

FIRESIDE CHAT: MUNICIPAL SECURITIES

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DONALD LANGEVOORT: Good afternoon. I'm Donald Langevoort, professor of law at Georgetown University and host of the Fireside Chats of the Securities and Exchange Commission Historical Society. The Securities and Exchange Commission Historical Society is a nonprofit organization separate from and independent of the SEC. The Society preserves and shares the history and historic records of the SEC and of the securities industry through its Virtual Museum at www.sechistorical.org. Today's chat will be preserved in the museum so you can listen to the discussion or read the transcript later.

Today's Fireside Chat looks at the regulation of municipal securities. Our guests are Michael McCarthy, chairman of the Bond Market Foundation and former head of Public Finance for Goldman Sachs and Company, and Christopher Taylor, executive director of the Municipal Securities Rulemaking Board since 1978. Our remarks made today are solely our own and not representative of the Society. Our speakers cannot give investment or legal advice. We want to thank the Bond Market Association for sponsoring today's Fireside Chat.

Mike, let me begin with you. You've been in the municipal bond market business for some 30 years. How has the municipal bond market changed since you entered the industry? What's different about today from the mid-1970s?

MIKE McCARTHY: Well, just about everything is different, Don. When I started in early 1976, it was really a tiny industry, very low issuance volume. We're guessing -- Kit and I were talking about that earlier today -- maybe \$25 to \$50 billion a year versus last year, \$380 billion. It's certainly had its ups and downs in the time periods since then, but that gives you an idea of the general growth of it. It also is a business back then that was dominated by competitive sales rather than negotiated underwritings, competitive bidding, and as a consequence there were very few public finance professionals in the business. I'm guessing 50 or less when I started, and now that would be a small, one small firm would have 50 professionals.

There was also very little regulation -- today's topic -- at that time. They were just generally under the purview of the SEC, but MSRB was just coming into being, partly in response to the New York City and

State crises, and it was a pretty, pretty wide-open business, and it's still a business where there's room for a lot of creativity but now it's fairly heavily regulated.

DONALD LANGEVOORT: What about the investor base? Has that changed remarkably to a more retail investor orientation?

MIKE McCARTHY: Yes. There are certainly -- it's certainly a market that's dominated by retail investors now. Back then it was the banks and the insurance companies were the biggest investors and you really didn't have a mutual fund industry to speak of. You had unit investment trusts but you did not have the big kind of open-end funds that you now have that are dominant buyers or have been at various times. And in any case, they are proxies for individuals in any case. They buy like institutions but they're busying for individuals, buying municipal bonds for individuals. But way back in 1976, it was bank trust departments, banks for their own portfolios, insurance cap, property and casualty insurance companies. Those were the big investors.

DONALD LANGEVOORT: And I take it it's largely investors who began to look at the tax savings associated with municipal bonds who started coming into the market and brought a new set of opportunities to the business.

MIKE McCARTHY: Well, I think municipal bonds were probably always bought by people that had to pay taxes, whether they were banks paying corporate taxes or trust departments on behalf of individuals who were going to pay taxes. They don't make a great of sense to invest in if you're not a taxpayer, and for that reason you don't have pension funds or corporations that don't pay tax buying municipal bonds.

The other major thing that happened in this industry was the growth of the money market business. There was no money market business to speak of other than the somewhat disreputable business of selling notes made disreputable [chuckles] by New York City back then, notes that there was no way to pay them off other than selling new notes. And when you were shut out of the market, then there was no way to pay those notes. But the business grew from, say, 1980 from a couple of billion dollars to hundreds of billions of dollars now of outstanding tax-exempt instruments that are sold to short-term investors.

DONALD LANGEVOORT: What about changes in the kinds of instruments or the kinds of securities being sold by municipalities? The story of the industrial development bond and those kinds of bonds was a big

part of securities regulation as it's looked at this issue for a long time. Has that, has the type of issue that you've seen changed?

MIKE McCARTHY: It has, but not as greatly as you might think. I mean, there were certain types of issuers that gradually over one tax act or another over time, especially in the '80s, were precluded from selling tax-exempt bonds as it was thought to be an abuse of the value of the tax exemption, but the primary issuers are the same. You still have the states and cities and counties on their general credit, and then you have housing bonds and electric utility bonds and water bonds and school district bonds that are still the mainstays of the market.

DONALD LANGEVOORT: Well, let's turn to the regulation issue, and you put your finger on it before. Prior to 1975 or prior to the mid-1970s, it's fair to say that securities regulation took a hands-off approach to municipal securities. I think the story is told in the drafting of the Securities Act of 1933 that James Landis had in early drafts a provision that would have made municipal and government issuers subject to the act. He said in a letter the mayors of the country rose up en masse and pretty quickly that dropped out of the legislation that ultimately became law, and so I guess for decades really municipal securities regulation was not a subject that received a lot of attention.

And then in 1975, Congress made significant amendments to the securities laws that among other things created the Municipal Securities Rulemaking Board. So I guess the basic question is what happened? Is it a story about what went on in New York City? Kit, why don't you tell us that story?

CHRISTOPHER TAYLOR: The story starts in the early '70s, because what was happening then was that there were a lot of people coming back from the Vietnam War with accumulated monies and the like, and there was even growth in the volume of issuances from what it had been in the last '60s. And the types of issuance that was going on at the time had led a number of dealers to offer bonds that were in some cases actually nonexistent projects against nonexistent projects and the like, and they employed some very high-pressure sales techniques with people, and this really was what led the Congress to adopt the '75 Amendments. Those amendments -- and I think it's important to point out -- only cover regulation of the dealers of municipal securities. They don't cover the issuers of municipal securities, and when you made mention of Mr. Landis and the like, one has to point out, in this context anyway, that the '33 Act never applied to of municipal securities, and the '34 Act didn't apply until 1975 when we were created.

DONALD LANGEVOORT: So what is the connection between all the publicity that was going on with respect to New York City and the emergence of regulation of the business?

CHRISTOPHER TAYLOR: Actually, the legislation was being passed in Congress. I think it was actually passed in June of '75, and the first board met in September of '75. And if one goes back and looks at the New York City crisis, it was happening right on top of that. In fact, I've heard stories of the original board members actually meeting and spending some time on MSRB business and then having to sit down and talk about the New York City crisis because some of these people were very prominently involved in resolving what was going on in New York City at the same time.

DONALD LANGEVOORT: Talk a little bit about -- either of you -- about that New York City crisis, what happened and what lessons did that produce for both the industry and regulators. What was surprising and what lessons were learned?

MIKE McCARTHY: It missed me by about one year. I started in the business in February of 1976, so it had just happened and was still happening, but I will admit to not having a great idea of what was going on around me at the time. Just as, you know, a person on the scene though in living in New York City, it was very intense what was going on. It called into question a lot of the ability to borrow short term, as I mentioned before, and that became very, very difficult to do for any issuer. And certain states and cities that had come close but not fallen quite as far as New York City at that time were penalized in the marketplace via their interest rates had to be paid for years after that. So it, I think it had a very salutary effect on many issuers and the end dealers. The dealers realized that they had to step up and make sure that the disclosure on these situations was adequate. And I think the growth of the industry at the same time put a big premium on training people and making sure they understood what they had to do to make sure that they were fairly presenting bonds to investors.

CHRISTOPHER TAYLOR: It was also interesting, and maybe not so much on the question of how it affected regulation, but it was one of the few instances where you see a market close on an issuer because of their financial situation. In the Fall of '74 the city did a bond deal and it came out on syndicate price restrictions and dropped ten points within a day, and that sort of precipitated the crisis. And then there was some short-term debt that they wanted to issue in early '75, and they really couldn't get that off the ground, and all of a sudden the market shut. I don't think -- I can't think of many other instances even since then where markets just shut because of a lack of investor confidence in the whole process. It's not something that one really wants to see.

It was interesting because I think that because legislation was working its way through to create the board and to establish a system of regulation, it gave some confidence to people that, okay, there was going to be at least dealer regulation down the road. We didn't have to sort of suddenly have this crisis and suddenly try to figure out a scheme of regulation at the same time.

DONALD LANGEVOORT: I'm sure the political issue was very contested as to whether to go beyond dealer regulation, as we saw in the '75 Amendment and address that basic question, should issuers have some responsibilities here. In fact, the Tower Amendment that appears in the '75 legislation goes clearly in the opposite direction and says [laughter] that's not something we're going to see in securities regulation.

CHRISTOPHER TAYLOR: Oh, absolutely. And for the benefit of everybody listening, the Tower Amendment basically says that neither the SEC nor the MSRB can adopt any regulations which require issuers to provide information to the market presale. And another aspect of the amendment says the SEC can do post-sale production of information or post-sale production of information but the MSRB cannot. So the MSRB is clearly taken out of the role of being involved directly or indirectly in providing the market with issuer information. The SEC has very limited extent. But I think one has to contrast this certainly today in the context of what regulation looks like, because on the corporate side the accountants are regulated, accounting principles are regulated, lawyers are regulated, the issuer has direct regulation, and you have this whole -- all the way down through the dealer community. Trustees, paying agents, all in the corporate side, everybody is regulated, but on the municipal side the only person that's regulated are the dealers. So all of the problems of regulation flow through the dealer community.

To get back to your question of gee, was it discussed? Oh, yes, it was discussed and debated, and that's why the Tower Amendment was put in place by issuer groups to make sure that it didn't, the MSRB's creation didn't extend over to issuer regulation. Subsequent to that there were a number of bills put into Congress all the way up to 1979 calling for at first direct issuer regulation, accounting regulation, various cuts at this whole thing, and there was even an attempt in the early '80s to do this. But as you pointed out, the mayors tended to rise up and strike, and the last one was in the mid-'80s when John Dingell proposed somewhat the same idea of some sort of issuer regulation, and they rose up and six weeks later he cooled that legislation [laughter] very quickly in view of what was strong opposition.

DONALD LANGEVOORT: Yes, it's an interesting political story. Keeping in that same time period, obviously, we now have the creation in 1975 of the Municipal Securities Rulemaking Board. I suspect many people listening to this conversation have little idea where the MSRB fits in the scheme of self-

regulation in the securities industry, ways in which it's like the NASD or some of the other self-regulators, ways in which it's different. So give a little lesson in that.

CHRISTOPHER TAYLOR: Well, we are certainly the oddball. We are the first and only congressionally created self-regulatory organization, the others being, the most prominently known, New York Stock Exchange, NASD, all the regional exchanges. They are all sort of private organizations that fell under a portion of the act. They met certain requirements in the act and so they became self-regulatory organizations. Congress said, "You will exist and you will do this."

The one thing that they did do at that time which was very different, and it was partly the structure of the industry, banks were very involved in the municipal securities business and as were securities firms, and yet at the time Glass-Steagall separated banks' activities with regard to the securities market, so a compromise had to be found to deal with the involvement of banks. So the board itself reflects a lot of the political situation at that time, and there's some validity even today on that composition: five banks representatives, five securities representatives, and five public members. We were the first SRO to have mandated public members, although they were only a third of the group.

The other part of it was, we have no examination and enforcement powers, unlike the other SROs who not only wrote rules, ran markets, but then they enforced their rules for their own markets. We only had the power to set standards. We set standards for the industry, and I think that's what separates us from a lot of the SROs. We don't run a market and we don't have a market mechanism like the NASDAQ or the New York Stock Exchange floor. We just write the standards to which dealers are held.

DONALD LANGEVOORT: And things like surveillance, inspection, enforcement gets parceled out to other self-regulators?

CHRISTOPHER TAYLOR: Yes. The NASD does it for securities firms involved in the business as well as the three federal bank regulators. And in effect, it was an anomaly that, it was a certain amount of amusement in the early days of the board because we basically wrote banking law. Here was a private organization writing banking law and our rules had to be, in draft form, had to be sent over to the bank regulators. They would comment to the SEC in the early days, but the SEC had the final say as to whether the rule went into effect as they do today.

DONALD LANGEVOORT: Did that work out? Certainly during that time and much since there's been somewhat of a different philosophy in the bank regulators about things like disclosure and how you go about regulating the industry compared to what you see in the securities business. Was it awkward to have to deal with two separate enforcement arms and two separate philosophies?

CHRISTOPHER TAYLOR: There were times when you really did see that difference come through, and the banks taking the approach of safety and soundness which was a basic overall philosophy and would look at the whole, and less concerned with what I would call consumer protection type of regulation which is mostly what securities regulation is aimed at.

There were lots of debates back then because, as Mike pointed out, the business then, the customer community were basically institutions, and so there was a very strong tug-of-war to whether or not the board should be writing true sort of customer regulation, if you will, that you saw the exchanges doing, or whether we should take much more of a hands-off approach. Parenthetically I should note that I wrote some of the comment letters written by the Federal Reserve in opposition to early MSRB rules for the same safety and soundness. "Gee, this regulation is too much."

MIKE McCARTHY: Hard to believe.

CHRISTOPHER TAYLOR: Yes, I know. I was looking over at Mike at that time. But, in fact, it is a difference in approach, and it still exists today to a large degree.

DONALD LANGEVOORT: Now, not to jump too far ahead in our history because we have a lot of things to come back to, but Glass-Steagall did finally meet its demise pretty much in the Gramm-Leach-Bliley legislation, and we have a much different philosophy of how the financial services industry is regulated. Has the MSRB's structure and philosophy been updated to reflect the regulation?

CHRISTOPHER TAYLOR: Gramm-Leach-Bliley did remove Glass-Steagall but in the intervening time one of the things the board did was write a rule called G-37 on political contributions. And the reach of G-37 in the context of the modern financial services industry or the current financial services industry is such that it goes all the way to the top of a securities firm, but when that securities firm is part of a bank holding company it does not extend to the bank holding company or its operations. And as Mike and I were discussing earlier over lunch, there is a debate even today about whether banks enjoy an unfair advantage within the municipal securities business because of G-37 or not. So the issues of banks versus

securities firms that started out in the early days of 1975 are still there today, that there are differences in the way in which the organizations approach issues.

DONALD LANGEVOORT: Do you think if the MSRB were being reconstituted today you'd see the same kind of 5-5-5 structure?

CHRISTOPHER TAYLOR: I hesitate to speculate where Congress would be. In the current atmosphere I wouldn't be surprised that you would see the SEC or others arguing for a majority of public members, but I think you would have to look -- you'd probably have a fairly even split between the other two, again, for the G-37 issue which is a very strong -- it is one of the big topics we talk about.

DONALD LANGEVOORT: I want to come back to sort of play through the history. We've now created the MSRB in the late 1970s, and the New York City crisis focused a lot of investor and public attention on this market. As we move onto the 1980s, I want to look at some of the stress points there, and I guess in the public's eyes the next big event that shook the industry is Whoops [WPPSS], the Washington Public Power Supply System. Mike, what was that about, and again, I'm going to ask you that same question. What surprises did it provide, what lessons did the industry learn from WPPSS?

MIKE McCARTHY: Well, I guess we learned that running five nuclear power plants is probably not a very good idea, but that's a pretty specific thing. I think that again it came down to disclosure, how much was the issuer and its advisors disclosing to the investors, and to the underwriters for that matter, about what was going on at WPPSS. Later on you can ask the same thing about Orange County and any of these situations. They tend to all come back to was, did anybody really understand what was going on? If they did, did they really explain it in a way that people could assess the risks?

WPPSS was a very interesting situation that most, almost all of the bonds that WPPSS sold -- and they sold at competitive bidding -- they did not have underwriters in there poking around asking questions, you know, doing what they do, and their counsel in their doing what they do trying to find out what happened, what was going on.

Now, you might argue -- and I think many of us would argue -- that we shouldn't have bid on those bonds, the dealers shouldn't have bid on them if they were not confident about that, and that's pretty clear, but they did. But the disclosure obligations at that point really had to be with the issuer and its advisors, the bond counsel and engineers, and it just wasn't adequate is what turned out. And I think

people have tried to make sure after that, again, that they were not going to be fooled, that they were going to make sure that they had all the information they needed, and if they didn't hopefully some of us decided not to bid if we weren't sure. You know, when in doubt don't bid. Don't just bid because it's big and it's out there and you might sell it. That's not a very good idea, as it turns out.

DONALD LANGEVOORT: I'm curious whether is one of the things that happened as a result of WPPSS was extensive private litigation. We had learned in the 1970s that Rule 10b5, the basic anti-fraud provision of the securities laws, certainly did apply to the issuance of municipal securities. With WPPSS I was told recently -- only I'm not totally sure it's accurate -- that it still stands as one of the small number of largest -- one of the largest settlements in the history of class-action litigation against which even today's Enron and WorldCom things are measured. Was there a different perception after New York City and WPPSS that this was really a litigation-sensitive issue, that you had to worry about class actions and things like that in a way that you might not have before?

MIKE McCARTHY: Not that I'm aware of, Donald. There may have been that awareness that some levels of the firms, perhaps the general counsel's office. Now I think the thing that the firms were aware of was that they had just better be very, very careful about what they bought and what they sold and what was disclosed, and that general awareness has lasted through to today, I would say. It's true. I mean, there's nothing like a couple of big bankruptcies or defaults on the payment of bonds to make people pay more attention and be a little smarter about -- less greedy and more smart about what they're doing.

CHRISTOPHER TAYLOR: I don't think, Don, that people really focused in the market, focusing on the private litigation aspect of it because everyone in the bond business sort of typically believes that if there is a default there is going to be a suit to recover because it is debt. So I think it's hard to compare it with an Enron or a WorldCom or some of the more recent stuff where you're really dealing with equity and you're trying to prove that there was some sort of other kinds of fraud going on through the whole entity. It was really everyone in the bond business believes that these are contracts, and so the question is how do you resolve a contract and who knew what when, and it was not uncommon to have kind of litigation for that. Yes, it was a big thing.

I think the more interesting part about WPPSS was, as Mike pointed out, it goes back to disclosure. We'd had, if you think about sort of the timing of things, you had the '75 New York City crisis which actually played itself out over a four- or five-year period into the early '80s. And then right as that was ending you have the WPPSS default, and then that played out over six or seven years, culminating in the SEC adopting Rule 15c2-12, which by 1990, that didn't come into place until 1990. And this is 15 years after

the board was created which said a dealer could not bring an issue to the market without there being an official statement which is like a corporate prospectus. I think -- and I'll let Mike comment on this -- that always, 15c2-12 always sort of makes dealers feel a little funny because it's a requirement on dealers for an issuer to come up with a document.

MIKE McCARTHY: Sure.

DONALD LANGEVOORT: We'll come back to that in a minute. What were the issues in the '80s, from your perspective? What were you worrying about at the MSRB?

CHRISTOPHER TAYLOR: Oh, there were several things. One, we had just put in the basic set of rules, so in the early '80s there was a lot of refinement of those rules. As Mike pointed out, the volume was growing very rapidly, lots of new types of debt coming in there. Housing bonds were a big deal. They had a thing called extraordinary calls or unexpended bond proceed calls, and what we found by the mid-'80s is that there were a lot of deals being sold for which investors were not getting complete information. And we actually proposed a rule in 1986 that said, look, dealers have to disclose call information.

Well, it turned out, we found out in the course of the comment period that dealers did not have access to call information. That information would normally be found in a prospectus or an official statement, and yet there wasn't that kind of thing, so you had two forces coming together. You had the WPPSS business going on and people saying no disclosure there, and we're seeing a lot of other problems again focused in on what's the deal, what's the basis of the contract, you know, what's the financial status of the issuer, and what are the characteristics of the deal? And they came in, they came and culminated in 1989-1990 with the adoption of 15c2-12.

DONALD LANGEVOORT: What was the industry's attitude to that? Was the industry supportive of -- I understand that it does seem like an end run to say it becomes the underwriter's or the dealer's responsibility to get issuer disclosure, and given the Tower Amendment one can see why things are structured that way. But in the aftermath of WPPSS and the other issues that you're talking about and the growth in the retail side of the business, was there a perception that some formalized disclosure system was needed?

MIKE McCARTHY: Well, keep in mind that before and after 15c2-12, most, almost all issues, had official statements at the time of the issuance of the bonds anyway. I think the community as a whole -- the

issuers, dealers, lawyers, investors -- all believed that you should have that, you needed to have it, and they need to be very good. Things like WPPSS would just raise the bar in terms of making sure that you had it right, but I don't think there was any real debate about whether it's a good idea to have a disclosure document. Of course it is, and very few people would disagree with that. I mean, one little piece of the deck in corporate shelf registrations were happening, and we felt that for high-quality municipal issuers you ought to be able to go in and just sell a couple hundred million dollars worth of bonds of a known credit without printing an official statement beforehand. And there was a lot of, you know, there was a lot of creativity about how to meet this requirement, and it was done in the right way, I think, but it did hold you back a little bit.

The other part of this question, it was quite awkward at times to have the requirement be on the dealers for the disclosure and yet the issuers had to produce most of the information, and it was back also the Tower Amendment. The dealers, if you could ask them privately, would probably say, "Get rid of the Tower Amendment," or would have said it, but all of their clients didn't want that so no one could say that and didn't say it. I think that the dealers were often put in the middle. We were the lever that was used to regulate the industry, and being a lever can be pretty uncomfortable at times.

CHRISTOPHER TAYLOR: I think one has to sort of also keep in mind that -- and I want to separate what investors were wanting and what was coming out of WPPSS which was tell us about the status of the issuer from what the MSRB wanted at that time, which is tell us what the characteristics are of the bonds. Tell us when there's going to be a call feature. Tell us the circumstances under which that call will take place. Those are sort of fundamental things that are necessary for an investor and even a dealer to properly evaluate pricing, and we knew that that wasn't that kind of basic information available to the whole dealer community. Some dealers, as Mike said, there were official statements out there but some dealers had access to them and others didn't, and what we were sort of pushing for was universal access to the basic characteristics of the information.

I think it's probably a good point, Don, to also, since we're in the '80s, to point out one of the fundamental things that happened which was the Tax Reform Act of 1986. It sort of overlaid our concerns, WPPSS, and everything else was the Tax Reform Act of 1986 which said, oh, and by the way, banks no longer enjoy quite the tax advantage. Kicked them out of the market. Alternative minimum tax was put in on property, casualty insurance companies, and overnight the industry started to gravitate very strongly to a retail customer base. So now I think we're often called one of the markets that is predominantly retail, even more so than even the equity markets.

DONALD LANGEVOORT: 15c2-12, which came in the late '80s, was that a response to any other scandals? To get the SEC to do something as dramatic and back-doorish as that usually takes some strong political pressure, and I guess --

CHRISTOPHER TAYLOR: That was WPPSS.

MIKE McCARTHY: That was purely WPPSS.

CHRISTOPHER TAYLOR: Even though it took a while to play out.

MIKE McCARTHY: Yes. I think that was WPPSS. That's how I remember it.

DONALD LANGEVOORT: Were there perceptions of abuse as the industry gravitated and needed to make up its market? Did the '80s see other?

CHRISTOPHER TAYLOR: Not really. Not of that kind of magnitude. I mean, WPPSS, as you pointed out, one of the biggest settlements of all time. It was getting -- people were going to Congress, there were hearings on it. There was a lot of pressure put on the SEC to produce the WPPSS Report. They did come out with a WPPSS Report. It was several volumes, as you may recall, and that's really what was the pressure behind 15c2-12, and I don't think there really was any other specific instance that I can think of.

MIKE McCARTHY: Well, no, I can't think of any, but no doubt there were plenty of instances where inadequate disclosure was made. And it may not have cost anybody any money in the long run, but there are different levels of care and competence in the industry among the dealers and sophistication among the investors. So the quality, there is no uniform quality -- still isn't, really -- of disclosure in the business.

CHRISTOPHER TAYLOR: Going back to the political aspect as well, I think one has to bear in mind what the SEC's perspective was on all of this, which was, here they had just gotten done with the New York

City Report, and there was real questions about disclosure in that aspect. Then you turn around and WPPSS comes along, so you have two of the biggest at the time, biggest defaults of all time in the securities markets happening in the new area, all centered around disclosure. Nothing was there, and so 15c2-12 I think was the response to that.

DONALD LANGEVOORT: Now we move to the '90s and a number of events, I suspect, ought to be the subject of our discussion. You've already touched on one of them, the pay-to-play issue that culminated in the adoption of G-37. In many of the books about securities and securities regulation in the 1990s, Arthur Levitt takes a lot of credit for pushing that issue and moving it forward. I guess I think it deserves some stories from you. How did G-37 start out? When did that issue of dealing with potential for corruption in the way that the bond business is allocated start coming to the board's attention?

CHRISTOPHER TAYLOR: I'll start with 1991. We actually published a notice in 1991 to the whole industry saying that the board had observed political contributions beginning to play a role or what appeared to be playing a role in the selection of underwriters, and that the board was in a sense raising the flag at that time and saying if there wasn't a change in behavior the industry could well expect the board to take further action.

The board did do by 1993, and I'll go at least as far as I know the events. In May of 1993 we announced to the industry that we would be discussing that at our July meeting. We discussed it at our July meeting, and on August 4th, 1993 held a press conference, announced that we were going forward with a draft rule called Rule G-37 on political contributions, and that we intended to publish it by the end of August. Overlaying that, with no disrespect to Arthur, was the fact that he was going through Senate hearings in July and confirmed in early August. And if you look at the SEC's testimony in September of 1993, because we were actually called up to testify as a result of a series of articles that appeared in the popular press that summer, we were asked to testify about what we were doing about political contributions playing a role in underwriting.

The SEC's testimony basically said, "We're not sure the board has the authority to write a Rule G-37," and sort of said the board's on their own. We went ahead and adopted the rule, got comment from the industry, revised the rule, finally filed it with the SEC. Arthur Levitt did get behind and supported the idea and helped push through the approval at the Commission, and I think the rest, as they say, is history in some sense. It is a very different rule than most rules in the securities industry because it contains its own penalty. Anyone making a political contribution, you're allowed to do that, but if you make it beyond certain limits then you are not allowed to do negotiated underwriting for a period of two years from the contribution.

There's no violation of the rule. That's always misunderstood. There's no violation of the rule for making the contribution and not doing business. The only violation comes when you give the contribution and do do business.

MIKE McCARTHY: Right.

CHRISTOPHER TAYLOR: And it was a very controversial rule. Mike, maybe you can give some perspective on how it was received in the industry.

DONALD LANGEVOORT: And Mike, go back a little bit to how the issue of fair competition in getting bond business was viewed within the industry before G-37.

MIKE McCARTHY: Just to put it in a couple different perspectives, when I first started out in the business, I don't think this was an issue at all, partly because the switch over to doing mostly negotiated sales gradually took place and it started to build up in the early '80s, and there it became a question of underwriters being selected by the issuer rather than bidding for something.

DONALD LANGEVOORT: Why did that take place? Why did that change toward negotiation take place?

MIKE McCARTHY: Because the structures got more complicated and the ability to, the flexibility inherent in a negotiated sale was just superior in most cases to a competitive sale. If you had something that was very well known and very kind of plain vanilla looking, where everybody understood what they were getting, you might, if you caught a good market, get a better deal in a competitive sale, a straight-up competitive sale. And in a negotiated sale you got all the flexibility of the structure right up to the last minute and change it really during the marketing period, so there were a lot of reasons for it and there was a lot of competition for this business, a tremendous amount of competition, and by that time a lot of people in the business. Remember I said that we started out, I wasn't sure there were 50. Well, you know, by the time of the '86 Tax Act there were probably 500 people in the business, and there was a lot more business but still, the ratios had changed.

And so there was a lot of competition. Most of it, I think, was competition based on ideas and client coverage and the things that you would want it to be in a really ideal world. Some of it for sure was based on just political considerations, not necessarily contribution but friendships, relationships. And frankly, the way almost all business is given out -- by governments, at least -- is based on relationships and friendships and price, but all of these things come into the mix. It's not just one.

The request for contributions from issuers began to build, and as the dealers agreed to do it and the other people could see that that was happening, it built very rapidly until by the end, I would say, that it was really quite remarkable. It was an unhappy thing for us to have to deal with all of these things. You on the one hand want to show support for your clients, on the other hand you don't want to be in this position all the time. So G-37 was quite unpopular with our clients for obvious reasons but was less unpopular maybe with the dealer community depending on who you were and what the exact situation was. It was a very good thing to have everybody be in the same boat and not be able to -- to not be asked and not be basically able to make those contributions.

It was not a good thing where you had people that you would support, that you genuinely wanted to support, and you could not. You felt that your basic rights as a citizen were being impinged on a way that didn't happen to other people doing business with the government, with local government.

CHRISTOPHER TAYLOR: Which ultimately led to First Amendment litigation regarding G-37.

MIKE McCARTHY: Correct. I know it was upheld, but it still doesn't necessarily make people feel that it was fair to them in all cases. But it's -- and just part of it is, all of the other vendors that deal with state and local governments are not. None of them are included under a rule like this, and so you're definitely standing out in that situation.

DONALD LANGEVOORT: So the political battle was with the issuer community largely?

CHRISTOPHER TAYLOR: It started out --

MIKE McCARTHY: Well, some dealers on behalf of their clients as well.

CHRISTOPHER TAYLOR: And I also think G-37 is a very tough rule because the penalty is so severe. And the board chose a very severe penalty because it was viewed as the only way to make sure that there was a fundamental change in dealer behavior, that there wasn't some quick end runs around the rule. And so putting a two-year ban was put in place to say, "This is going to be severe and this is going to be a big deal," and there were some very highly publicized two-year bans. We had a board member, a sitting board member, in the midst of a \$300 million plus deal suddenly have to withdraw. He was the lead manager. They had discovered a political contribution and he had to withdraw, and that sort of thing does send a very clear message to the industry that that sort of thing will not be tolerated.

DONALD LANGEVOORT: Now, Mike pointed this out a minute ago. There are other people who do bond business besides municipal securities dealers and G-37 only relates to them. One of the spillover issues was should this philosophy be turned on lawyers, advisors and others who might be in the same position. Do you have a sense now, either of you, that the outcome of all this, which is severe regulation with respect to dealer, more softer standards -- be they active in this area with respect to lawyers -- has created an even playing field or has it just been something of an earthquake that shifts the balance of power somewhere else?

MIKE MCCARTHY: Well, I think in the end, the only reason that it's just the dealers is that we're the only ones who are directly regulated. That's the simple answer. And I think it doesn't work on a voluntary basis, so I don't understand how it is that other people are eventually going to be covered by a similar rule. It's on a federal basis, maybe state laws state by state, but the people, frankly, that are passing the laws have no interest in, you know, very little interest in passing these kind of laws, and it's not because they necessarily have poor motives. They don't view it as corruption. They view it as the way the world works, and indeed it is the way the world works, and so I don't blame them for taking those positions.

But I think it's just going to be the dealers. I think there are always questions around the edges about, as Kit mentioned, about dealer banks or the holding companies of banks that own dealers. There are questions about consultants that you hire that are not covered by the rule. I'm not in the industry now, but I understand this from Kit that this is a hot topic, and so as much as you try to cover it, there's always going to be things at the fringes that you can't quite get, and I'm sure that will be the case with this rule.

DONALD LANGEVOORT: As we move into the 1990s, we have one more high-visibility scandal, Orange County, as well as yield burning and a variety of other things that made the news. I guess from a regulation perspective, one of the big issues was continuous disclosure in the bond market after the offering circular is prepared and how you can go about providing issuer-specific information to investors

on an ongoing, real-time basis. 15c2-12 was amended in the 1990s to create a further obligation on the part of dealers to educate, and I guess the MSRB has played a significant role in the area of gathering and making information available through repositories.

CHRISTOPHER TAYLOR: Well, we've tried, anyway.

DONALD LANGEVOORT: Okay. Talk about that a little bit.

CHRISTOPHER TAYLOR: Going back to the first, the original adoption of 15c2-12, once dealers were required to come to have an official statement in hand when they did a new issue of municipal securities, we turned around and required the dealer to send us a couple of copies, and we made permanent storage of those copies and essentially made that information universally available to anyone that wanted it. We became, as we called it ourselves, the source of last resort for the official statements. As you pointed out, by the mid '90s there was a desire for continuing disclosure. You know, what is the ongoing status of the issuer, not just what at the time of issuance? And once again, 15c2-12 sort of does this end run or tries to deal with the Tower Amendment restrictions by saying to the dealer, "Okay, you do this. You know, you can't bring a deal without their being continuous disclosure." And we said, "Well, we'll take in some of that," which was required under 15c2-12. We were supposed to be the sort of central collection point for what was called material events disclosure. Something material happened at the issuer. We were supposed to get something.

That's not turned out the way the Commission envisioned it I think at the time, and in fact there's been active industry discussion even as we speak with an organization called the Muni Council which we established two years ago but is really basically issuers and investors talking about how do we get a flow of information on a regular basis into the market. And the Muni Council is, literally as we speak, setting up what they call a central post office to collect secondary market disclosure. So the whole issue of disclosure continues to roll along.

DONALD LANGEVOORT: So right now, an investor who wanted some sense of where an issuer stood with respect to likelihood of default, how would he or she go about finding that information?

CHRISTOPHER TAYLOR: First thing, go to your dealer because they're going to have more access to the information than you will as an individual. The requirements of 15c2-12 with regard to continuous disclosure only say that an issue that came after 1996, Summer of 1996, was supposed to have an

annual official statement or an annual statement. Those statements are usually 180 days after the end of the fiscal year, so you're talking about very stale information with regard to that kind of stuff. The material events disclosure is largely very sparse, so there really isn't a lot of current information on the infrequent issuers. Now, if a big issuer is coming to market, they're coming two, three times a year. You're seeing an official statement every two or three months, so you know what the current status of that issuer is. It's the people that come once every five years where you really end up having questions about knowing what their current status is.

MIKE McCARTHY: There are two other sources of information, Kit. One is the rating agencies publish rating reports on all of these issuers.

CHRISTOPHER TAYLOR: Yes.

MIKE McCARTHY: And they do surveillance. It's a tough job. There are lots of issuers, and the levels of surveillance may not always be there, but it's -- I would suggest to an issuer or to an investor, you know, look, if you haven't got access to it, call them and get it for the most recent rating report. It may not be any more current but it's analytical actually and not just repeating what the issuer had to say. It's also true that some of the dealers do do research and publish it about certain issuers, but that is another source, but it's kind of erratic in the sense that not all of them are covered by all of the firms and some firms don't do any of it.

And the last thing to keep in mind is that more than half of the market is insured by bond insurers who are rated AAA, which actually takes a lot of the legwork out of it -- can -- for an individual investor. They are wanting to rely. They should not. They should understand the underlying issuer and they should understand the underlying credit, because insured or not, trading levels are affected by underlying issuer events. But as a proxy for really understanding what's going on, paying for AAA insurance which they do when they pay for it in a lower yield, investors, that is a very, very major part of the market, and maybe something I should have said in the beginning about one of the major developments in the market. More than half of the issuers are insured every year, and that percentage is not going down. If anything, it's slightly going up.

DONALD LANGEVOORT: Well, we've just talked about transparency with respect to issuer information. I guess the other issue worth talking about as we draw to a close is the other aspect of transparency which is transparency of prices and other market data so that investors have a sense that the prices they

get when they buy and sell bonds is a fair price. That's a big issue right now. Has that been a big issue for a long time? Is it one of those things that's been on the boards?

CHRISTOPHER TAYLOR: Actually, I go back again to 1993 and the Congressional Oversight Hearings when we announced and said we'd had stuff out for comment to the industry and we summarized it in that testimony and said, "Look, you know, we are going to move forward with price transparency." And at the same time the SEC at that same hearing said, "Oh, yes you will." And subsequently in 1994, after a lot of backing-and-forthing, we ended up committing to the SEC to go all the way to real-time transaction reporting which will take place in January '05, and in the interim we have been providing a lot of price transparency on what's called a T+1 basis, trade date plus one. We are releasing all of the information that we get, almost all of it, the next day, and this has been done in stages from 1995 to the present.

DONALD LANGEVOORT: Will the real-time transparency closely resemble what we see in the equity markets?

CHRISTOPHER TAYLOR: Well, actually, yes and no, in terms of the fact that yes, you'll see it on the same day, but I think it's important to realize there are a million-and-a-half different municipal securities outstanding. That compares with less than 50,000 equities and the like. And of that million and a half, less than one percent trade on a given day. So if Don Langevoort owns a particular security and you're waiting for it to pass beneath the bottom of the screen on your TV, you could be very close to death's door before you actually see it happen. Very few of the bonds trade on a given basis.

So here's a plug for the Bond Market Association. They take the data that we produce and they put it up on a Website called www.Investing In Bonds.com, where individuals can go in, type in their CUSIP number which is the identifier number, and see all the trading activity -- trade date, price, and whether it was a purchase from a customer or a sale to a customer or an inter-dealer trade.

DONALD LANGEVOORT: When I visited your offices a couple of weeks ago you showed me a mural that is a time line that goes all the way back to the '70s if not before and talks about how regulation of the muni bond industry has changed over time. Give me an idea, if you have to imagine what that mural is going to look like five or ten years from now, what some of the big events that are going to end up on it are going to be.

CHRISTOPHER TAYLOR: Boy, that one's a tough one. Certainly pricing goes there. I think what happens when we have more and more attention on pricing and price transparency, and dealers are more and more aware of that, it eventually works its way back to the perennial issue of disclosure, because how can you adequately price unless you know what the current status of the issuer is. So that at some point in the game in the next five years we'll be looking at does the new central post office and the efforts being made by issuers and investors to improve the disclosure system, how have they worked out and are they adequate to meet the needs of a market that is one of the largest issuers of debt in the United States. I mean, all the state schools and everything that we see every day are built out of it.

DONALD LANGEVOORT: Mike, any thoughts about where we're going?

MIKE McCARTHY: Yes. It's a fascinating chart, and the history of regulation is always that more is better not. [Laughter.] So I don't anticipate that we'll start to see some of the rules go away. I think we might look at -- if I look at what isn't regulated, that will probably be what's on that chart. What isn't regulated is, issuers are not regulated. Perhaps if enough bad things happen there will be pressure to look at that again. Derivatives are not regulated in many ways because they're, quote, "not securities." These are the things I would look for ten years from now and say, you know, are they regulated now or not? We'll see.

DONALD LANGEVOORT: Well, thanks. We've run out of time. I just want to remind all the listeners that today's chat is now archived in the Society's Virtual Museum, so you can listen again to the discussion. A transcript of today's chat will soon be placed in the museum.

The next Fireside Chat will focus on state securities regulation. Our guest will be Christine Bruenn, securities administrator for the State of Maine and immediate past president of the North American Securities Administrators Association. The chat will be sponsored by the North American Securities Administrators Association. Please join us on Tuesday, June 22nd at 2:00 PM Eastern Daylight Time. Thanks for being with us.

(END)