“Preserving Municipal Market Trust --The Road Ahead”
Remarks by Chairman Arthur Levitt
United States Securities and Exchange Commission
New York State Government Finance Officers Assn.
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For some New Yorkers, there will always be only one Arthur Levitt. No matter what I may achieve in my own life, no matter what esteem I may earn, it will never approach the esteem with which my late father is still remembered in this town -- long after his 24 years as New York State Comptroller. I’m honored to be here today to talk about some of the same issues that concerned him so many years ago.

During his career as Comptroller, my father constantly pursued initiatives to improve financing practices in this State. He had an extraordinary appreciation for the pressures placed upon local finance officers. Addressing the Municipal Bond Women’s Club almost a quarter of a century ago, he remarked upon the magnitude of state and local government debt and the extent of the burden on the borrower, noting, “Our public requirements for capital facilities seem insatiable. At the same time the taxpayers justifiably demand a limit to their burden. . . Nationwide, borrowing in this area has increased almost fourfold in the last decade -- rising from $7 billion in 1960 to about $25 billion in 1971. It is questionable whether this rate of increase can -- or should -- be maintained during the present decade. But there is no doubt that the demand for new borrowings will continue to be high.”

Well, there may be those who disagreed with my father on any number of points, but he was not off the mark on the growth in borrowing -- by 1996, the amount of long term municipal debt nationwide had grown to more than $183 billion annually.

My father also understood the importance of disclosure -- and used his office to make available “a pro-forma Official Statement indicating what local governments can be expected to disclose about their finances and local economies when selling bonds and notes.” That was in 1977, when the purchasers of those bonds and notes largely were banks and other institutional investors.

Today, individual investors hold more than 72 percent of outstanding municipal bonds, either directly or through mutual funds. This fact alone should do much to explain the Commission’s focus on the municipal securities markets. In 1997, the holder of a municipal bond is likely to be a parent saving for her children’s education, or planning for his retirement -- or a person using a tax-exempt money market fund as part of a personal cash management plan. The holder may even live in the issuing community and desire exemption from state and local taxes, in addition to federal. But whoever the investors are, the law mandates, at a minimum, that the disclosure information provided them be free of misleading statements and omissions.

When I became Chairman of the Securities and Exchange Commission three and one-half years ago, the need for reform in the municipal bond market was obvious. There were conflicts of interest and practices, like “pay-to-play,” that would have stirred the envy of Boss Tweed -- practices that tarnished the reputation of the municipal market. Moreover, investors were deprived of continuing disclosure and price transparency -- basic information that is taken for granted in other markets. At the beginning of the twenty-first century, the municipal market appeared to be stuck in the nineteenth. And yet the importance of a healthy municipal market is well known to everyone in this room.

I knew about some of the problems from my own experience. Several weeks before I came to Washington, three young securities professionals came to talk to me about their career plans -- I always try to accommodate young people in that position. They worked in the municipal bond department of two major firms. One of them commented that the only way he was able to survive in the municipal bond business was by buying tables at political fundraising dinners, or by making contributions to officeholders in a position to award lucrative underwriting contracts. The others agreed this was common behavior. This practice is known as “pay to play.”

How terrible, that even the newest entrants into this very vital part of the securities business were being assimilated into this culture of pay-to-play. Little wonder that confidence in government is at such a low ebb today. This experience convinced me to try to change the practice, before it could be ingrained in the minds of a generation that will soon be the leaders of the industry.

When I came to Washington, I had a long talk about pay-to-play with Frank Zarb, one of the wise men of Wall Street. Frank suggested a voluntary ban on political donations by firms seeking underwriting business, and was able to persuade key people in the industry to sign on. This was the catalyst for a cultural shift that took place almost overnight and has since been reinforced with MSRB rule G-37.

The Board followed with a rule that shed light on consulting arrangements in the municipal market. It required written agreements between dealers and consultants who were retained to obtain municipal securities business. It also mandated the disclosure of such arrangements to issuers and to the MSRB.

One dealer challenged the Board’s rule forbidding pay-to-play on first amendment grounds and was rejected by the courts. Last March, the Commission brought its first proceeding for violation of this rule; our action against FAIC Securities, Inc. of Florida resulted in penalties and disgorgement in excess of $400,000.

There is more work to be done before the fight against pay-to-play is won. Lawyers, in particular, must take steps to sever the tie between political contributions and bond counsel work. The practice is almost impossible to defend -- it undermines the independence and credibility of bond counsel; it gives the appearance, if not the reality, of unethical conduct at best, and political corruption at worst. What a positive statement it would be if the lawyers were to raise themselves to the same standard of ethical conduct as the bond dealers. The Association of the Bar of the City of New York would like to do just that, by changing the disciplinary rules in New York State, and by asking the American Bar Association to consider similar steps later this year. How proud we would all be, to see the State of New York continue to lead the way.

We've made progress on other fronts -- with the help of other measures crafted with the cooperation and guidance of the issuers, underwriters, and investors who make this market work. Only a few years ago, for example, information about the issuer of a given municipal security was hard to come by. Today, not only do investors purchasing most newly offered municipal bonds receive a copy of the official statement, they also have continuous access to financial and other material information contained in central repositories -- a framework for disclosure established in partnership with muni market participants.

Three years ago, trading information for municipal bonds was beyond the reach of the average investor. Starting January 1st, price and volume information for retail trades of municipal securities will be publicly available within 24 hours through the MSRB's Price Transparency Program. In addition, the Program will provide regulators with a centralized audit trail of municipal securities transactions.

The last few years have also brought more than twenty enforcement actions by the Commission in connection with the offer or sale of municipal securities. These actions have involved virtually every market participant: national and regional underwriting firms, national and local financial advisory firms, employees of those firms, bond counsel, underwriters counsel, consultants -- and even issuers and elected officials.

The basic rules needed to reform the municipal market are now in place. We've worked hard with you and others to reach this point. It's up to all of us to do our share and make these measures work. For our part, you can count on the SEC to work with you to make sure issuers and others understand their obligations under the securities laws -- as we did last year in preparing the booklet "Questions to Ask Before You Approve a Bond Issue."

Issuers, for their part, are primarily responsible for the disclosure in their offerings. They must live up to that responsibility by providing accurate and complete information to investors. When an issuer fails to meet this serious obligation, it should surprise no one to see us take action, as we did in Orange County, California.

Even with the new measures we have put in place, regulation of the municipal market is limited, compared to other markets. Brokers and dealers are obliged to have a reasonable basis for the recommendations they make to their customers, to deal fairly with them, and to avoid conflicts of interest. We'll be monitoring dealer compliance through our Office of Compliance, Inspections and Examination and we expect the self regulatory organizations to do the same.

All persons who participate in a municipal securities transaction should now understand, if they didn't before, that they are prohibited from making material misstatements or omissions in connection with the offer, purchase or sale of a security. It should now be clear, if it wasn't before, that the antifraud provisions of the securities laws will be vigorously enforced in the municipal market as in every other market. The problems we continue to look at range from simple failure to disclose material information to pay-to-play practices and more complex problems like yield burning.

No change of this magnitude can be expected to go perfectly smoothly -- there will always be bumps in the road. Those bumps do not mean, however, that our direction will change. The road thus far has been surprisingly smooth. The bumps we've encountered point to a need for better communication.

Here's a good example: Some investors have complained that issuers, on the advice of their bond counsel or financial advisors, have reduced information flow to the minimum required under rule 15c2-12. Any such advice would be simply wrong-headed. Disclosure is the cornerstone of a healthy market. Our measures were put in place to move those at the back of the disclosure pack forward, not to allow those at the front to drop back.

There have been a few surprises along the way. This, too, is to be expected. Three years ago, when we set out on the path of reform, no one expected a general obligation issuer bankruptcy of the magnitude of Orange County. That experience carried its own important messages for issuers of municipal bonds. The need for great care in management of public funds is as important today as it was in my father's time. Over the last two years, Treasury Secretary Rubin and I have carried that message to municipal finance officers throughout America.

The Orange County bankruptcy reminded us that the municipal bond market is based upon trust -- and trust is won with difficulty, and easily lost. Trust erodes each time Chapter 9 is considered as an alternative to responsible but unpopular decisions to fulfill the obligations incurred by local governments -- such as making payments to bondholders.

There are also more subtle ways to erode trust -- such as the disturbing use of "eminent domain" calls by some issuers to refinance outstanding debt, callously breaking faith with their bondholders. A handful of small issuers have tried using this strategy recently, as an end-run around restrictions that otherwise prevent them from calling their bonds. These townships don't demolish public buildings -- but they do demolish the public trust.

Such short-sighted maneuvers jeopardize the municipal market's hard-earned reputation for credit quality. That reputation assures issuers of a receptive market for their offerings and thus an efficient source of funds. If commerce runs on certainty and contract, it follows that the most harmful thing that could happen to our markets is to breach that trust. The resulting skepticism erodes trust for all. "Eminent domain" deals may save issuers a few basis points -- but they come at the cost of the investors who bought the original bonds, not to mention the market itself.

It should be obvious by now that I inherited my father's passion for disclosure as well as his belief in the importance of the municipal market. I like to think that I also share some of his sensitivity to the concerns of local governments. I know these matters are close to your hearts as well.

The trust on which the municipal market is based can only be preserved by responsible action -- your responsible action along with that of every other participant in this market. The reform measures we have together put in place should help reinforce that trust. But the rules alone will never secure trust -- only the continuing responsible actions of all participants in the municipal market will preserve the bedrock of investor confidence on which these securities depend. I thank you for your leadership and support on many of these issues -- and I look forward to continuing to work with you for the benefit of American municipalities, American markets, and American investors.

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