REMARKS BY CHAIRMAN ARTHUR LEVITT
UNITED STATES SECURITIES AND EXCHANGE COMMISSION
GOVERNMENT FINANCE OFFICERS ASSOCIATION
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Good morning. I'm pleased to be here today. We've stood together on many important issues -- preserving private rights of action in litigation, for example, and working to improve our municipal bond markets. But while we've said our piece on litigation reform and the next step is up to Congress, the direction of municipal finance reform is still very much in our hands -- yours and the SEC's. That's what I'd like to talk to you about today.

I feel a sense of kinship with you, the financial officers of small and large governments across the country. I mean that almost literally, for I first learned about the awesome responsibilities of managing the people's money from my father, who for 24 years served as New York State Comptroller. From my youngest days, he impressed upon me the duty to care for the assets of the people prudently. He considered it a sacred trust. I regard his profession -- yours -- as one of the most important to the ordinary citizen, who often knows nothing of its existence, beyond the fact that taxes are paid, schools are built, roads are paved, and the pension check arrives on time.

I trace to my father my abiding interest in the integrity of the municipal debt markets, and my concern over recent examples of public money management gone awry. I know these are your concerns as well, and that you've spent many hours at this conference addressing them.

If you can put up with advice from an official of a somewhat larger, if not always better managed, governmental entity, I'd like to talk to you today about three aspects of the municipal market: the prudent management of public funds; the preservation of public trust; and the integrity of the offering process.

PRUDENT MANAGEMENT OF PUBLIC FUNDS

Perhaps no question is as pressing today as prudent investment. Large sums of public money have been lost through investment strategies so laden with risk that the notion that they were undertaken in fulfillment of the public trust seems incomprehensible. I know the tremendous concern each of you has with such losses. And you know firsthand the tremendous concern this has generated among state and local taxpayers.

The public has a right to expect that money will be available when needed to keep the schools open, to police the streets, and to meet the other civic needs for which they paid their taxes. When such funds can generate additional revenue in the interim, so much the better. Care must be taken, however, that the return received does not become a narcotic, inducing dependency by being built into annual budgets as a significant revenue source in and of itself. Such an addiction loses sight of the original purpose for raising the funds, and it courts disaster in the event of sudden market changes. Using the treasury function as a profit center has backfired on some sophisticated corporate managers in recent years; it is no less risky for public officials.

Our markets have undergone dramatic changes. Complex instruments have been developed that are capable of producing breathtaking returns -- or breathtaking losses. The three basics of public fund management, however, have not changed: **safety**, **liquidity**, and **yield** -- <u>in that order</u>.

In the complex markets of the 1990s, assuring safety is no longer as simple as examining credit quality. When investment terms and liquidity needs are mismatched, a volatile market can quickly eviscerate investments with even the most impeccable credit rating.

There are two important steps that can help assure safety: a written investment policy, and independent oversight. A written and publicly available investment policy, coupled with current internal portfolio information, reinforces accountability. But without an independent review of actual performance on a frequent basis, a written investment policy can quickly become so many words.

Frequent valuation -- or marking to market -- is a wise component of oversight, especially where a high degree of liquidity is needed. Greater "transparency" would also help; ready access to trade and quote information will facilitate mark-to-market calculations and increase the accuracy of independent reviews of performance.

I've encouraged corporations and mutual funds that are end users of derivative products and other potentially volatile instruments to adopt internal procedures to safeguard against unanticipated risk, and to control overall exposure. You are custodians of public funds -- it is only appropriate that I carry this message to you as well.

This turbulent year has produced some thoughtful advice, in particular the report prepared by the Derivatives Policy Group, which is actually a series of commitments by six firms that are significant market participants. The report provides useful guidance for end-users as well as for dealers and intermediaries.

The report of the Derivatives Policy Group also addresses counterparty relationships. It articulates guidelines that professional intermediaries can follow in their dealings with non-professional counterparties. I asked that sales practices be addressed; in response, the Group emphasized the need for the parties to a transaction to clarify the terms of their relationship prior to consummating a transaction.

To my mind, that's a good starting place from which the debate concerning counterparty relationships may proceed. Brokers and their customers must understand the terms of their relationship at the outset and for its duration. This understanding may need to be based on several factors, including the products offered; the customer's understanding of them; the associated risk; and the customer's capacity to value the products independently.

Let me say that the Derivatives Policy Group's counterparty standards are minimum standards. I believe, however, that even this minimum reflects the Commission's traditional desire to find a balance between customer and broker-dealer duties.

All customers -- whether it's your neighbor down the street, your local municipality, or a large, international corporation -- must take responsibility for understanding what they are buying and how it fits their investment objectives. But let's remember that responsibility is a two-way street.

I know that the GFOA has been active in expressing its views on the responsibilities of a broker-dealer to its customers, particularly those that may be classified as "institutional" investors. You have commented, for example, on proposals put forward in the past year by the National Association of Securities Dealers regarding the NASD's so-called "suitability rule." I'm limited in what I can say about the NASD's most recent proposal, because I anticipate that at some point the SEC will be presented with a rule filing on this issue. I can say, however, that the question of striking an appropriate balance between the obligations of broker-dealers and the responsibility of customers is critical.

You've recommended practices that promote the wise use of potentially volatile investment instruments. You've urged that finance professionals understand that market, interest rate and liquidity risk can all play a powerful role in the safety of any investment.

And you've underscored a rule that should apply to any investment strategy: exotic instruments should only be considered by entities that have the required expertise and resources. If I may make an analogy: Electricity is a wonderful thing, but if you don't understand it, you have no business trying to wire a house.

Your City Councils, boards, and supervisory bodies should review their lists of authorized investments regularly, and monitor the results closely. Surprising investment gains should set off alarms every bit as loudly as surprising losses.

At the same time, care must be taken not to be seduced by easy cures, such as narrowing lists of permitted investments to only the safest. You may as well avoid the dangers of wiring a house by outlawing electricity. One of the best ways to hedge against risk is to diversify, which is to <u>increase</u> choices. Rather than eliminate investment tools, steps should be taken to assure they are well understood, and wisely employed.

I'm glad to see that you're considering a policy statement supporting the development and adoption of model investment practices for your agencies. I said in my testimony before the Congress earlier this year that I believe regulation of state and local investment practices is best left to the states. I continue in that belief -- and yet I cannot help but express concern at the rising tide of loss our localities appear to have incurred. State and local governments must address this matter, and soon. If the SEC can be of assistance in this, I hope you won't hesitate to contact us.

The Commission is especially concerned because what is at stake here is not just the fate of one or two municipalities -- it is the entire mechanism of public finance, which is based on the public's trust. That trust has been eroded by the events of the last year, and that's the second item I'd like to talk to you about.

PUBLIC TRUST AND THE GENERAL OBLIGATION BOND

The bankruptcy filing of Orange County in early December forced us all to think the unthinkable: that a major issuer might someday break its contract with the public investor. In an age that has seen a crisis of confidence in government, some might believe a breach of promise to bondholders is inevitable. I strongly disagree for many reasons, but especially because a default is as calamitous for issuers and taxpayers as for investors.

Americans trust municipal bonds as they do few other instruments. A decade ago, individual investors held about 45 percent of outstanding municipal securities; today, they hold 70 percent. This huge market is now worth about $1.2 trillion. It is of critical importance to our nation's future. It represents the schools that teach our children, the water we drink, the power that enhances our lives and drives our economy, the roads that take us where we need to go.

The Orange County bankruptcy may impose costs on public finance that will be felt for years to come. No one understands that better than this group.

There may be another cost imposed as well -- one associated with the phrase "willingness to pay," that has at its roots financing structures that avoid constitutional debt limits. This development is not unique to California -- it is a reality of municipal finance in almost every state, and has been for a long time. You'll forgive me if I refer to my father again. In 1974, he released a study that examined New York State's debt obligations. The report emphasized the enormous power that governments wield when they issue debt, in effect committing taxpayers' dollars for years into the future. It emphasized the tremendous ethical responsibility borne by issuers of municipal securities. And it concluded that "debt is at the same time one of the most important of the fiscal mechanisms available to government -- and one of the most vulnerable to misuse." He raised special concerns about the propensity of his state to avoid constitutional limits on debt through the proliferation of debt-issuing agencies.

I recalled my father's concerns in the wake of Orange County's troubles. Years later, the financing vehicles that were of such concern to him have become a mainstay of finance for many communities. And now a large issuer has publicly put in question the validity of its own debts.

Whether sincere or a negotiating ploy, this expression of uncertainty may add a new premium -- a premium for legal risk.

Corporate debt and equity markets have had to cope with broken contracts time and again. But municipal bonds are different. Local government bonds typically carry the "full faith and credit" of the issuer. This is a pledge that investors will be repaid before anyone else. So strong is this obligation that even during the Depression, virtually all the debt that defaulted was repaid with interest, and with interest on the interest.

Since the Depression, no general obligation bond of a major issuer has ever defaulted. The consequences of such a default would clearly be heavy for the issuer -- and if anything, this would be even more true of non-general obligation debt, which carries <u>only</u> the moral obligation of the issuer to repay. The ensuing higher interest rates would effectively constitute a huge tax increase on the issuer's taxpayers. But a default would also severely unsettle a group just as important to local government as taxpayers -- the bondholders who lend it money, whether as individuals or through mutual funds -- hardworking women and men throughout America looking for a decent, secure investment for their children's schooling; or to start a business someday; or perhaps for retirement. If such a default occurs -- and I hope it does not -- it could impose increased costs on all borrowers in this market for many years to come. In the fraternity of municipal issuers, the actions of one affect the reputation of all. That's why you're so concerned -- and why we are, too.

It's been said that trust is won with difficulty and easily lost. Municipal bonds enjoy a solid reputation today because of the valiant efforts of many in the past. My fondest hope is that we will keep that legacy untarnished.

PUBLIC TRUST AND THE INTEGRITY OF THE OFFERING PROCESS

I'll close these remarks with a brief word about one other matter that threatens municipal finance: questions about the integrity of the offering process, especially those surrounding the unsavory practice known as "pay-to-play."

We've made great strides in our efforts to improve this market, yet we find ourselves in a situation in which an internationally renowned financial magazine like The Economist can still refer to "America's notoriously corrupt municipal bond market," as it did on April 15th of this year.

The enormous power of the municipal market -- not to mention its popularity -- demands that it operate with complete honesty and integrity. And yet, I'm sad to confess that certain practices in the industry remain closer to the back-room deals and "honest graft" of George Washington Plunkitt and his ward captains in 1905, than to the full disclosure and unimpeachable integrity demanded by our markets in 1995.

In sentencing a defendant in a recent pay-to-play case in Florida, U.S. District Court Judge Roger Vinson called the facts of the case "symptomatic of a pervasive problem in government today. Government officials believe they are entitled to special treatment by lobbyists." Referring to the bribes, fishing trip, and numerous dinners given to the defendant by a local underwriting firm, Judge Vinson stated that such practices "corrupt the integrity of our government. There is no area where the temptation is greater than in the area of bond issues."

Several organizations of municipal bond issuers have adopted resolutions to address the problem of pay-to-play, and some jurisdictions -- Florida, for example -- have made the ban on pay-to-play a matter of law. I understand that both houses of the Connecticut legislature have adopted a bill that would bar contributors from doing business with the State Treasurer's office for four years after the contribution. The City of New York has also demonstrated leadership on this issue; in its recent request for services, the City asked potential counsel whether they disclosed their political contributions.

I hope you, too, will help us curb this insidious practice; public investors deserve a municipal market that is governed by the invisible hand, not the greased palm. I'm certain that if you lead, others will follow.

There's one other aspect of market integrity: Three weeks from now, we'll open a new chapter in municipal finance -- a chapter we wrote together -- as the first phase of secondary market disclosure takes effect. Before they bring an issue to market, underwriters will need to know that issuers have agreed to provide annual financial information, as well as notice of certain types of events.

I deeply appreciate your contribution in crafting the final rule, including the limited requirements for small issuers. Your leadership of the Group of 10 was exemplary. At the same time, I am disheartened and amazed -- as I'm sure you are, too -- that even at this date, even after Orange County, there remain some who question the need for additional disclosure. Full disclosure by issuers, like the prudent management of public funds, is a crucial aspect of public accountability.

My friends, as recently as a few years ago, for most Americans, municipal finance was a kind of sleepy backwater. The three subjects I've discussed today -- prudent management, public trust, and the integrity of the offering process -- would hardly have raised a stir.

Today, they've been catapulted into the headlines. Citizens have worked hard to pay their taxes, only to see them swept away like a losing bet on a roulette wheel. Investors have loaned their savings to municipalities in need of cash, only to see the very obligation to repay brought into question. And all Americans have seen the currency of public trust debased by bribery and graft. Throughout our nation, people are wondering, "How can such things happen in this day and age?"

They're right to ask the question -- because for all the progress the municipal market has made, many of its practices are far more appropriate to the past than to the future.

You and I can change that -- but we can't do it alone. For the sake of our cities, our states, and our nation, let's <u>continue</u> to work together to create a municipal market that's worthy of the 21st century.

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