made available to the staff responsible for the recommendations.

Although the amendments only create specific review obligations with respect to material event notices, annual financial information disseminated into the marketplace must be taken into account by dealers in making recommendations to investors in order to meet their obligations under MSRB rules, and their existing obligation to have a reasonable basis on which to recommend securities to investors. Material event notices are the type of information required to be disclosed to a customer pursuant to MSRB rule G-17.[80]

The amendments provide certain exemptions. If neither the issuer nor any obligated person is obligated with respect to more than $10 million in municipal securities outstanding following an offering, the offering will be exempt from the amendments on the condition that an issuer or obligated person makes a limited undertaking to provide upon request, or annually to a state information depository, at least the financial information or operating data that is customarily prepared, and made publicly available. In addition, the undertaking must meet the amendment's requirement regarding notices of material events. This exemption need be satisfied only for offerings over the $1 million principal amount threshold for application of the rule. In addition, the pre-existing exemptions for offerings that are limited placements, short-term securities, and securities with demand features remain. The amendments add an exemption from the annual information requirement for offerings of securities with maturities of less than 18 months.

The amendments are being phased in over a short period of time to allow municipal issuers and underwriters the time to put necessary procedures in place to comply with the new rules. The amendments will begin to go into effect on July 3, 1995. When they become fully effective on January 1, 1996, these amendments should result in significant improvements in the existence and availability of secondary market disclosure.

**8. Improvements in Accounting and Financial Reporting.**

The Government Accounting Standards Board ("GASB"), created in 1984, promulgates standards of accounting and financial reporting, that are encouraged or are required to be followed in a majority of state and local governments. The goal of these standards is to provide guidance that will result in useful information for users of financial reports including, among others, investors. Through December 31, 1994, GASB has issued 27 Governmental Accounting Standards Board Statements ("Statements").

GASB Statement No. 3, <u>Deposits with Financial Institutions, Investments (including Repurchase Agreements), and Reverse Repurchase Agreements</u>[61] addresses, among other matters, the accounting and disclosures required with respect to investments by state and local government entities including repurchase and reverse repurchase agreements. While that standard requires disclosure of the market value and carrying value of each major category of investments, it does not require that any specific accounting method be followed in determining the carrying amount. The standard does require, however, that the accounting principles used to determine carrying amounts be disclosed in a footnote.

Thus, there currently is no articulated standard that governs how state and local governments must measure the carrying value of these investments.[n] Orange County's financial statements, which were certified as prepared in accordance with GAAP, for the fiscal year ended June 30, 1993, indicate that investments were valued at cost, with noted exceptions. A footnote to the statements discloses information required by Statement No. 3 including the carrying value and market value of investments. As of June 30, 1993, aggregate market value of investments exceeded aggregate cost by approximately $50 million.

Standards for accounting recognition and disclosure of investments recently have been addressed by GASB in Technical Bulletin No. 94-1, Disclosures about Derivatives and Similar Debt and Investment Transactions ("Technical Bulletin"). The Technical Bulletin prescribes standards of disclosure to be followed for derivatives and similar financial instruments. The Technical Bulletin recognizes that structured notes are similar to derivatives. Among other matters, the Technical Bulletin requires disclosure of risks "to the extent that these risks are above and beyond those risks that are apparent in the financial statements or are otherwise disclosed in the notes to the financial statements."

The issuance of the Technical Bulletin should improve state and local governments' accounting and disclosures for investment activities including those involving derivatives and similar instruments. Further progress by GASB in addressing these critical accounting and financial reporting issues is necessary. The Commission does not have authority with respect to the accounting principles applicable to municipal issuers, and it does not oversee the standard setting process of GASB, as it does with respect to the FASB.

In order for the adoption of improved accounting and disclosure requirements to be most useful, information must be provided on a timely basis. Current financial statement practices vary widely. The Government Finance Officers Association's ("GFOA") Guidelines do not provide guidance on the timeliness of financial statements for offerings of municipal issuers' general obligation bonds. Antifraud proscriptions are the principal legal mandate governing the currency of financial information in municipal offering documents. Likewise, reporting practices to the secondary market are equally diverse. Indeed, the provision of audited financial statements within six months following the close of the fiscal year is not widely enough practiced for the Commission to have incorporated the standard into its recent rulemaking. Instead, the new rules require that financial information be provided at least annually and that audited financial statements be provided when and if available to the issuer. The economic events of 1994 are an outstanding example of how rapidly and significantly markets and market values can change and the importance of disclosure of current information.

**9. Improving Price Transparency.**

Improving issuer disclosure practices is not our only effort in the municipal market. While enhanced price transparency is needed throughout the debt markets, including the corporate debt market, the need is most acute in the municipal bond market, given the broad and diverse investor base in that market.[illegible] In a completely transparent market, all market participants have equal and immediate access to all quotations, including the size of the quotations, and to reports of prices and all volumes in all trades effected in the market. Price transparency enhances market liquidity and depth, and fosters investor confidence, while a lack of price information impairs market pricing mechanisms, weakens competition, and prevents investors from monitoring the quality of their executions.

There are significant structural differences between the secondary market for municipal debt when compared to the secondary market for other debt issues. Although there exist over one million different municipal securities issues, only an average of 180 issues trade actively in the secondary market at any given time. Further, most trading activity in municipal securities issues occurs shortly after issuance. Municipal securities also are priced very differently from equity issues, based in part on the way they trade. Nevertheless, these differences should not preclude last sale reporting to public investors and market participants for actively traded municipal securities. The Commission therefore is overseeing the development and implementation by the MSRB and market participants of proposals to make pricing information available to investors.[84]

The MSRB has a four phase program to make this information available:

> **Phase One**: As of January 16, 1995, reports of inter-dealer transactions and daily high-low and average price figures for the most frequently traded issues will be made public.
>
> **Phase Two**: Through 1995, these requirements will be expanded to include institutional customer transactions.
>
> **Phase Three**: Through 1996, these requirements will be expanded to include retail transactions.[85]
>
> **Phase Four**: In early 1997, there will be more contemporaneous reporting of transaction information.

In addition to the MSRB's program, the PSA has proposed to develop a generic scale and yield curve for AAA-insured revenue bonds, to be made available to daily newspapers.[86] The PSA also has proposed to establish a "900" number, which investors could call to obtain price information regarding particular municipal securities.[87] If we determine, over the next three months, that these initiatives have not progressed to our satisfaction, we will consider other regulatory action to ensure that investors have access to pricing information.[88]

The cooperation of market participants in efforts to improve price transparency may produce a market-sponsored solution. As a result of both the disclosure and price transparency initiatives, the Commission has set the framework for a radical change in how business is conducted in the municipal securities market.

### 10. "Pay-to-Play" Practices.

"Pay-to-play" practices in the municipal securities market typically involve payments by underwriting firms in the form of political contributions to state or local officials or similar arrangements with these officials in order to be considered for an award of certain types of municipal securities business. These practices undermine underwriter and market integrity. Given the size and depth of this market, the perception that certain practices called into question the integrity of the market takes on added significance.

With my full support, voluntary industry efforts were initiated to end "pay-to-play" practices. In October 1993, seventeen of the largest municipal securities dealers agreed to adopt a "Statement of Initiative," providing that political contributions made, in any manner, for the purpose of influencing the awarding of municipal finance business should be prohibited. To date, over 50 firms have agreed to adhere to the Statement of Initiative.

In April 1994, the Commission approved an MSRB proposed rule change, MSRB rule G-37, relating to the linkage between political contributions and municipal securities business. MSRB rule G-37 prohibits municipal securities dealers from conducting certain types of municipal securities business with an issuer within two years after any contribution by the dealer or certain affiliated persons to officials of the issuer who could influence the awarding of municipal securities business. Thus, if a dealer, or any covered employee makes a contribution, the rule would prohibit the firm from participating in a negotiated underwriting with the issuer for a two year period. The rule exempts contributions from covered employees, up to $250 per election, to officials for whom the employees are entitled to vote. Rule G-37, and amendments to rules G-8 and G-9 (concerning recordkeeping and record retention), require firms to maintain records and to disclose aggregate information regarding political contributions to facilitate compliance and examinations.

I would like to take this opportunity to salute the efforts of both the MSRB and the participants in the voluntary initiative to curb abuses of political contributions in the municipal securities market. I believe that these efforts were "potent medicine." But the damaging effects of "pay-to-play" practices, both real and perceived, make such medicine, even if unpleasant, necessary to help restore credibility to the municipal securities market.

Since its adoption, I believe that the rule already has had a positive effect on the municipal securities market. Stopping the practice of "pay-to-play" benefits everyone, not merely the participants in the municipal securities markets. As I have said before -- the proceeds from the issuance of municipal securities are used to fund some of the most basic needs that we all take for granted: clean water, schools, and airports, to name a few. The publicity the rule has received in the press has served notice that unethical conduct in the municipal securities market will not be tolerated. The integrity of the municipal securities market has been the focus of our enforcement activities in recent months, and will continue to be so.

**D. Rating Agencies.**

The role of rating agencies in the Orange County situation has attracted some attention.[89] Since 1981, the Commission has encouraged, but not required disclosure of ratings in prospectuses. Prior to 1979, such disclosure was prohibited in registration statements and prospectuses. The Commission is currently in the process of revisiting the sufficiency of its ratings disclosure policy for Commission registrants.[90] With respect to offerings of municipal securities, the Interpretive Release and recent rule amendments addressed the need to provide investors with information concerning material ratings changes.

In addition, the Commission has incorporated into its rules the use of credit ratings issued by "nationally recognized statistical rating organizations" ("NRSROs"). The Commission first incorporated the use of ratings issued by NRSROs in connection with certain provisions of the net capital rule in order to distinguish between different grades of debt instruments. Subsequently, the term NRSRO has been employed in other areas of the federal securities laws,[91] including the use of this term by Congress in the Secondary Mortgage Enhancement Act of 1984.[92]

Despite this use of the term NRSRO, it has never formally been defined by the Commission. Instead, rating agencies have sought no-action assurances regarding their NRSRO status. In reviewing a no-action request from a rating agency, the Commission staff reviews several aspects of the requesting rating agency's practices.[93] Once a rating agency is designated as an NRSRO, however, the staff's ability to effectively monitor the agency diminishes significantly. While the staff does retain the right to withdraw a rating agency's no-action letter if the facts warrant, very little formal information is received from NRSROs. All of the current NRSROs have voluntarily registered as investment advisers under the Investment Advisers Act of 1940 ("Investment Advisers Act"). Nevertheless, there is concern that the examination, disclosure, and antifraud provisions of the Investment Advisers Act may not provide the Commission with an appropriate degree of oversight with regard to these NRSROs.

In light of the expanded use of credit ratings in the Commission's rules, on August 31, 1994, the Commission issued a concept release soliciting recommendations on the use by the Commission of the ratings of NRSROs in its rules.[94] The concept release solicited comment on the continued use of the term NRSRO in its rules, the no-action process described above, as well as the nature of the Commission's oversight role with respect to NRSROs.[95] The Commission has received 19 comment letters from, among others, U.S. and foreign rating agencies, issuers, academics, and broker-dealers. The staff currently is reviewing these comment letters.

**E. Sales of Securities to Municipalities.**

Broker-dealers that recommend the purchase or sale of a security, including a derivative security, are subject both to sales practice standards arising from the antifraud provisions of the federal securities laws, and to the suitability and other fair dealing rules of the securities self-regulatory organizations ("SROs") (except that such rules of the National Association of

Securities Dealers, Inc. ("NASD") currently do not apply to exempted securities, including government securities).[96] The antifraud provisions prohibit false or misleading statements. In addition, the SRO rules provide that a broker-dealer must have a reasonable basis for believing that its securities recommendations are suitable for the customer in light of the customer's financial needs, objectives, and circumstances. The NASD rule requires broker-dealers to make a suitability determination before executing a trade in a recommended security, other than an exempted security.[97] While these suitability rules apply to recommendations made to all customers, the manner in which they apply depends, among other things, on the nature and circumstances of the customer. The NASD currently has solicited member comment on an interpretation of its suitability rules that seeks to delineate the obligations of a broker-dealer when making recommendations to a larger, more sophisticated institutional investor.[98]

### F. Working Group Investment Policies and GFOA Model Code.

The range of permissible investments for state or local governmental entities is controlled by state or local law. The Commission does not believe federal legislation in this area would be appropriate. The Working Group has begun working with representatives of state and local governments to promote sound investment practices. I am hopeful that the Working Group will be successful in assisting the states and other interested parties in encouraging the use of written investment policies that will take into account not only the risks that were present in Orange County's situation, including its leveraging strategy, but other types of risks as well. Likewise, the National Association of State Treasurers ("NAST") has announced the establishment of the NAST Task Force on Local Government Investment Pools to review its past guidance to states operating or considering the formation of local government investment pools.[99] As demonstrated so vividly in Orange County, leveraging investments can magnify losses as well as profits. Governmental entities should have a method for determining whether and how to use leveraging techniques. Moreover, they should have controls in place to ensure that their investments do not exceed established limits.

In addition, any investment policies should address the potential risks of investing in the types of interest rate sensitive structured notes and derivatives in which Orange County invested. Orange County's experience illustrates that the market risk that comes with these and other derivative instruments may be significant. The GFOA's June 1994 statement recommending practices for the use of derivatives by state and local governments[100] could provide a starting point for developing sound written investment policies.

I strongly encourage all end-users, including state and local governments, to take definitive steps toward ensuring the proper understanding and effective management of derivatives risk. As I recommended in my June 16, 1994 letters to the chief executive officers of the nation's largest mutual funds, close attention should be given to all elements of risk management, including matters of pricing, trading strategies, accounting issues, and internal controls. Likewise, in its July 1993 report, the Global Derivatives Study Group of the Group of 30 recommended that end-users have risk management systems that are commensurate with the nature, size, and complexity of their derivatives activities.[101] In implementing effective risk management strategies, I urge involvement by officials at the highest levels of state and local government in formulating derivative policies and procedures and in exercising meaningful oversight of internal controls.

**G. Effect of Continuing Disclosure and Need for Legislation.**

While improved disclosure will not prevent municipal defaults or all market disruptions -- even public reporting companies can become insolvent due to poor management or adverse market conditions -- the increased efficiency in the market derived from improved issuer disclosure will benefit not only investors, by alerting them to potential problems earlier, but municipal issuers and their taxpayers as well, who should incur lower financing costs. Improved disclosure practices as called for by the rule amendments and the Interpretive Release also may provide the incidental benefit of deterring unwarranted speculative activity by local government officials that, if fully disclosed, could harm the issuer's credit rating or otherwise impair its ability to obtain financing. Improved disclosure in the municipal markets therefore may result not only in better markets, but also may result in better management of government funds.

The Commission's municipal disclosure initiatives, undertaken pursuant to its antifraud and municipal securities dealer authority, provide a foundation for substantial enhancement of disclosure and offering practices in the municipal securities market. These initiatives are quite recent, and the rulemaking will be effective for offerings beginning in 1995. Congress, therefore, may wish to assess the efficacy of these initiatives before considering any legislative action to change the largely exempt status of municipal securities issuers under the federal securities disclosure laws. Such action would have profound effects on the municipal bond market and, given the 52,000 issuers of municipal securities, could require significant resources to administer.[102] Of these 52,000 issuers, approximately 71% are small municipal issuers with less than $10 million in bonds outstanding.

As indicated in the Interpretive Release, however, the Commission supports legislation addressing the exempt status of conduit securities under the federal securities laws. Bonds used to finance a project to be used in the trade or business of a private entity are, from an investment standpoint, equivalent to corporate debt securities issued by the underlying corporate obligor, in which the investor looks, and can only look, to a private entity for repayment. Investors need the same disclosure regarding the underlying non-municipal corporate obligor as they would receive regarding any corporate obligor under the same regulatory and liability scheme. In the Interpretive Release, the Commission renewed its legislative recommendation to amend Section 3(a)(2) of the Securities Act and Section 3(a)(29) of the Exchange Act to remove the registration exemption for the non-governmental corporate credit underlying municipal conduit securities involving private activity financings, and the Commission continues to support this recommendation.

## III. Conclusion.

Mr. Chairman, I hope that I have made it evident how deeply committed the Commission is to reforming the municipal securities business. To us, this thriving market represents much more than money -- it represents the schools that teach our children, the water we drink, the power that drives our economy, and the roads that take us where we want to go. This market should be governed by the very highest standards. I am confident that, with Congress' support, and with the continued cooperation of the industry, we will succeed in attaining those standards.

## ENDNOTES

1. The information contained in this statement concerning the events surrounding the bankruptcy filings by Orange County is based on publicly available information. The Commission is currently conducting an investigation into a number of aspects of these events. This statement does not discuss nonpublic matters relating to that investigation or that may become the subject of actions by the Commission or by other authorities.

2. Public Securities Association. In any given year there are between 6000 and 8000 new issuances.

3. The Bond Buyer, "Holders of Municipal Debt," July 1, 1994, at 5.

4. 11 U.S.C. §§ 901 et seq.

5. "Valuation of County of Orange Investment Portfolio," Salomon Brothers Inc., December 13, 1994.

6. County of Orange, Office of the Treasurer-Tax Collector Annual 1992-93 Financial Statement, September 10, 1993 ("Treasurer's 1993 Report").

7. G. Bruce Knecht, "Derivatives Lead To Huge Loss in Public Fund," Wall St. J., December 2, 1994, at A3. A report entitled "Valuation of County of Orange Investment Portfolio" released by Orange County financial advisors after the bankruptcy filing lists the "Amount Contributed by Fund Investors" as $7.42 billion as of December 12, 1994.

8. County of Orange, California Office of the Treasurer-Tax Collector Annual 1993-1994 Summary Financial Statement, September 26, 1994 ("Treasurer's 1994 Report").

9. Jessica Crosby, "Fullerton Workers' Savings at Risk; CITIES: 78 Employees Have Deferred Savings in County Fund," Orange County Register, December 22, 1994, at 18.

10. See, e.g., Cal. [Educ.] Code § 35010.

11. Treasurer's 1993 Report.

12. Cal. [Gov't] Code § 53684.

13. H.G. Reza, "Injured Children's Families Fear Losses in Bond Fiasco," Los Angeles Times, December 18, 1994, at A1.

14. See United States Bankruptcy Court Central District of California, Case No. SA 94-22272-JR, Ex Parte Motion of County of Orange Pursuant to Local Bankruptcy Rule 113(1) for Emergency Order Authorizing Certain Payments of Amounts Equal to Interest on Bond Obligations of County due January 1995; Declaration of Gedale B. Horowitz in Support Thereof; see also Betsy Bates and Marilyn Kalfus "Analysis: grim view for schools," Orange County Register, December 22, 1994.

15. See Cal. [Gov't] Code § 53684 (authorizing county treasurers to invest funds). On December 5, 1994, Citron resigned as county treasurer and was temporarily replaced by his deputy, Matthew R. Raabe.

16. A "repurchase agreement" provides for the "sale" of securities (generally government securities) by a dealer to a customer, with a simultaneous agreement by the customer to "resell" the securities back to the dealer on a date certain or on demand, not more than one year after the original transaction. "Reverse repurchase agreements" are repurchase agreements where the dealer agrees to "buy" securities from the customer in exchange for funds, and the customer simultaneously agrees to pay funds and "buy back" the securities at a later date certain or on demand by the dealer.

17. Treasurer's 1993 Report.

18. Id.

19. See Treasurer's 1993 Report and Treasurer's 1994 Report. Orange County's investment fund averaged annual returns of 10 percent annually over the past 15 years. Sallie Hofmeister, "Many Questions, but Too Late," N.Y. Times, December 6, 1994, at D1.

20. See Leslie Wayne, "Big County Is Facing Huge Loss," N.Y. Times, December 2, 1994, at D1; Laura Jereski, "Orange County Fund Losses Put at $2.5 Billion," Wall St. J., December 12, 1994, at A3.

21. Inverse floaters are one of a variety of structured notes. Others include instruments which return an amount of principal at maturity that may vary in accordance with other indices.

22. Such notes carry limited credit risk; Orange County's difficulties occurred without a single default by an issuer of the structured notes.

23. This "leveraged borrowing," as press accounts characterize the Orange County holdings, likely reflects the significant amount of reverse repurchase agreements. Municipal securities and government securities are exempted securities for purposes of Sections 7 and 11 of the Securities Exchange Act of 1934 and Regulations G, T, U and X, promulgated thereunder, which govern extensions of credit to purchase or maintain ownership of securities. The requirement that a customer must deposit a certain amount of cash or eligible securities in his or her account is known as a "margin" requirement.

    The original justifications for controls on margin included protecting "the margin purchaser by making it impossible for him to buy securities on too thin a margin." Stock Exchange Practices, Report of Senate Comm. on Banking & Currency, S. Rep. No. 1455, 73rd Cong., 2d Sess. 11 (1934). At that time, government securities were issued predominantly in the form of traditional, interest bearing bonds. Unlike corporate and municipal issues, government debt posed no credit risk to investors, allowing the federal government to borrow at a lower cost than individuals, corporations, or municipalities. Borrowing by investors to purchase government securities therefore was not an issue of concern to the drafters of the Exchange Act.

    More recently, there has been a proliferation of government securities which are more complex, and riskier, than the traditional bonds on which they are based. "These instruments include mortgage-backed securities and real estate mortgage investment conduits ("REMICS") issued or guaranteed by government agencies or GSEs, zero-coupon instruments such as STRIPS [separate trading of registered interest and principal], agency mortgage-backed securities stripped into interest-only and principal-only pieces, and over-the-counter options on government securities." Department of the

Treasury, Securities and Exchange Commission, Board of Governors of the Federal Reserve System, Joint Report on the Government Securities Market (January 1992). The ability of GSEs to package pools of mortgages into different REMIC tranches, for example, has permitted investors to earn rates of return which were higher than those of the mortgage securities underlying the REMIC itself, and higher than the rate at which investors can borrow. In addition, the strong demand for high yield instruments issued by well-capitalized GSEs, combined with the tremendous volume of mortgages GSEs bought and resold in the secondary mortgage markets, enabled the GSEs to reduce their borrowing costs through structured notes designed to meet the specific demands of investors.

State and local governments, in particular, invest heavily in government securities, due to their reliance on such investments as "safe" obligations. H.R. Rep. No. 103-255, 103rd Cong., 1st Sess., at 32 (1993). State and local governments therefore may face a disproportionate portion of the risk posed by these investments, which although perceived generally to pose no credit risk, may actually pose other significant risks to the investor.

24. See supra note 5. The Treasurer's 1993 Report refers to a "Local Agency Investment Pool" and a "Commingled Fund" through which deposits were invested. Press accounts also refer to a "Bond Pool."

25. Press accounts describe the reverse repurchase agreements in terms of loans collateralized by pledged securities. See Jereski, supra note 20.

26. N.Y. Times (December 10, 1994), at 39. According to the New York Times, all of the repurchase agreement counterparties, with the exception of Merrill Lynch, Pierce, Fenner & Smith and Donaldson, Lufkin & Jenrette, had liquidated their securities subject to reverse repurchase agreements by December 10, 1994.

27. Of the handful of bankruptcies that have been filed under Chapter 9, most have involved small local governments.

28. A rating that is assigned to a debt instrument reflects the creditworthiness of the issuer with respect to the specific obligation and is based on the rating agencies' opinion as to the likelihood that the issuer will be able to meet its principal and interest obligations. Rating agencies state that their ratings do not comment on market price or suitability for a particular investor, and are not a recommendation to purchase, sell, or hold a particular security.

29. S&P also downgraded to "D" two taxable pension obligation bonds.

30. Moody's defines those issues rated "Caa" as "extremely poor."

31. See Moody's Investors Service, Inc., Moody's Lowers the Ratings on Short-Term and Long-Term Obligations of Orange County, California (Press Release) (January 6, 1995).

32. See, e.g., "Today Orange County . . .," Business Week, December 19, 1994, at 28. "It still isn't clear whether those firms are prohibited from liquidating their collateral in the wake of the filing. 'People are scared to death,' says one Wall Street Executive. 'No one wants to be the last to get their money.'" Id.; "Orange County is to Sue Some Firms; It Defaults on $110 Million Bond Issue," Wall St. J., December 9, 1994, at A3;

"Orange County Defaults, Wall Street Sells," Washington Times, December 9, 1994, at B8.

33. In re Orange County Investment Pools, Complaint of Orange County Investment Pools, Plaintiff v. Nomura International Securities, Inc. (Bankr. C.D. Cal.) (No. SA 94-22273-JHR) (December 9, 1994).

34. Section 559 of the Bankruptcy Code enforces contractual agreements between repurchase agreement counterparties to liquidate their positions upon the insolvency of the other party to the agreement. The 1984 amendments to the Bankruptcy Code were enacted to reverse the holding of Lombard-Wall, which held that the holder of securities subject to a repurchase agreement was subject to the automatic stay of the Code. Lombard-Wall Inc. v. Columbus Bank & Trust Co., No. 82 B 11556 (Bankr. S.D.N.Y. Sept. 16, 1982). See S. Rep. No. 65, 98th Cong. 47 (1983).

35. The Working Group, which was created following the October 1987 stock market break, is chaired by the Secretary of the Treasury, and includes the Chairmen of the Board of Governors of the Federal Reserve System, the Commodity Futures Trading Commission, and the Commission.

36. For example, in July 1994, the Working Group submitted to Jack Brooks, then Chairman of the House Committee on the Judiciary, a proposed amendment to the Bankruptcy Code that would clarify the validity of netting of spot foreign exchange agreements under the Bankruptcy Code. The Working Group also submitted to Congress, as well as to the Commission, a report entitled "Financial Market Coordination and Regulatory Activities of the Treasury, Federal Reserve, SEC, and CFTC in 1993-1994" (October 1994).

37. Orange County issued both taxable and tax exempt notes. Both taxable and tax exempt money market funds had holdings of the affected notes. Fund advisers have told the Commission staff that prior to the revelations concerning the effects that the Pool's losses would have on the creditworthiness of Orange County, these notes appeared to satisfy the credit quality conditions of Rule 2a-7.

Certain Orange County notes are subject to credit enhancements from third parties (such as banks), and we have been advised that the values of these notes were not significantly affected by the Orange County bankruptcy.

38. Rather than determining the market value of their portfolio securities on a daily basis, as other open-end investment companies do, most money market funds maintain a stable share price by using the amortized cost method of valuation. Under the amortized cost method, portfolio securities are valued by reference to their acquisition cost as adjusted for amortization of premium or accretion of discount. See Rule 2a-7, ¶ (a)(1). Under Rule 2a-7, a fund must monitor the actual market prices of its portfolio securities and, if the deviation between the market value and the amortized cost of the portfolio exceeds one half of one percent, the fund's board of directors must promptly consider what actions, if any, should be initiated. See Rule 2a-7, ¶ (d)(6). These actions may include causing the fund to sell and redeem shares at less than $1.00 -- that is, "breaking a dollar."

39. In September 1994, the US Government Money Market Fund, a series of Community Bankers Mutual Fund, Inc. (the "CAM Fund"), announced that it would liquidate and distribute less than $1.00 a share to its shareholders. The CAM fund incurred losses because certain adjustable and floating rate instruments in its portfolio had interest rate adjustment mechanisms which, in an environment of increasing interest rates, resulted in the market value of the instruments being less then their par value. Many press reports have cited this liquidation as the first instance in which a money market fund had broken a dollar.

40. Some funds took this approach even though their holdings of Orange County notes were small enough that the funds were not in danger of breaking a dollar. The advisers to these funds proposed to purchase Orange County notes from their funds to assure that the fund would be shielded from the uncertainties presented by the Orange County bankruptcy.

41. These puts are designed to place funds in the position of being able to continue to value the Orange County notes at or near their pre-bankruptcy prices until the puts are exercised, more permanent credit support (such as a letter of credit) can be obtained, or Orange County's ability to make payments on the notes is clarified.

42. This no-action process was first used in 1989, when several money market funds held defaulted commercial paper of Integrated Resources, Inc. Subsequently, the Division used this procedure to allow advisers to purchase or provide puts with respect to other securities that were in default, such as securities that were backed by Mutual Benefit Life Insurance Company, an insurance company seized by New Jersey regulators in June 1991. See generally Investment Company Act Rel. No. 19959 (Dec. 17, 1993) 58 FR 68585 (Dec. 28, 1993), at notes 12 and 28. Most recently, the Division has used this procedure in connection with the repurchase by fund advisers of certain structured notes the value of which declined substantially as a result of increases in interest rates. In December 1993, the Commission proposed a new rule under the Investment Company Act that would permit fund affiliates to purchase from a money market fund securities that are no longer eligible for money market fund investment at the higher of the securities' amortized cost value or market value, without having to seek prior Commission approval. Id. at Section IV. Funds using the exemptive rule would continue to be required to notify the Commission in the event of a default with respect to portfolio securities that account for one half of one percent or more of a fund's assets before the occurrence of the default. See Rule 2a-7, ¶ (c)(5)(iii).

43. The statutes contemplate "pooled securities" in the context of securities securing deposits of local agencies in state or national banks or other authorized depositary institutions, see Cal. [Gov't] Code §§ 53630 et seq., not in the context of investments made by the Treasurer.

44. Cal. [Educ.] Code § 35010.

45. Cal. [Civil Proc.] Code § 573.

46. Cal. [Probate] Code §§ 3412, 3413, 3611.

47. Cal. [Gov't] Code § 53684.

48. Cal. [Gov't] Code §§ 53601, 53635.

49. Id.

50. The Commission, under Rule 2a-7 under the Investment Company Act, places significant restrictions on the types and quality of securities that may be purchased by money market mutual funds. These restrictions are intended to assure that money market fund investment policies are consistent with the maintenance of a stable net asset value. In the case of other types of investment companies, the Commission seeks to assure that investment objectives and policies are fully and clearly disclosed to investors. In addition, investments by investment companies are subject to leverage restrictions and liquidity requirements. See Investment Company Act Section 18, 15 U.S.C. § 80a-18 (leverage restrictions) and Investment Company Act Rel. No. 18612 (March 12, 1992), 57 FR 9828 (March 20, 1992) (limits on investments in illiquid securities).

51. Section 2(b) of the Investment Company Act states, in relevant part, that:

> [n]o provision in [the Investment Company Act] shall apply to, or be deemed to include . . . a State, or any political subdivision of a State, or any agency, authority, or instrumentality of any one or more of the foregoing, or any corporation which is wholly owned directly or indirectly by any one or more of the foregoing, or any officer, agent, or employee of any of the foregoing acting as such in the course of his official duty . . . .

15 U.S.C. § 80a-2(b). Section 2(b) also exempts from registration and regulation the United States and certain investment pools created by the federal government, its agencies and instrumentalities.

52. On a number of occasions, the staff has agreed that state and local governments can rely upon the broad Section 2(b) exclusion to operate or participate in pools for the collective investment of cash balances (e.g., proceeds from tax collections and bond offerings) without registering or complying with the regulatory requirements of the Investment Company Act. See Minnesota School District Liquid Asset Fund Plus (pub. avail. Feb. 27, 1985); Illinois School District Liquid Asset Fund Plus (pub. avail. June 15, 1984); Pennsylvania School District Liquid Asset Trust (pub. avail. Mar. 3, 1982); Pennsylvania Local Government Investment Trust (pub. avail. Mar. 2, 1981); State of New Jersey Cash Management Fund (pub. avail. Jan. 30, 1978); Massachusetts Municipal Depository Trust (pub. avail. May 23, 1977). In the Minnesota School District Liquid Asset Fund Plus letter, the staff noted that, having stated its views on a number of occasions, it would no longer respond to letters on this issue.

In fact, the staff has never formally taken the position that a pool sponsored directly by a municipality is not eligible for the Section 2(b) exclusion. The staff has informally taken the view, however, that an instrumentality of a state agency, or an instrumentality of a state instrumentality, is outside the scope of Section 2(b), and thus may not rely on the section's exclusion.

53. In addition, Citron is not now, and to our knowledge has never been, registered under the Investment Advisers Act of 1940. Section 202(b) of that Act excludes from regulation any officer of a municipality acting in the course of his official duties. As Treasurer of Orange County, Citron was an officer of the County and appears to have been acting in the course of his official duties in his management of the Orange County funds.

54. To meet the Section 2(b) exclusion, the Pools would have to be "instrumentalities" of Orange County or other municipalities. We understand that the Pools were not specifically designated as instrumentalities of Orange County under California law. Even though the Pools may not be organized as separate legal entities, the Pools may be considered instrumentalities under Section 2(b) if they have been operated to carry out governmental functions of the participating municipalities. The Commission staff has indicated that an entity may be considered an instrumentality under the Investment Company Act even if it is not designated as a public instrumentality under municipal law. Compare Massachusetts Municipal Depository Trust (Trust specifically designated as an instrumentality of the Commonwealth of Massachusetts) with Pennsylvania Local Government Investment Trust (whether Trust is designated as a public instrumentality not specified).

55. Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others, Securities Act Release No. 7049 (March 9, 1994), 59 FR 12748.

56. Securities Exchange Act Rel. No. 34961 (Nov. 10, 1994), 59 FR 59590.

57. Securities Exchange Act Rel. No. 34962 (Nov. 10, 1994), at 59 FR 59611.

58. Id.

59. See Securities Act Section 3(a)(2), 15 U.S.C. § 77c(a)(2) (exemption from registration requirements and civil liability provisions of the Securities Act); Exchange Act Section 3(a)(12), 15 U.S.C. § 78c(a)(12) (defining exempted securities to include municipal securities).

60. Pub. L. No. 94-29, 89 Stat. 131 (1975). The 1975 Amendments did not create a regulatory regime for municipal issuers or impose any new requirements on municipal issuers. Indeed, Section 15B of the Exchange Act expressly limited the Commission's and the MSRB's ability to establish municipal issuer disclosure requirements. Section 15B(d)(1) of the Exchange Act prohibits the Commission and the MSRB from requiring municipal securities issuers, either directly or indirectly, to file any application, report, or document with the Commission or the MSRB prior to any sale by the issuer. This section does not, by its terms, preclude the Commission from promulgating disclosure standards in municipal offerings, although there is no express statutory authority contained in the Exchange Act over disclosure by municipal issuers. Section 15B(d)(2) of the Exchange Act prohibits the MSRB, either directly or indirectly, from requiring issuers to furnish investors or the MSRB with any "report, document, or information" not generally available from a source other than the issuer. This section was intended to make clear that the legislation was not designed to subject states, cities, counties, or any other municipal authorities, to any disclosure requirements that might be devised by the MSRB. These sections are collectively known as the "Tower Amendment." Division of Market Regulation, Securities and Exchange Commission, Staff Report on the Municipal Securities Market (Sept. 1993), at Appendix A.

61. 17 CFR § 240.15c2-12. See Securities Exchange Act Rel. No. 26100 (Sept. 22, 1988), 53 FR 37778 ("1988 Release"); Securities Exchange Act Rel. No. 26985 (June 28, 1989), 54 FR 28799 ("1989 Release"). Rule 15c2-12 also contains specific exemptions for three types of municipal securities offerings.

62. NRMSIRs are not the only source of information in the municipal market. The MSRB has developed its Municipal Securities Information Library ("MSIL") system, which currently collects information and disseminates it to market participants and information vendors. MSRB rule G-36 requires brokers, dealers, and municipal securities dealers acting as underwriters in primary offerings of municipal securities to send copies of the issuer's final official statement to the MSRB. The Official Statement and Advance Refunding Document-Paper Submission System ("OS/ARD") of the MSIL collects and makes available on magnetic tape and on paper official statements and advanced refunding notices. Securities Exchange Act Release No. 29298 (June 13, 1991), 56 FR 28194. As a part of the MSIL system, the MSRB commenced operation of its Continuing Disclosure Information ("CDI") pilot system in January, 1993. The CDI system is a central repository for voluntarily submitted continuing disclosure documents relating to outstanding municipal securities issues. Securities Exchange Act Release No. 30556 (April 6, 1992), 57 FR 12534. Neither the MSIL OS/ARD system nor the CDI system is a NRMSIR; the Commission has previously stated that it would consider the competitive implications of a MSRB request for NRMSIR status. See Securities Exchange Act Release No. 28081 (June 1, 1990), 55 FR 23333, 23337 n.26.

63. These three NRMSIRs are American Banker-Bond Buyer, the J.J. Kenny Co., and Bloomberg, L.P.

64. See 1988 Release at 53 FR 37787; 1989 Release at 54 FR 28811.

65. Id.

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

67. The adequacy of the disclosure provided in municipal securities offering materials is tested against an objective standard. An omitted fact is material if there is

> a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable [investor]. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available.

TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976).

68. Interpretive Release at 59 FR 12751-52.

69. Id.

70. Id.

71. Id. at 59 FR 12752. The Interpretive Release noted that 46 states required, or are in the process of establishing a requirement, that the state's government financial statements be presented in accordance with GAAP. State Comptrollers: Technical Activities and Functions (1992 Edition).

72. The Interpretive Release noted that an appropriate period appeared to be within six months of the close of the fiscal year, based upon the Commission's understanding of prevailing practice. However, many commenters responding to the solicitation of comments on the companion rulemaking discussed below took the position that for many municipal issuers, it was not reasonable to require that they obtain audited financial statements within six months.

73. Interpretive Release at 59 FR 12753.

74. Id.

75. Id. at 59 FR 12751.

76. Id.

77. Securities Exchange Act Rel. No. 33742 (March 9, 1994), 59 FR 12759.

78. Securities Exchange Act Rel. No. 34961 (Nov. 10, 1994), 59 FR 59590.

79. These comment letters represented the comments of over 475 groups and individuals. The comment letters and a summary of the comment letters prepared by Commission staff are contained in Public File No. S7-5-94. See also Public File No. S7-4-94.

80. See MSRB Manual (CCH) ¶ 3581.30 (interpreting MSRB rule G-17 to require that a dealer disclose, at or prior to sale, all material facts concerning a transaction, including a complete description of the security). See also 1988 Release at n.50 and accompanying text.

81. GASB Statement No. 3 was issued April 1986 effective for financial statements for periods ending after December 15, 1986.

82. American Institute of Certified Public Accountants, Audit and Accounting Guide, "Audits of State and Local Government Units," at ¶ 7.15.

83. Pursuant to Exchange Act Section 3(a)(12), municipal securities are exempt from the transaction reporting requirements of Exchange Act Section 11A. MSRB rule G-14 allows for the voluntary dissemination of transaction information, and establishes requirements for transaction reports voluntarily disseminated. MSRB rule G-13 prohibits the dissemination of a quotation relating to municipal securities unless the quotation represents a bona fide bid for, or offer of, municipal securities, and the quotation is based on the dealer's best judgment of the fair market value of the securities. The MSRB's rules do not require municipal securities brokers or dealers to disseminate firm quotations or last sale reports.

84. See Securities Exchange Act Rel. No. 34962 (November 10, 1994), at 59 FR 59611.

85. See Letter from Robert H. Drysdale, Chairman, MSRB, to Arthur Levitt, Chairman, SEC (Nov. 3, 1994) at pp. 3-7. Available in Public File No. S7-6-94.

86. See Public Securities Association, Serving Investors' Price Transparency Needs in the Municipal Bond Market: A Program to Improve Price Information to Investors (Nov. 10, 1994).

87. Id.

88. We have stated that we may consider other regulatory action, including reconsidering disclosure of mark-ups in riskless principal transactions, disclosure of mark-ups in all transactions, or direct action to require price reporting.

89. See Michael Utley, "Orange County Sees Moody's Downgrade Following Shortfall in General Budget," The Bond Buyer, January 9, 1995, at 3; Steve Emmons, "As Credit Rating Slides, So May County's Image," L.A. Times, December 8, 1994, at A1; Thomas T. Vogel, Jr., "Orange County Fund Had Green Ratings Light," Wall St. J., December 6, 1994, at C1.

90. See Securities Act Release No. 7986 (Aug. 31, 1994), 59 FR 46317 (Sept. 7, 1994) (proposals to require disclosure with respect to security ratings in prospectuses).

91. For example, the Commission employs NRSRO ratings as a basis for distinguishing between certain types of securities that may be issued using simplified registration procedures under the Securities Act. See Adoption of Integrated Disclosure System, Securities Act Release No. 6383 (Mar. 16, 1982); Adoption of Simplification of Registration Procedures for Primary Securities Offerings, Securities Act Release No. 6964 (Oct. 22, 1992). NRSRO ratings also are employed in connection with investment restrictions applicable to money market funds. See 17 CFR § 270.2a-7. Rule 3a-7 under the Investment Company Act, which exempts certain structured financing from registering under and complying with the Investment Company Act, also utilizes the ratings of NRSROs. See Exclusion from the Definition of Investment Company for Structured Financing, Investment Company Act Release No. 19105 (November 19, 1992), 52 SEC Dkt. 4114.

92. Pub. L. No. 98-440, § 101, 98 Stat. 1689, 1689 (1984). See 15 U.S.C. 78c(a)(41). Congress employed the term "NRSRO" in the definition of a "mortgage related security."

93. The staff considers several criteria when determining whether to provide no-action assurances to a requesting credit rating agency. In determining whether a rating agency possesses the characteristics of an NRSRO, the staff considers a number of criteria. The most important criterion is that the rating agency is in fact nationally recognized by the predominant users of ratings in the U.S. as an issuer of reliable and credible ratings. The staff also assesses, among other factors: (1) the agency's organizational structure; (2) the agency's financial resources; (3) the size and quality of the agency's staff; (4) the agency's independence from the companies it rates and its reputation for integrity in the marketplace; (5) the agency's rating procedures; and (6) the agency's establishment and compliance with internal procedures to prevent misuse of non-public information.

94. Exchange Act Release No. 34616 (Aug. 31, 1994), 59 FR 46314 (Sept. 7, 1994).

95. One of the questions presented was whether the Commission should take further steps regarding NRSROs, in order to increase its regulatory oversight role. Id. at 46317.

96. The Commission is the appropriate regulator, of course, of the broker-dealers through which state and local governments may invest in government securities. Prior to the Government Securities Act Amendments of 1993 ("GSA Amendments"), see Pub. L. No.

103-202, 107 Stat. 2344 (1993), recommendations made by a broker-dealer involving the purchase or sale of a government security were subject to the antifraud prohibitions of the federal securities laws, but were exempt from the more particularized sales practice standards of the NASD. Under the GSA Amendments, the NASD, which is the only registered securities association, was given the authority to adopt sales practice standards for its members' government securities transactions.

97. See, e.g., NASD Rules of Fair Practice, Art. III, § 2 ("In recommending to a customer the purchase, sale or exchange of any security, a member shall have reasonable grounds for believing that the recommendation is suitable for such customer upon the basis of the facts, if any, disclosed by such customer as to his other security holdings and as to his financial situation and needs."). See also New York Stock Exchange Rule 405 (the "know your customer rule"); American Stock Exchange Rule 411.

98. NASD Notice to Members 94-62 (August 1994).

99. See Testimony of the National Association of State Treasurers before the Committee on Banking, Housing and Urban Affairs, United States Senate (Jan. 6, 1995). In 1989, NAST issued a Statement in Favor of Full Disclosure for Local Government Investment Pools.

100. GFOA, Recommended Practice, "Use of Derivatives by State and Local Governments," adopted June 7, 1994.

101. Group of Thirty, "Derivatives: Practices and Principles," (July 1993), at 18.

102. (Source: The Bond Buyer). By way of comparison, there are approximately 12,000 companies (other than investment companies) currently filing reports with the Commission.