



December 17, 1987

BY HAND

Honorable David S. Ruder  
Chairman  
Securities and Exchange Commission  
450 Fifth Street, N.W.  
Washington, D.C. 20549

Re: Adequacy of Information in the Municipal Securities  
Markets

Dear Chairman Ruder:

The Municipal Securities Rulemaking Board ("Board") is the self-regulatory organization charged with primary rulemaking authority with respect to all brokers, dealers and municipal securities dealers ("dealers") effecting transactions in municipal securities. Over the past several years the Board has been scrutinizing the adequacy of information in the municipal securities market. The Board has concluded that dealers and investors do not have adequate access to information about municipal securities and their issuers. As discussed below, municipal securities have grown more complex and information problems have engendered pricing, trading and processing inefficiencies in the municipal securities market which must be corrected. The Board is seeking the Commission's cooperation in obtaining improvements in the flow of information to the municipal securities marketplace. The Board also believes it is necessary and appropriate to seek the thoughtful cooperation of all market participants and relevant enforcement organizations in this endeavor.

The Board's Authority Over Information About Municipal Securities

The Board was established under the Securities Acts Amendments of 1975 which added section 15B to the comprehensive scheme of federal regulation of the securities markets set forth

in the Securities Exchange Act (“Act”).<sup>1</sup> The Board is composed of 15 members -- five individuals representing securities firms, five individuals representing dealer banks and five individuals representing the public. At least one public member must represent issuers and one must represent investors.<sup>2</sup> The Board is vested with broad rulemaking authority applicable to all transactions in municipal securities effected by brokers, dealers and municipal securities dealers.<sup>3</sup>

Since its inception, the Board, through the adoption of its fair practice rules, has sought to ensure that municipal securities investors are apprised of all information material to their investment decisions.<sup>4</sup> In particular, rule G-17 of the Board’s rules of fair practice requires dealers to deal fairly with all persons and prohibits them from engaging in any deceptive, dishonest or unfair practice. The Board has interpreted this rule to require a dealer to disclose, at or before the sale of municipal securities to a customer, all material facts concerning the transaction, including a complete description of the security, and prohibits a dealer from omitting any material facts which would render other statements misleading. In addition, rule G-19, on suitability, prohibits a municipal securities professional from recommending a transaction in municipal securities to a customer unless the professional has reasonable grounds for making the recommendation in light of information about the security available from the issuer or otherwise and believes that the transaction is suitable for the particular customer. With regard to confirmation disclosure, rule G-15(a) requires that a dealer provide a customer with a confirmation evidencing their municipal securities transaction which includes a standard (legal) securities description as well as certain other important items of information about the securities,

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1 Prior to adoption of the 1975 legislation, municipal securities were exempt from the federal securities laws except for the post hoc application of the antifraud provisions of those laws. Section 15B requires all municipal securities dealers, including dealer banks and securities firms dealing solely in municipal securities, which had not previously been regulated, to register with the Commission and subjects certain of these entities to financial responsibility and reporting requirements.

2 Board members serve staggered three-year terms.

3 The areas of rulemaking specified in section 15B(b)(2) are: professional qualification; prohibition of fraud and unfair practices; form and content of quotations; arbitration; scope and frequency of compliance inspections; recordkeeping; defining separately identifiable department of a bank; fees; selection of Board members; foster coordination among persons engaged in clearance and settlement and, facilitate a free and open market. Pursuant to section 19(b) of the Act, the Board has adopted rules in all of these areas.

4 It is important to note that the Board has authority only to write rules. It has no inspection or enforcement authority. The Congress has designated the National Association of Securities Dealers, Inc. as the enforcement authority for securities firms; the Office of the Comptroller of the Currency for national banks; the Federal Reserve Board for banks of the Federal Reserve System, and the Federal Deposit Insurance Corporation for state banks that are not members of the Federal Reserve System.

such as whether the securities are prerefunded, issued at an original issue discount, taxable or subject to the alternative minimum tax.<sup>5</sup> These requirements apply to all municipal securities transactions in the primary and secondary markets.<sup>6</sup>

#### Board Authority to Require Dissemination of Issuer Disclosure Documents

One of the Board's most important fair practice rules is rule G-32 on disclosures in connection with new issues. The rule requires a dealer selling new issue municipal securities to a customer to deliver by settlement of the transaction a copy of the final official statement, if one is prepared by or on behalf of the issuer.<sup>7</sup> The offering statement is the sole official source of information about a municipal security. While other summary sources of information are available about municipal securities,<sup>8</sup> the official statement is the only document that contains a

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<sup>5</sup> It should be stressed that since the confirmation is received by a customer after the investment decision is made and the transaction occurs, its delivery does not excuse a dealer from the obligation to disclose material information about a security to a customer prior to executing the transaction.

Rule G-12(c) specifies similar confirmation requirements for inter-dealer transactions.

<sup>6</sup> The Board also has discussed the potential for creating new automated systems to provide current market information on municipal securities. In March 1985, the Board published a notice reviewing the history of automated systems for the dissemination of quotations and trade reporting on municipal securities and soliciting industry comment on the development and use of such systems. In January 1986, the Board published a summary of the comments received. The commentators generally expressed interest in these issues and in hearing the views of other industry members, but questioned whether such systems could be utilized in the municipal securities market. The Board continues to be hopeful that such systems can be devised for municipal securities in the near future. MSRB Reports, vol. 6, no. 1, pp. 21-22 (January 1986).

<sup>7</sup> If no official statement is prepared, a dealer must provide a written statement to that effect. In a negotiated sale of new issue securities, a dealer also must deliver certain written information about the underwriting arrangements.

<sup>8</sup> Information services include electronic data bases containing descriptive information, underwriting and initial market information and underwriting information databases. These sources may not contain complete descriptive information and/or may not be available until the security is trading in the secondary market.

complete description of the securities, which rarely changes over the life of the issue,<sup>9</sup> as well as a “snapshot in time” of the issuer and its credit.<sup>10</sup>

As noted above, rule G-32 applies only if an issuer voluntarily prepares an official statement.<sup>11</sup> This reflects the fact that municipal securities issuers are not regulated, except under the antifraud provisions of the federal securities laws. Unlike the corporate securities market in which issuers generally are prohibited from selling new issue securities except by a prospectus, section 15B(d) of the Act, the “Tower Amendment”, expressly prohibits the Board from requiring issuers to prepare offering material or to distribute such documents to dealers or purchasers of their securities. Section 15(B)(d) has two broad prohibitions against issuer regulation.

Paragraph (1) provides:

Neither the Commission nor the Board is authorized under this title, by rule or regulation, to require any issuer of municipal securities, directly or indirectly through a purchaser or prospective purchaser of securities from the issuer, to file with the Commission or the Board prior to the sale of such securities by the issuer any application, report, or document in connection with the issuance, sale, or distribution of such securities.

This paragraph expressly protects issuers from being required, directly or indirectly through the underwriters, to file disclosure documents with the Board or the Commission as a condition of bringing an issue to market.

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<sup>9</sup> A major exception is when an issue has been advance refunded. In such an instance the official statement will indicate that the issuer has reserved the right to advance refund and one must refer to the refunding and escrow documents for a complete description of the terms and conditions of the refunding.

<sup>10</sup> This “issuer” information quickly may become outdated. However, issuers of all rated issues must prepare annual financial statements as a condition of maintaining a rating by the major rating agencies.

<sup>11</sup> As the municipal securities market has grown, market participants have required the preparation of official statements. Today, the Board understands that most issues of municipal securities over \$1 million par value are accompanied by official statements, the contents of which generally comport with the Government Finance Officers Association’s (“GFOA”) Disclosure Guidelines for State and Local Government Securities.

The GFOA recently adopted revisions to its suggested guidelines for issuers which, if followed, would improve the content of official statements. The Guidelines also recommend that issuers make official statements available over the life of the issue. In commenting on the proposed revisions, the Board noted its concern with the voluntary nature of the Guidelines.

Paragraph (2) provides:

The Board is not authorized under this title to require any issuer of municipal securities, directly or indirectly through a municipal securities broker or municipal securities dealer or otherwise, to furnish to the Board or to a purchaser or prospective purchaser of such securities any application, report, document, or information with respect to such issuer: provided, however, that the Board may require municipal securities brokers and municipal securities dealers to furnish to the Board or purchasers or prospective purchasers of municipal securities applications, reports, documents, and information with respect to the issuer thereof which is generally available from a source other than such issuer. Nothing in this paragraph shall be construed to impair or limit the power of the Commission under any provision of this title.

This paragraph prohibits the Board, but not the Commission, from requiring an issuer to provide any information to it or to a purchaser of the issuer's securities. The Board expressly is permitted to require dealers to provide information about the issuer that generally is available from a source other than the issuer.

As a result of the Tower Amendment, rule G-32 is carefully drawn to require a dealer selling new issue municipal securities to a customer to deliver by settlement of the transaction a copy of the final official statement only if one is prepared by or on behalf of the issuer.

#### Need for Improving Information in the Municipal Securities Market

Since 1975, when the Board was created, the municipal securities market has changed dramatically. In 1975 the volume of municipal securities was \$29.3 billion par value; municipal securities were relatively simple instruments, only a few standard call features existed and defaults were rare. Since then the volume of municipal securities has grown to a high of \$222.2 billion par value in 1985,<sup>12</sup> and the variety and complexity of bonds have increased greatly. New types of municipal securities have been developed including warrants, leases, zero coupon bonds and puts, and there has been a proliferation of revenue bonds. More important, a typical issue may include a number of complex extraordinary and other call features, put options and variable and/or convertible interest rates.

The complexities of municipal securities make it essential that professionals and investors have access to complete and timely descriptive information about municipal securities and the issuers.<sup>13</sup> Although the Board's disclosure requirements have kept pace with developments in municipal securities, it is concerned that the flow of information to the market has not. Notwithstanding its rule G-32, the Board is aware that official statements often are not disseminated to purchasers of new issue municipal securities and may not be available to dealers

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12 In 1986 the volume of municipal securities was \$147.3 billion par value.

13 For example, an investor who is not well informed about an issue may lose his expected investment return when extraordinary or other call features are exercised.

when they begin selling municipal securities. Since the Board has no inspection or enforcement authority, the Board does not have adequate information explaining why official statements are not available to customers by the time the securities are received and the transactions completed. The Board is concerned, however, that the completion, printing and delivery of official statements may be a low priority for issuers and dealers involved in the underwriting.<sup>14</sup> In 1984-85, the Board spent considerable effort revising rule G-32 to obtain better compliance without sacrificing the important regulatory objective of timely dissemination of official statements. Since then, the Board has publicized the revised rule and has called for better compliance and stricter enforcement.<sup>15</sup> If these efforts do not improve the dissemination of official statements, the Board believes there may be a need for greater authority to require that official statements be available prior to the time trading begins in a new issue.

In the secondary market, dealers often do not retain official statements and may not have quick access to official statements to review complete descriptive information for issues they are trading.<sup>16</sup> Since summary sources do not contain complete descriptive information, some dealers trade municipal securities or sell municipal securities to customers without knowledge of important features of the securities. This has resulted in pricing and trading inefficiencies and customer protection concerns. One of the most common issues raised in customer arbitrations

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14 Perhaps this is because the preparation of such a document cannot be a precondition to the issuance of municipal securities.

15 See, e.g., MSRB Reports, vol. 7, no. 2, pp. 7-14 (March 1987). In March 1987, the Board sent letters to the National Association of Securities Dealers, Inc., the Office of the Comptroller of the Currency, the Federal Reserve Board and the Federal Deposit Insurance Corporation, calling for stricter enforcement of the rule. While some enforcement efforts have begun, the Board generally has not seen increased compliance with rule G-32.

16 While The Bond Buyer sponsors a repository of official statements, it does not include all official statements. The documents are available in microfiche form and paper copies may be requested. In addition, in its recent revision to its Disclosure Guidelines, the GFOA recommended that issuers make official statements available for the life of issues. These sources, however, do not allow quick access to the documents for use by dealers during the trading day.

brought under the Board's rules is whether call features adequately were disclosed to a customer at the time of trade.<sup>17</sup>

#### Establishment of a Mandatory Repository

The Board believes that the problems discussed above could be resolved within the current statutory framework by the creation of a mandatory repository of official statements and certain refunding documents.<sup>18</sup> As an ideal, the Board believes that a requirement to supply these documents to the repository should be placed on issuers, since the official statement is an issuer's document and since the issuer ultimately has control over its preparation. In addition, to facilitate access to and dissemination of information contained in official statements, the documents should be provided in computer-readable ("digital") form promptly after the issuer satisfies applicable state and federal regulations pertaining to the sale or award of a new issue of municipal securities.<sup>19</sup> The repository should have the capacity to make the information available to all interested persons, for a fee, shortly after receipt of the information.<sup>20</sup>

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17 In September 1986 and May 1987 the Board proposed draft amendments to rule G-15 to require dealers to deliver to customers, upon request, certain written descriptive information about securities sold in the secondary market. The Board suggested that, given the complexity of municipal securities, secondary market customers should be provided with complete written information upon request. MSRB Reports, vol. 6, no. 4, pp. 3-4 (September 1986); MSRB Reports, vol. 7, no. 3, pp. 3-5 (June 1987). The commentators generally agree that investors should have access to written descriptive information about municipal securities in the secondary market. They point out, however, that often the issuer's official statement is the only source of complete descriptive information about a security and suggest that they would have compliance problems because of the difficulty and cost of obtaining official statements in the secondary market. The Board has not taken final action on the draft amendments.

18 It does not appear feasible to obtain official statements prepared prior to the establishment of an official repository. Therefore, the benefits that will accrue will be prospective and may not improve access to information for outstanding issues of municipal securities.

19 For example, the Board understands that some jurisdictions require subsequent ratification of a sale or award by the issuing body.

Requiring that the official statement be supplied on or after the date of sale would avoid the presale filing prohibition of section 15B(d)(1) of the Act.

20 The Board would expect information vendors to access the information received by such a repository in the new issue market.

A mandatory repository should alleviate information problems for municipal securities participants. In the primary market, as noted above, issuers preparing official statements would be required to complete the final official statement promptly after the date of sale or award.<sup>21</sup> This should result in fewer delays in printing official statements so that they can be made available to dealers to deliver to primary market customers by settlement of transactions as required by rule G-32.<sup>22</sup> In addition, a dealer executing transactions in a new issue could access an official statement on an in-house computer screen to review descriptive information necessary to price the securities or to explain or describe the security to a customer. Although the system may permit users to generate copies of documents on in-house printers, its primary value would be its electronic access. The Board does not intend that the repository would be used by syndicate members and other dealers to obtain paper copies of the official statements to deliver to customers in the primary market.

Even greater benefits from a repository would accrue in the secondary market. Dealers trading in an issue would be able to view on their computer screens pages from an official statement at the precise time they need the information. This instantaneous access would make it possible for dealers to review complete information about the municipal securities they trade and thereby make the disclosures required by Board rules.<sup>23</sup> Moreover, copies of an official statement, or portions thereof, could be readily obtained when necessary.<sup>24</sup> Finally, information vendors would have a reliable source of all official statements and these sources of information would be more complete and more timely than now is possible.

The Board reiterates that the repository must be mandatory if it will succeed in obtaining all official statements. Therefore the Board believes that the repository should be created under governmental auspices. The Board also believes it would be preferable to establish the repository under the current statutory scheme if possible. It appears that such action may be possible pursuant to the Commission's broad rulemaking authority under the antifraud provisions of section 10(b) of the Act. The information the Board has received indicating that dealers generally do not have sufficient access to information about securities they are selling to customers raises significant questions about the adequacy of disclosure to the public as mandated

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21 Generally, certain features of an issue, including coupon rates, prices and maturity dates, are not set until the date of sale.

22 The typical length of time from the date of sale or award until settlement or delivery of a new issue ranges from two weeks to one month.

23 The Board's concern at this time is improving access to descriptive information about municipal securities. It recognizes, however, the potential for the repository to collect updated issuer information throughout the life of an issue.

24 As noted earlier, the Board's efforts to require dealers to provide complete written call information to customers upon request revealed that most dealers do not have access to portions of official statements and are reluctant to incur the expense of obtaining the whole document even when it is available.

by rule 10b-5 under the Act. More effective access to the official statements would alleviate this concern without any undue regulatory intrusion on issuers.<sup>25</sup>

The Commission's rulemaking authority under section 10(b) is not diminished by the Tower Amendment. Although the Board is prohibited from directly or indirectly requiring issuers to provide information to the Board or to customers, no similar restrictions apply to the Commission. Moreover, section 15B(d)(2) expressly states "[n]othing in this paragraph shall be construed to impair or limit the power of the Commission under any provision of this title." Thus, it appears that the Commission, under section 10(b) of the Act, may have authority to require issuers to provide official statements to a central repository.

The Board believes that improved access to official statements is critical to the efficiency of the municipal securities market and the protection of investors. This is an issue which requires the thoughtful participation of all market participants. The Board welcomes the opportunity to meet with the Commission to discuss in more detail the possible development of a mandatory official statement repository. The Board is prepared to cooperate with the Commission and to serve a leadership role in facilitating such a project. While the Board prefers that a mandatory repository be established within the current regulatory framework, it is committed to supporting legislation to establish one if such action is determined to be necessary or appropriate. The Board also is committed to exercising its full rulemaking authority by taking whatever additional actions are necessary to bring improvements in this area.

Sincerely,

James B.G. Hearty  
Chairman

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<sup>25</sup> As noted earlier, official statements now are being prepared for most municipal securities issues.