

HEARING ON DISCLOSURE
in the
MUNICIPAL SECURITIES MARKET
COMMITTEE ON COMMERCE
UNITED STATES HOUSE OF REPRESENTATIVES

JANUARY 12, 1995

Materials Provided by the
MUNICIPAL SECURITIES RULEMAKING BOARD

**Statement of the Municipal Securities Rulemaking Board
on
Developments in Municipal Securities Disclosure**

Summary of Major Points

- * The MSRB has taken a number of initiatives to increase disclosure in the municipal securities market.
- * In 1990, it created the Municipal Securities Information Library -- or MSIL -- system as a central repository of official statements, making them available to the market and the public.
- * Since January 1993, the Continuing Disclosure Information -- or CDI -- system (which is part of the MSIL system) has offered issuers and trustees a means of voluntarily disseminating short, time-sensitive, continuing disclosure notices to the market and the public. To date, issuer and trustee use of the CDI system has been disappointing.
- * The MSRB believes issuer disclosure should be improved and has considered how to increase issuer use of the CDI system, but the MSRB's rulemaking authority is limited to dealers.
- * The MSRB supports the recent amendments to SEC Rule 15c2-12. The amendments should increase issuer use of the CDI system and improve the amount and timeliness of issuer information available to the municipal securities market and the investing public. The MSRB is working on expanding the CDI system to accept longer documents from more issuers and trustees.
- * Repeal of the Tower Amendment is not a practical option for addressing issuer disclosure. Such repeal would not provide the MSRB with any direct authority to regulate issuer disclosure -- it would only allow the MSRB to pursue stronger indirect measures through additional dealer regulation. Such indirect regulation would be burdensome on dealers, could reduce market liquidity, and could not be enforced directly against issuers.
- * The MSRB's Transaction Reporting Program, which will soon begin operation, will provide the public, for the first time, with daily information about municipal securities transactions, and will provide enforcement agencies with a database of all trades for their surveillance activities.



**Testimony of
Robert H. Drysdale, Chairman
Municipal Securities Rulemaking Board**

Before the

**Committee on Commerce
United States House of Representatives**

January 12, 1995

Chairman Bliley and Members of the Committee:

The Municipal Securities Rulemaking Board appreciates the opportunity to provide its views concerning disclosure in the municipal securities market. My name is Robert Drysdale and I am Chairman of the MSRB. I am also President and Chief Executive Officer of PNC Securities Corporation. With me is Christopher Taylor, the Board's Executive Director.

In recent years, the municipal securities market has undergone dramatic growth and change. Individual retail investors have entered the market in increasing numbers -- both directly and through mutual funds -- replacing institutional accounts as the predominant purchasers of municipal securities. Municipal securities also have changed. Innovative and complex features now create tailor-made securities for virtually every investment objective. These changes have magnified the importance of disclosure in the municipal securities market.

The main focus of the MSRB is the protection of municipal securities investors and disclosure has been a priority of the Board for a number of years. As you know, the MSRB's rulemaking authority extends only to dealers and only to their municipal securities activities. The Board does not have authority to write rules governing the activities of other market participants, such as municipal issuers. We believe the MSRB has been very effective in its dealer regulation activities. We also have worked to facilitate access to municipal issuer disclosure in the market.

In 1987, the Board announced a number of long-range priorities regarding disclosure. Since that time, we have made significant progress on systems for providing market participants with more information regarding the description and value of municipal securities, and more information about the issuers of municipal securities. I would like to discuss two of these initiatives: (1) the Municipal Securities Information Library -- or MSIL -- system and (2) the Transaction Reporting Program.

MSIL System

The official statement for a new issue of municipal securities contains the issuer's disclosure of the terms of the issue and the issuer's financial condition at issuance. In 1987, the MSRB concluded that there was a need for a central, comprehensive collection of official statements for municipal securities issues so that any interested person could obtain complete information about the features of municipal securities. In 1990, the MSRB adopted rule G-36 to require underwriters to provide copies of official statements to the Board. The MSIL system

serves as a central repository for these official statements, making them available to the market and the public in both electronic and paper form. Currently, the MSIL system contains approximately 50,000 official statements.

While official statements are important to understanding an issue of municipal securities, the Board concluded that ongoing information about municipal securities and municipal securities issuers also is vitally important to the long-term health and liquidity of the market. From a regulatory perspective, such information plays a critical role in helping dealers fulfill their customer protection responsibilities in the secondary market. If issuers do not publicly disclose material developments affecting their securities after issuance, then dealers cannot inform their customers of such information or make the necessary suitability determinations and pricing decisions.

The complex features of today's municipal securities increase the likelihood that the value of the securities will be affected by post-issuance events. As more complex features are added to municipal securities, such as those found in many derivative products, the need for secondary market information becomes even more critical. In 1990, the Board filed a plan with the SEC to expand the MSIL system to accept certain types of continuing disclosure information voluntarily provided by issuers and trustees. After SEC approval of this plan in 1992, the Board's Continuing Disclosure Information -- or CDI -- system began operation. Since January 1993, this system has offered issuers and trustees a means of voluntarily disseminating short, time-sensitive, continuing disclosure notices to the market and the public. Unfortunately, to date,

issuer and trustee use of the system has been disappointing. In the last two years, the Board has processed approximately 1,700 disclosure notices -- the vast majority of which have been redemption notices which are not the type of time-sensitive, market-oriented disclosure for which the system was developed.

The Board believes that municipal issuer disclosure should be improved. Over the past two years, it has considered how to increase use of the CDI system, as well as how to enhance dissemination of such information through other channels.¹ However, the Board's ability to influence the disclosure practices of issuers is limited. As mentioned previously, MSRB rules apply only to dealers. Also, the Tower Amendment restricts the Board from adopting rules governing dealers that indirectly impose a presale filing requirement on issuers or that indirectly require issuers to produce documents or information for delivery to bond purchasers or to the Board.

Although it has been suggested that repeal of the Tower Amendment would be an effective way to regulate municipal issuer disclosure, we do not believe that would be a practical option. Repeal of the Tower Amendment would not provide the MSRB with any direct authority to regulate issuer disclosure -- it would only allow the Board to pursue stronger indirect action through additional dealer regulation (for example, dealers could be prohibited from selling an issue of municipal securities if the issuer has not made certain continuing disclosure). Such indirect regulation, however, would be burdensome on dealers, could reduce market liquidity, and could not be enforced directly against issuers.

In 1994, the SEC published an interpretive release of the antifraud provisions of the federal securities laws and adopted amendments to SEC Rule 15c2-12 relating to the obligations of municipal market participants. The amendments to Rule 15c2-12, among other things, prohibit dealers from underwriting an issuance of municipal securities without having reasonably determined that an issuer has undertaken to provide annual financial information and notices of specified material events. Such material events are precisely the type of information that the Board's CDI system is designed to accept and disseminate. The amendments to Rule 15c2-12 indirectly will require issuers to provide such disclosures either to the CDI system or to each of a number of other repositories designated by the SEC. The Board is working on expanding its CDI system to take in longer documents from more issuers and trustees and looks forward to greatly increased use of the system in the years ahead.

Because the new amendments to Rule 15c2-12 are not yet in effect, questions remain as to the level of issuer compliance and the efficiency of information dissemination to the market. Even so, we believe these new requirements will greatly improve the amount and timeliness of information available to the municipal securities market and the general public. The Board commends the SEC on its efforts to improve issuer disclosure in this market and supports the SEC's interpretive release and amendments.

The Committee's letter of invitation asked that the Board address how its initiatives can help to avoid problems similar to those in Orange County. One problem appears to be the lack of adequate disclosure about the County's investment practices and the effect of such practices on

Orange County bondholders. The Board provides a mechanism -- the CDI system -- through which issuers, such as Orange County, may disclose material events to the market. Whether issuers take advantage of this system is an issue for the Congress and the SEC.

Transaction Reporting Program

The need for disclosure of information on securities trading in the municipal securities market also has grown in recent years. In 1993, the MSRB announced plans to undertake a Transaction Reporting Program to collect and publish information on municipal securities transactions. We are currently testing the system using "live" transaction data, and plan to make the program fully operational within the next few weeks. The Board believes that the program will provide substantial benefits to the municipal market, including more accurate valuation of individual securities, and enhanced surveillance of the municipal market, particularly in the areas of sales practices, pricing, and fair dealing with customers. Our goal is to collect and make available transaction information that is both comprehensive and contemporaneous. The Transaction Reporting Program is a first step toward providing transparency to all market participants and toward creating a comprehensive surveillance database of actual transaction data for use by the agencies responsible for enforcing MSRB rules.

The Transaction Reporting Program will be implemented in four phases. The first phase is scheduled to begin this month and will provide a daily public report of inter-dealer -- or "wholesale" -- transactions that occurred the previous business day. This phase also will result in a surveillance database of all inter-dealer transactions which will be available exclusively to the

enforcement agencies. During the second phase in 1995, the Board plans to add institutional customer transactions to the daily reports and surveillance database, and to collect time-of-trade information. During the third phase in 1996, the Board will add retail customer transactions. And the fourth phase in 1997 will require reporting of transactions closer to the actual time of trade, for example, at the end of each business day or within a certain time after each trade.

The municipal securities market is different from the equity and corporate securities markets, and the MSRB designed the Transaction Reporting Program to provide the public with price and volume information that reflects this difference. On a typical day, approximately 2,000 municipal securities issues, out of approximately 1.5 million issues outstanding, might be traded between dealers. The daily report will include aggregate information about market activity on the previous business day, and additional information about the most frequently traded issues -- initially defined as those trading at least four or more times during the day -- including a description of each security, the number of times it was traded, and its high, low and average price for that day. We expect that, in the current market environment, approximately 80 to 240 issues will be reported each day. The Board will disseminate the report electronically to subscribers' computers, and will make paper copies available. We believe this information will be republished in a number of sources -- such as newspapers -- which are accessible to individual retail investors.

The Board will closely review system operations and the information that is made public through the daily reports, with a view toward reflecting a greater number of issues and

transactions in the reports. In addition, the Board is working with the NASD and bank regulatory organizations to ensure that the program's outputs will meet their requirements for surveillance of the municipal market and the enforcement of Board rules.²

Conclusion

In conclusion, while the MSRB's authority to deal with issuer disclosure is limited, it has highlighted the need for greater information and has sought, through its MSIL system, to provide a disclosure mechanism for those issuers that wish to use it. Also, in the area of transaction reporting, the Board seeks to ensure that important trade information is made available to the investing public and enforcement agencies.

1. In August 1993, the Board announced a rulemaking initiative, including a confirmation disclosure requirement and other dealer mandates, designed to encourage the production of continuing disclosure documents. After the September 1993 announcement of the SEC's intention to act in this area, the Board suspended its own efforts and offered its assistance to the SEC.
2. Letter from Robert H. Drysdale, Chairman, MSRB, to Arthur Levitt, Chairman, SEC, (November 3, 1994), a copy of which is attached.



November 3, 1994

The Honorable Arthur Levitt
Chairman
Securities and Exchange Commission
450 Fifth Street, N.W.
Washington, D.C. 20549

Dear Chairman Levitt:

On October 19, 1994, members of the Commission staff met with Board staff and asked that the Board provide an update on its planning concerning the transaction reporting program for municipal securities. The Board reviewed the status of the program at its November 1994 meeting and is pleased to provide the Commission with the following report.

The Board filed with the Commission amendments to rule G-14, on Reports of Sales or Purchases, on June 20, 1994. The amendments would require dealers to report their inter-dealer transactions in municipal securities to the Board for purposes of transparency and surveillance. The Board's filing with the Commission also described the planned facility to disseminate certain price and volume data based on the transaction information received, as well as the planned creation of a surveillance data base, with detailed information on each transaction, for use by each of the regulatory agencies responsible for enforcing Board rules.

Although Phase I of the transaction reporting program will be limited to inter-dealer transactions, the Board realizes that the program must be expanded in the near future and has announced plans to do so. The Board consistently has stated that its ultimate goal for the program is to collect and make available transaction information in a comprehensive and contemporaneous manner.¹ The Board has made clear that it intends to add institutional customer transactions and to collect time-of-trade information in Phase II of the program, to add retail customer data in Phase III, and to require more contemporaneous reporting of transaction information in Phase IV of the program.² The Board wishes to reiterate to the Commission its

¹ See, e.g., "Board to Proceed with Pilot Program to Disseminate Inter-dealer Transaction Information." *MSRB Reports*, Vol. 14, No. 1 (January 1994) at 13-16.

² See "Pilot Program for Transaction Reporting," Press Briefing Materials, September 12, 1994. This information was presented to a number of industry associations during August and September and to the press on September 12, 1994.

commitment to these goals. As noted in the schedule set forth below, Phase I of the program is on schedule for a January 1995 start-up date. The Board has budgeted amounts for its current fiscal year (ending September 30, 1995) that appear to be sufficient to implement Phase I and to make most or all of the planned enhancements necessary for Phase II, scheduled to begin operation in December 1995. The Board further believes that its resources in coming years will be sufficient to complete the longer-range enhancements.

Implementation Activities for the Pilot Program for Inter-Dealer Transaction Reporting

Testing of the pilot computer system to date has verified the Board's 1991 study of inter-dealer transaction data and has shown that, on a typical day, about two thousand municipal securities issues may be traded between dealers. Of these issues, transaction data on the most frequently traded issues—initially defined as those trading at least four times during the day—will be summarized in the daily public report to be disseminated by the Board.³ The Board expects that, in the current market environment, approximately 80 to 240 issues would be reported on each day. The size and composition of the list obviously would vary from day to day, depending upon market activity. The Board will review closely system operations and the information that is made public through the daily reports, with a view toward reflecting a greater number of issues and transactions in the reports. At a minimum, the Board will review the threshold number of transactions for reporting prior to the initiation of each new phase of the program.

Rather than require dealers to report their transactions through a separate transaction reporting system, the Board elected to require reporting through the existing automated system for "comparison" of inter-dealer transactions.⁴ The Board has long recognized that timely and accurate submission of transaction data to the comparison system is essential, both for the price reporting program and the movement to T+3 settlement.⁵ The Board has initiated a number of

³ The daily report initially will include aggregate information about market activity on the previous business day, and additional information about municipal securities that were traded four or more times, including a description of each security, the number of times it was traded, and its high, low and average price for that day.

⁴ Comparison is the process by which dealers submit their inter-dealer transaction data to a central clearing agency. When transaction data submitted by both sides of a transaction match, the transaction is said to "compare." The comparison process facilitates timely settlement.

⁵ See "Report of the Municipal Securities Rulemaking Board on T+3 Settlement for the Municipal Securities Market," *MSRB Reports*, Vol. 14, No. 2 (March 1994) at 5-14.

educational efforts and has facilitated a major enforcement effort aimed at achieving this goal.⁶ Additional steps will be undertaken as soon as the Commission approves the Board's filing on transaction reporting.⁷ The Board believes that these efforts with respect to the use of the comparison system will be sufficient to ensure that Phase I operates successfully as planned. The Board, however, remains committed to introducing transparency to the market through its transaction reporting program and, if problems with the use of the comparison system emerge that cannot be overcome, the Board will explore alternative systems and methods—in lieu of the comparison system—for collecting transaction data.

Prior to system start-up, the Board will file with the Commission the program's fee schedule for subscribers to the daily public report and provide a report of final system details, including the format of computer-readable daily report files. The Board also will be testing the pilot computer system and evaluating availability and security features in a report to the Commission.

The Board plans to start operation of the pilot transaction reporting system for trades occurring on and after January 1, 1995. It will solicit comments from subscribers to the daily report, dealers and others regarding improvements to the content and format of the report,⁸ and determine appropriate enhancements which will be reported to the Commission prior to their implementation.⁹ During the first quarter of 1995, remote access capabilities will be implemented for providing surveillance data via telephone lines to enforcement agency staff.

⁶ See "Enforcement Initiative: Rule G-12," *MSRB Reports*, Vol. 14, No. 2 (March 1994) at 19 and "Enforcement Initiative," *MSRB Reports*, Vol. 14, No. 3 (June 1994) at 35.

⁷ The Board is planning to hold a meeting on December 5 with a number of dealers in New York City to explain the amendment to rule G-14 as regards timely submission of inter-dealer transaction data to the Board. The Board also plans to ask dealers to provide the names of contact persons so that the Board will be able to communicate directly with the person responsible for submitting transaction reports to the Board.

⁸ A Transaction Reporting Users Group has been established, consisting of potential subscribers to the daily report of inter-dealer transactions. The group's role will be to suggest possible improvements to the report and to inform the Board of any problems encountered in using the system.

⁹ Of course, the Board will continue to file any matters with the Commission as required pursuant to Section 19(b)(1) of the Securities and Exchange Act, and Rule 19b-4 thereunder.

Enhancements to the Pilot Program

The Commission staff has asked for a schedule of planned enhancements to the transaction reporting system. These enhancements are organized into Phases II (addition of time of trade and institutional customer transactions), III (addition of retail customer transactions) and IV (more contemporaneous trade reporting).¹⁰ Since the Board is currently in the process of detailed planning for these phases, at this time they must be described more generally than Phase I. The following schedule represents the Board's commitment to an aggressive timetable for an unprecedented regulatory initiative in the municipal securities market. The dates provided are subject to the normal uncertainties that attach to any major systems implementation. It should also be noted that the success of the program enhancements will depend in part upon the cooperation and considerable efforts of industry members, who will be asked to make major changes in their current transaction processing procedures in order to reach the goal of comprehensive and contemporaneous transaction reporting.

SCHEDULE OF ENHANCEMENTS (PHASES II—IV)

1995

February

Coordinate Phase II issues of time of trade and institutional customer trade reporting by working with registered clearing agencies to define administrative and technical parameters for collecting such data. (This activity will continue as needed.)

Draft preliminary statement of requirements for Phase II computer system.

March

Publish, for industry comment, an exposure draft of a Phase II concept document for time of trade and institutional trade reporting. The draft would encompass, among other things: collecting institutional customer trade data from currently operating confirmation/acknowledgement systems; collecting time of trade data from dealers; enhancement of the public daily report to include institutional customer information; and concepts of operation for processing and reporting information.

¹⁰ Since the exact goal for "contemporaneous" reporting cannot be decided until industry comments are received and feasibility determinations are made, in this schedule the term "more contemporaneous reporting" is used to denote the specific requirement which will emerge from the rulemaking process.

April

Develop preliminary architecture for Phase II computer system and prepare to begin systems development.

May

Comments due from industry on exposure draft of concept document for time of trade and institutional trade reporting.

Finalize requirements for Phase II computer system.

July

Commencement of combined Phase III/IV study of vendors' automated services for retail customer trade processing and other proprietary systems used by dealers for trade processing.

September

File with Commission Phase II rule amendments adding time of trade and institutional customer trade information to rule G-14 transaction reporting procedures.

Publish, for industry comment, exposure draft of concept document for Phases III and IV. The Board would request industry participants and electronic information providers to suggest the most feasible and cost-effective technical solutions to collecting and reporting retail customer trade information. The Board plans to present options for submission of such information from the securities firm's data processing systems (e.g., the record-keeping system) in a standard format to a central file maintained by the Board. Comments also would be requested regarding the most cost-effective means for timely reporting, e.g., whether, at the commencement of Phase IV, data should be collected at the end of the trading day and later phased to contemporaneous collection, or whether more contemporaneous collection should be implemented directly.

October

File with Commission facility changes regarding time of trade and institutional customer trade information.

December

Projected date of Commission approval for amended rules for time of trade and institutional trade reporting (December 11). Projected date of operation for Phase II computer system (December 18).

1996

January

Industry comments due on exposure draft of Phase III/IV concepts.

February

Develop preliminary architecture for Phase III/IV computer system and prepare to begin systems development.

March

Finalize requirements for Phase III computer system.

April

File with Commission Phase III rule amendments adding retail customer trade information to rule G-14 transaction reporting procedures.

July

Finalize requirements for Phase IV computer system.

August

File with Commission Phase IV rule amendments adding more contemporaneous reporting of trade information to rule G-14 transaction reporting procedures.

September

Projected date of Commission approval for amended rules for retail customer trade reporting.

File with Commission facility changes regarding retail customer trade information.

November

Projected date of operation for Phase III computer system.

1997

January

Projected date of Commission approval for rule amendments for more contemporaneous reporting.

February

File with Commission facility changes regarding more contemporaneous reporting.

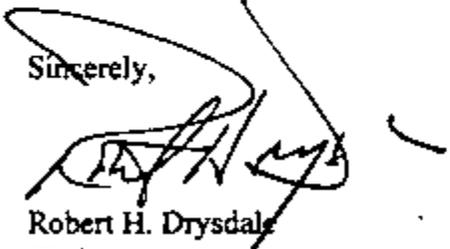
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Projected date of operation for Phase IV computer system.

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The Board appreciates the opportunity to provide the Commission with additional information on its plans for the transaction reporting program. If you or Commission staff should have questions about these plans, please do not hesitate to contact me or Christopher Taylor.

Sincerely,



Robert H. Drysdale
Chairman

RHD/lml