UNITED STATES
SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

OFFICE OF MUNICIPAL SECURITIES

August 25, 1995

The Honorable Richard H. Baker
Subcommittee on Capital
Markets, Securities & Government
Sponsored Enterprises of the
Committee on Banking and Financial
Services
U.S. House of Representatives
One Hundred Fourth Congress
2129 Rayburn House Office Building
Washington, D.C. 20515

Dear Chairman Baker:

Thank you for the opportunity to appear as a witness at the July 26th hearing of the Subcommittee for Capital Markets, Securities and Government Sponsored Enterprises. I am writing in response to questions raised by you in your letter of August 4, 1995, regarding further consideration by the Subcommittee relating to Chapter 9 of the federal bankruptcy code, the adequacy and timeliness of municipal disclosure, and state oversight of governmental investment practices. I have set forth below your questions together with the staff's responses.

1. What would be the benefits of standardized reporting requirements across the country? What would be the drawbacks?

As set forth in our written testimony of July 26, 1994,[1] in 1993, the Commission's Division of Market Regulation conducted a comprehensive review of the municipal securities market, which underscored the need for improved disclosure practices in both the primary and secondary municipal securities markets.[2] The Interpretive Release[3] published by

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[1] Testimony of Paul S. Maco, Director, Office of Municipal Securities, U.S. Securities and Exchange Commission, Regarding the Municipal Securities Market, Before the Subcommittee on Capital Markets, Securities and Government Sponsored Enterprises Committee on Banking and Financial Services, United States House of Representatives (July 26, 1995) at B-3.

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

the Commission in March 1994, while acknowledging significant improvement in disclosure practices in recent years, identified several areas of primary market disclosure that needed increased attention.

Standardized reporting requirements would have the benefit of facilitating comparison of municipal credits by investors and would benefit issuers by providing guidance as to their disclosure responsibilities. Uniform disclosure standards are available through industry disclosure guidelines, such as those promulgated by the Government Finance Officers Association, as well as accounting standards promulgated by the Government Accounting Standards Board.[4] We anticipate that the increased focus on municipal disclosure resulting from our recent initiatives will lead to wider acceptance of these standards. Of course, compliance with standardized disclosure requirements would never excuse non-compliance with the overlying antifraud provisions of the federal securities laws.

Uniform standards, however, may not be feasible. In addition to the 50 states, the District of Columbia, Guam, Puerto Rico and the Virgin Islands, the municipal securities market consists of a variety of issuers organized under, and often unique to, the laws of each of the 50 states. As noted in the Joint Response to the Commission's recent proposed amendments to Rule 15c2-12, "each state's system has evolved over the years in response to unique economic and political circumstances."[5] Mindful of this complexity, the Commission's

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[3] Statement of the Commission regarding Disclosure Obligations of Municipal Securities Issuers and Others, Securities Exchange Act Rel. No. 33741 (March 9, 1994) 59 FR 12748 (the "Interpretive Release").

[4] In addition, the National Federation of Municipal Analysts has published voluntary disclosure guidelines covering industry specific sectors. See Disclosure Handbook for Municipal Securities 1992 Update, National Federation of Municipal Analysts (Nov. 1992).

[5] Joint Response to the Securities and Exchange Commission on Releases Concerning Municipal Securities Market Disclosure, prepared by American Bankers Association's Corporate Trust Committee; American Public Power Association; Association of Local Housing Finance Agencies; Council of Infrastructure Financing

amendments to Rule 15c2-12 were aimed at "providing issuers with significant flexibility to determine the appropriate nature of that disclosure."[6]

Before amending existing laws relating to municipal securities, the Commission recommends that the recent disclosure initiatives be given a chance to take hold.[7] If the recent reforms do not achieve the intended improvements in disclosure practices, then consideration of more extensive measures could be considered.

2. How can we call disclosure adequate when Orange County sells a bond issue in June of 1995 with many pages of unaudited financials from June 30, 1994? Given Orange County's problems, why did the market accept outdated financial information?

The Commission currently is conducting an investigation into a number of aspects of events preceding the bankruptcy filings by Orange County, California. It is not appropriate to discuss non-public matters that may relate to the investigation or that may become the subject of actions by the Commission or by other authorities. Therefore, the staff can comment only generally on the guidance that the Commission's recent initiatives provide for local government units regarding their disclosure obligations.

The Interpretive Release discusses the disclosure obligations of participants in the municipal securities

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Authorities; Government Finance Officers Association; National Association of Counties; National Association of State Auditors, Comptrollers and Treasurers; National Council of State Housing Agencies; National Federation of Municipal Analysts; and Public Securities Association, August 11, 1994, p. 5. "It is virtually impossible to define uniform national rules with any specificity given the different types of issuers and obligations issued by separate borrowing entities." Id.

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

[7] 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 (Jan. 12, 1995) at 30.

markets under the antifraud provisions of the federal securities laws. Among other things, the Commission emphasized the need for a municipal securities issuer to provide ongoing and timely disclosure of its financial condition.

The Commission also stated in the Interpretive Release that after extensive discussion with market participants, it appeared that, for the most part, audited financial statements of municipal issuers for the most recently completed fiscal year are available within six months after fiscal year end. The Commission also endorsed the use of unaudited and interim financial information in the absence of current audited annual statements. Nevertheless, the market routinely will accept an offering without audited or interim financial information. Indeed, when the Commission proposed that municipal issuers provide audited financial statements on an annual basis, many commenters stated a strong objection that such a requirement could not be applied to all issuers. In many cases, municipal issuers are only audited by the state auditor every two or three years. Thus, any requirement for audited financial statements could have an adverse impact on an issuer's ability to gain access to the public markets.

3. The SEC has seemed reluctant in the past to bring anti-fraud actions against municipal issuers based on misleading disclosures. Is there a role for more aggressive enforcement in this area?

Where the Commission finds that investors have been defrauded, it will not hesitate to take enforcement action. The Commission believes that its enforcement program is an indispensable part of its efforts to improve disclosure in this area. In one of his earliest public pronouncements, Chairman Levitt identified the municipal securities market as an area of heightened interest for the Commission.[8] Reflecting this emphasis, the Director of the Commission's

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[8] Testimony of Arthur Levitt, Chairman, United States Securities and Exchange Commission, Concerning the Municipal Securities Market, Before the Subcommittee on Telecommunications and Finance, Committee on Energy and Commerce, U. S. House of Representatives (Sept. 8, 1993).

Division of Enforcement, William R. McLucas, stated earlier this year that the municipal securities area was a top priority for the Division.[9]

Since June 1994, the Commission has instituted six enforcement actions that involved participants in either the primary or secondary municipal securities market. Four actions were brought in federal court, and two were filed as administrative proceedings before the Commission. Each of those enforcement actions charged the defendants or respondents with one or more violations of various antifraud provisions of the federal securities laws or violations of certain rules of the Municipal Securities Rulemaking Board (the "MSRB") that the Commission enforces. All but one of the enforcement actions discussed above involved, in part, material misstatements or failure to disclose some material fact to investors in an offering of municipal securities.[10] The individuals and firms charged represent a broad cross-

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[9] See SEC Official Says Bond Enforcement Major Priority, The Bond Buyer (Jan. 26, 1995).

[10] Securities and Exchange Commission v. Stifel, Nicolaus and Company, Inc., (W.D. Okla.), Lit. Rel. No. 14587 (Aug. 3, 1995); Securities and Exchange Commission v. Michael Goodman and Harold Tzinberg, (E.D. Minn.), Lit. Rel. No. 14471 (April 19, 1995); In the Matter of Joseph LeGrotte, Securities Act Rel. No. 7200, Securities Exchange Act Rel. No. 36036, Administrative Proceeding File No. 3-8763 (July 31, 1995); In the Matter of Sidney Gould, Securities Act Rel. No. 7201, Securities Exchange Act Rel. No. 36037, Administrative Proceeding File No. 3-8764 (July 31, 1995); Securities and Exchange Commission v. Nicholas A. Rudi, Joseph C. Salema, Public Capital Advisors, Inc., George A. Tuttle Jr. and Alexander S. Williams, (S.D.N.Y.), Lit. Rel. No. 14421 (Feb. 23, 1995); Securities and Exchange Commission v. Terry D. Busbee and Preston Bynum, (N.D. Fla.), Lit. Rel. No. 14387 (Jan. 23, 1995) and Lit. Rel. No. 14508 (May 24, 1995); In the Matter of Thorn, Alvis, Welch, Inc., John E. Thorn, Jr., and Derryl W. Peden, Securities Act Rel. No. 7069, Securities Exchange Act Rel. No. 34248, Administrative Proceeding File No. 3-8400 (June 23, 1994); and In the Matter of Derryl W. Peden, Securities Act Rel. No. 7069, Securities Exchange Act Rel. No. 35045, Administrative Proceeding File No. 3-8400 (Dec. 2, 1994).

section of market participants and include underwriters of municipal securities and their employees, a municipal securities broker, financial advisors, underwriters' counsel and bond counsel. At the same time, the Division has provided substantial assistance in two criminal actions where a total of four individuals were charged, three of whom have pled guilty.

In addition, without commenting about any particular matter, the Division of Enforcement has more than twenty investigations underway that involve different aspects of the municipal securities markets. While it is not possible at this time to say how many of those investigations will result in enforcement actions, the matters under investigation include possible false and misleading disclosure by municipal securities issuers.

4. The SEC's emerging municipal securities regulatory framework seems to put a substantial amount of the responsibility for mistaken or misleading disclosures by municipalities on the shoulders of market participants like underwriter[s] and dealers. Is this a deliberate policy decision or is it merely because the securities laws are drafted to give you so little jurisdiction over municipal issuers relative to market professionals? Would you like more authority to directly regulate municipal disclosure?

The regulatory scheme applicable to municipal securities represents a deliberate policy, undertaken pursuant to the Commission's antifraud and municipal securities dealer authority, to prevent abuses in connection with the purchase and sale of municipal securities. Brokers, dealers, and municipal securities dealers serve as the link between the issuers whose securities they sell and the investors to whom they recommend securities. Investors, especially individual investors, place their reliance on these securities professionals for recommendations regarding municipal securities. Brokers, dealers, and municipal securities dealers, in recommending the purchase or sale of securities, are subject to both sales practice standards arising from the antifraud provisions of the federal securities laws,[11] and the

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[11] The courts and the Commission have long emphasized that, under the general antifraud provisions of the federal securities laws, Section 17(a) of the Securities Act of 1933 ("Securities Act") and Sections 10(b) and 15(c)(1) and (2) of the Securities Exchange Act of 1934 ("Exchange Act"), a broker-dealer recommending securities to

suitability and other fair dealing rules of the MSRB.[12] Issuers of municipal securities also are subject to the antifraud provisions of the federal securities laws.[13] The focus of the municipal securities regulatory scheme on deterring fraudulent practices associated with the purchase and sale of these securities represents a careful balancing of the relative burdens associated with such deterrence on issuers, brokers, dealers, and municipal securities dealers in light of the Commission's authority.

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investors implies by its recommendation that it has an adequate basis for the recommendation. Consistent with this view, in 1988, the Commission issued an interpretation regarding underwriters' obligations to have a reasonable basis for recommendations, and their responsibility, in fulfilling that obligation, to review in a professional manner the accuracy of the offering statements with which they are associated. See Securities Exchange Act Rel. No. 26100 (Sept. 22, 1988) 53 FR 37778.

[12] MSRB rule G-19 requires brokers, dealers, and municipal securities dealers that recommend any municipal securities transactions to have reasonable grounds, based upon information available from the issuer and facts disclosed by the customer or otherwise known about the customer, for believing the recommendation is suitable. See MSRB Manual (CCH) ¶ 3591. MSRB rule G-19 also requires such brokers and dealers to make reasonable efforts to obtain information from non-institutional customers concerning the customer's financial status, tax status, investment objectives, and other similar information. Id. Rule G-17 requires brokers, dealers, and municipal securities dealers to deal fairly with all persons. See MSRB Manual (CCH) ¶ 3581. The MSRB has interpreted rule G-17 to require that a dealer disclose all material facts concerning the transaction which could affect the customer's investment decision and not omit any material facts which would render other statements misleading. See MSRB Manual (CCH) ¶ 3581.30. MSRB rule G-30 requires brokers, dealers, and municipal securities dealers to ensure that the prices set for customer transactions are fair and reasonable. See MSRB Manual (CCH) ¶ 3646.

[13] Section 17(a) of the Securities Act and Section 10(b) Exchange Act apply to issuers of municipal securities.

As Chairman Levitt has stated in testimony before Congress,[14] the Commission's municipal disclosure initiatives provide a foundation for substantial enhancement of disclosure and offering practices in the municipal securities market. The amendments to Rule 15c2-12 are consistent with the Commission's authority to promulgate rules and regulations to define, and prescribe means reasonably designed to prevent fraudulent, deceptive, or manipulative acts or practices. Legislative action to change the largely exempt status of municipal securities issuers under the federal securities disclosure laws would have profound effects on the municipal market, and, given the 52,000 issuers of municipal securities, could require significant resources to administer.

As indicated in the Interpretive Release, the Commission supports legislation addressing the exempt status of conduit securities under the federal securities laws. Bonds used to finance a project which is 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 obligor, in which the investor looks, and can only look, to a private entity for repayment. Investors need the same disclosure regarding the underlying municipal corporate obligor under the same regulatory and liability scheme.

5. Merrill Lynch appears to have played different, and potentially conflicting, roles in its relationship with Orange County. What concerns exist when the same firm plays potentially conflicting roles including certain combinations of the following: underwriting offerings made for investment purposes, lending the issuer money to purchase investments, acting as financial advisor, and selling the issuer investment products?

Brokers, dealers, and municipal securities dealers participate in a broad range of financial and business relationships, arrangements, and practices in the course of their dealings with issuers. Many of these arrangements are customary and appropriate. For example, it is common for dealers to arrange repurchase agreements that effectively finance government securities purchased from such dealers.

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[14] 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 (Jan. 12, 1995) at 30.

Nevertheless, the combination of some functions, particularly dealer activities and financial advisory functions may, without careful consideration, result in conflicts of interest, breaches of duty, or less than arm's length transactions.[15] Because of the infinite variation in relationships with issuers, brokers, dealers, and municipal securities dealers must be aware of duties that arise in the course of their dealings with issuers, and must prudently manage their activities to avoid these problems. Similarly, issuers must develop appropriate internal controls and guidelines to assure themselves that they are obtaining the best possible services at appropriate prices and without undue risks, including risks created by conflicts of interest.[16]

Existing rules call for certain disclosure by offering participants. MSRB rule G-23[17] establishes ethical standards and disclosure requirements for brokers, dealers, and municipal securities dealers who act as financial advisors to issuers of municipal securities. Specifically, rule G-23 requires that financial advisory relationships, including the basis for compensation, be set forth in writing; sets forth the conditions under which a broker, dealer, or municipal securities dealer may act as an underwriter for an issuer with which it has a financial advisory relationship; and requires disclosure to customers of the existence of dual financial advisory and underwriting relationships.

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[15] See Securities and Exchange Commission v. Stifel, Nicolaus and Company, Inc., (W.D. Okla.), Lit. Rel. No. 14587 (Aug. 3, 1995) (acceptance by underwriter of undisclosed payments from third parties that sold investments to municipal bond issuers).

[16] See MSRB Reports, Vol. 11, No. 3 (Sept. 1991) at 11 (MSRB statement encouraging underwriters and state and local governments to maintain the integrity of the process of selecting parties involved in the underwriting of municipal securities); MSRB Reports, Vol. 13, No. 3 (June 1993) at 15 (MSRB determination to meet with issuer groups to discuss whether measures could be adopted by issuers or state legislatures to ensure that political contributions do not influence the underwriter selection process).

[17] See MSRB Manual (CCH) ¶ 3611.

In addition, the Interpretive Release addressed questions of conflict 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 the offering. 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 use of proceeds, underwriters' compensation, and other expenses of the offering.

I hope these answers are responsive to your questions. Please do not hesitate to contact me if we can provide you and the Subcommittee with further information.

Sincerely,

Paul S. Maco/smg

Paul S. Maco
Director
Office of Municipal Securities

QUESTIONS FOR MR. MACO
CAPITAL MARKETS SUBCOMMITTEE HEARING ON MUNICIPALITIES

▸ What would be the benefits of standardized reporting requirements across the country? What would be the drawbacks?

▸ How can we call disclosure adequate when Orange County sells a bond issue in June of 1995 with many pages of unaudited financials from June 30, 1994? Given Orange County's problems, why did the market accept outdated financial information?

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▸ The SEC's emerging municipal securities regulatory framework seems to put a substantial amount of the responsibility for mistaken or misleading disclosures by municipalities on the shoulders of market participants like underwriter and dealers. Is this a deliberate policy decision or is it merely because the securities laws are drafted to give you so little jurisdiction over municipal issuers relative to market professionals? Would you like more authority to directly regulate municipal disclosure?

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