

SEC Historical Society

The Remaking of the Municipal Market 16th Annual Meeting Program

June 4, 2015

Linda Chatman Thomsen: Good afternoon and welcome to the 16th Annual Meeting program of the Securities and Exchange Commission Historical Society. I am Linda Thomsen and it is my great honor to be the 2015-16 President of the Board of Trustees. I was thinking as I walked into this building that it was not that long ago when I moved to the SEC's new building for the first time; it's just about one decade ago, so time does fly.

It is a pleasure to welcome all who are participating in today's program – both those here in person in the auditorium at the SEC, and those watching the broadcast live through our virtual museum and archive of the history of financial regulation at www.sechistorical.org. On behalf of my fellow trustees, I would like to thank all the Commissioners and every member of the staff of the U.S. Securities and Exchange Commission for their enduring friendship and support for the work of the Society. While we all know that the Society is independent of and separate from the SEC and receives no public funding, the bonds of mutual respect and partnership have been strong since the Society's founding in 1999. We hold this Annual Meeting program in early June each year in recognition of the passage on June 6, 1934 of the Securities Exchange Act and the subsequent establishment of this wonderful institution. At the conclusion of the program we invite everyone here and all staff to join us for an ice cream social in the main entrance foyer in celebration of the SEC's 81st anniversary. Happy 81st birthday!

The Society's Board of Trustees is on the cusp of determining a new and potentially-greater future for the SEC Historical Society and our unique virtual museum and archive of the history of financial regulation. I am proud to work with a distinguished group of fellow trustees, and welcome our new trustees: Timothy Burke, co-head of the securities enforcement and litigation practice of Morgan Lewis & Bockius LLP, based in Boston; Robert Helm, a partner with Dechert LLP in Washington and a leader of the firm's financial services practice group; John Liftin, a managing director and general counsel of D.E. Shaw & Co. in New York; and Richard Roberts, a principal of Roberts Raheb & Gradler LLC in Washington and a former SEC Commissioner.

I am also very pleased to work with my fellow officers for the coming year: Chairman – W. Hardy Callcott, Sidley Austin LLP in San Francisco; President-Elect – David Lynn, Morrison & Foerster LLP in Washington; Vice President for Development – George McKann of Drinker Biddle & Reath LLP in Chicago; Vice President for Museum – Daniel Goelzer of Baker & McKenzie LLP in Washington; Treasurer – Cynthia Fornelli, Center for Audit Quality in

Washington; and Secretary – Lisa Beth Lentini of Carlson Wagonlit Travel in Minnetonka, Minnesota.

I also would be remiss not to mention the extraordinary work of the staff: Carla Rosati, Executive Director, who is both a visionary and who pays attention to every detail, much to our great advantage; and Matnita Green, Office Manager-Bookkeeper, who is joining us today. We would be lost without both of them.

My fellow trustees and I thank all of you who generously support the mission of the Society – to share, preserve and advance knowledge of the history of financial regulation through our virtual museum and archive. Your gifts make possible the continued access, building and outreach of the museum. As our 2014 Annual Report attests, we are very careful stewards of the funds given. I would go so far as to say we try to spend every dollar twice, but I would be reluctant to say that in this building, as it isn't true. We spend it once, but very carefully, and it really does make the museum's phenomenal growth and outreach possible.

I am now honored and delighted and, let's be honest, slightly intimidated to introduce Mary Jo White. First, she genuinely is a person who needs no introduction, and second, you know from the outset that any introduction would be entirely inadequate. I decided to be brief and to steal a page from another Chair's playbook. When confronted with similar situations, Bill Donaldson would throw out a stream of words and descriptors. So as I thought of descriptors when we think of Mary Jo White, first and foremost most of us on the defense side think of tough. Exceedingly smart, very thoughtful, inexhaustible and I think for those who work with her, exhausting. Profoundly disciplined, direct and simultaneously realistic and optimistic and for a grown-up, I think that takes a strength that is hard to imagine. Accomplished and inspiring. All of those things are important but the ones that I coming back to over and over, she is fair and has a keen sense of justice, and her integrity is unparalleled. As I think about that list, with the possible exception of her smarts, which are a talent, and perhaps her stamina, who knows where she gets it, everything else is a virtue. Virtues are things that we work out, and that were not given to us and not something we are born with. What is left off the list is another virtue that obviously belongs on the list and that is courage. We know – as Aristotle once said - all virtues are fundamentally equal except courage is the first virtue, because it makes all other virtues possible. With that, it is my great delight to introduce Mary Jo White.

Mary Jo White: Thank you very much, Linda; I'm delighted to be here. You left off short, which I thought would be first on the list instead of tough. Congratulations to you on becoming President. The last time I saw Linda here, she was in what I call the holding cell in the lobby. So you know that I do things for those who visit us, including sometimes alumni, when I saw the visitor center – which is a temporary situation, because we are renovating the bigger visitors waiting room – I did remove the barriers and put couches, I think within a day. I consider that a major achievement but that is my free association with your new President.

Good afternoon. I am delighted to be able to speak to you this year. I do think this yearly event of the SEC Historical Society is always the right occasion to underscore that those of us who currently have the privilege of serving at the SEC are part of a long and honorable tradition. The staff is beyond compare, with its dedication, high-mindedness and expertise, making us all very

proud to work here. The SEC alumni are undoubtedly the biggest, most supportive and most enthusiastic group of any government agency or private entity anywhere around the world. The SEC's history is one of important public service and a tradition of protecting investors and bringing confidence to the financial markets. The SEC's commitment to markets that are both safe and fair, as well as dynamic, has given millions of people the opportunity to share in the growth of the American economy, while facilitating capital formation to fuel the economy. Those of us who are or who have been part of the SEC tradition can be rightly proud of our role in shaping the financial system that meets the needs of both the visionary entrepreneurs and those contributing as much as they can to their 401(k) or for their children's college education. Now as a reminder of your service at the SEC, I have been asked to briefly share what we are working on, now and in the near future. I think you will recognize in that work the mission that brought many of you to the agency and which should continue to resonate long after you leave your SEC post. Since I arrived in April 2013, it has been critically important for us to complete, and complete well, the rulemakings mandated by Congress under the Dodd-Frank and JOBS Acts, but it is also important, despite all the challenges, to keep our focus on areas of core importance to investors in our markets not encompassed by these mandates. Since I became Chair, the Commission has proposed or adopted more than 30 substantive rules, including significant rules directly responding to the financial crisis, like reforms for money market funds, asset-backed securities and credit rating agencies; rules to enhance the resiliency and integrity of the systems that support the critical market infrastructure of our equity markets; and rules aimed directly at increasing the protection of the funds and assets of investors, and securing their information in the custody of brokers and investment advisers. Finally we are seeing light at the end of the mandated tunnels, and the staff should be proud of their herculean efforts to not only complete the many rulemakings but also to have done so with the staff's characteristic expertise and with the agency's core mission as an important lens even when operating within often quite proscriptive statutory frameworks.

Enforcement, of course, remains a core function. In fiscal year 2014, we filed 755 enforcement actions and obtained orders for more than \$4.16 billion of disgorgements and penalties. Even though those numbers are records, they do not tell the whole story, nor even the best part of the story. When you look past the number of cases and the dollar amounts, you see an enforcement program focused on violations that cut to the core of our mission and span the range of all market participants. Changing the no-admit/no-deny settlement protocol for certain cases has strengthened the impact and message of our enforcement program. Admissions can bring about greater public accountability and that public accountability can boost investors' confidence and serve as a stronger deterrent. The new protocol will continue to evolve and grow. This year you have seen and will see significant enforcement cases in all aspects of our program, including significant market structure cases against exchanges and broker-dealers; important financial reporting and audit cases, and cases involving violations of the internal controls requirements; insider trading cases against traders of all different types; micro-cap fraud cases against repeat players, including promoters who have spearheaded many schemes and attorneys who facilitated them; asset management cases, including misrepresentation of fund performance and failure to disclose conflicts of interest.

In the regulatory arena, we have pivoted toward new challenges that spring from the creativity and dynamism of our markets. Our goal is to encourage that dynamism while keeping the

markets safe and stable. We're focusing on improving our risk oversight of the asset-managed securities industry. To do so, the staff has developed a broad set of initiatives to address the increasingly complex portfolios and operations of today's asset management industry in ways that we have not done before but necessary for today's markets. Last month, we proposed our first set of the new rules, ones that will improve the data and other information reported to the staff for analyzing risk in crafting appropriate regulatory responses. More will follow throughout the year.

We've begun the important tasks of raising the standard of care for investment advice owed to all retail investors. This has been an issue I've been focused on, and the SEC efforts date back many years. Whenever substantially-similar services are regulated differently, we should carefully consider and think long and hard whether the distinctions make sense from the perspective of both investors and the industry, and if not, what to do about it. I believe broker dealers and investment advisers should be subject to a uniform fiduciary duty standard of conduct that requires acting in the best interest of their clients and providing personalized securities advice to retail investors, and I have begun the path forward on that rulemaking with my fellow Commissioners.

It also goes without saying that market structure poses complex issues in both equity and fixed income markets. We recently proposed a rule to bring active proprietary traders into the jurisdiction of FINRA and we adopted late last year Regulation SCI – Systems Compliance Integrity – aimed at robust and resilient technology at exchanges and other critical market participants. There's obviously a lot of work to do in the market structure area and we have formed an equity market structure advisory committee, filled with some of the best minds in this space, to provide input from investors and experts across the spectrum of market participants. With respect to the fixed income markets, last summer I highlighted several initiatives to improve the quality and transparency of the prices received by investors in municipal and corporate bonds and we continue to make progress on that front. I will say I'm particularly glad this panel will be focusing on municipal securities today, given the importance of this multi-trillion dollar market to retail investors. We are also focused as an agency to promote capital formation. The JOBS Act provides a solid base for new opportunities for small and emerging companies, but there is more that we need to do. As you know, the Commission is proceeding with the pilot program that will widen tick sizes for certain stocks of smaller cap companies and we also exploring other ideas, encouraging the development of venture exchanges to provide more liquidity for smaller companies. The staff is well underway with its disclosure effectiveness project, which includes careful consideration of disclosure requirements for smaller companies. I will end my brief drive-by tour here. As you can see, as always there is a lot on our plate and resources, as ever, do not match our responsibilities and desire to do even more in furtherance of the mission. We have the very good fortune to be in a position where we can continue to rely on a tradition established more than 80 years ago with an extraordinarily talented and dedicated team. It is as always a significant challenge and important responsibility for the Commission and staff alike but the rewards of service are more than worth the hard work and inspired efforts that are the daily lot of this very critical agency. Thank you for being part of that and for being here today and for your support of the SEC tradition.

Kenneth Durr: Thank you, Chair White. I am Dr. Kenneth Durr, Executive Vice President of History Associates, Inc. and curator of The Municipal Securities Rulemaking Board Gallery on Municipal Securities Regulation.

The MSRB Gallery, opening December 1st, will be the fourth Gallery I have curated for the virtual museum and archive of the history of financial regulation. Previous Galleries covered Joseph P. Kennedy and the founding of the U.S. Securities and Exchange Commission, corporate governance, and self-regulatory organizations. This Gallery will complement the Gallery on self-regulatory organizations, which opened in 2010. Then, there wasn't enough time or room to appropriately address municipal securities regulation. I'm delighted that – thanks to the leadership of Carla Rosati, the SEC Historical Society's Executive Director and founder of the virtual museum and archive – we are now able to develop a Gallery on this important subject. With the generosity of The Municipal Securities Rulemaking Board, the Gallery will be built in commemoration of the 40th anniversary of the MSRB's founding in 1975. I am grateful to the support of all those at the MSRB – both current and former leaders – who have shared their history for the development of the Gallery.

I also want to recognize and thank Shauna Guner, recipient of the 2015 writing award for her essay, "What Are the Magic Words? Disclaimers in Official Statements." Her essay will be linked within the Gallery, and we are grateful for her participation and presence today.

Our program – The Remaking of the Municipal Market – is the last piece in the creation of the MSRB Gallery. Our focus will be the last three decades, from 1986 to today, looking at how issuer needs have changed over time, and how the other participants - broker-dealers, bond counsel, advisors and rating agencies - have adapted to the changing market. We will look at the principal regulators – the SEC and the MSRB - their comparative strengths and changes in that relationship over time. And finally, we will look at the implications of the MSRB taking on the role of information agency, in addition to rule maker, and its new post-Dodd-Frank mandate.

Joining with me today to provide their unique perspectives are Marcy Edwards, Vice Chair of the MSRB Board of Directors. She is a former Senior Financial Policy Advisor to the District of Columbia's Chief Financial Officer, a former Executive Vice President and a partner in the financial advisory firm Public Resources Advisory Group, and a Vice President and Manager with Moody's Investor Service.

Dr. W. Bartley Hildreth is a professor in the Department of Public Management and Policy, and former Dean, Andrew Young School of Policy Studies, Georgia State University. Bart is a member of the MSRB Board of Directors and has served since 1989 as editor-in-chief of the *Municipal Finance Journal*. He earlier served as director of finance for the city of Akron, Ohio.

Lynn Hume is Washington Bureau Chief for *The Bond Buyer*, the authoritative publication of the municipal bond market, focusing on tax, market practices, regulation, legislation and enforcement. Lynn is a former staff investigator for the U.S. House of Representatives' Subcommittee on Energy and the Environment, and a reporter for McGraw-Hill Publications.

Let me point out that their statements today do not reflect the positions of the MSRB or their respective institutions, but are their personal perspectives alone.

The ground rules are that we will cover the muni market over the last 30 years. We may look forward from time to time, and we may look back. It will be very much a discussion among the participants; I hope only to be a facilitator. We will assume knowledge of such familiar things as SEC, MSRB and EMMA, but will otherwise try to define our acronyms and arcane terminology as best we can.

Let's start with a bit of laying the framework for the emergence of the big changes in the municipal market. I think we'll agree that the 1986 Tax Reform Act came in the middle of, and sharpened the transition that was underway, from competed general obligation bonds to negotiated revenue bonds. Let's get some background to those big changes and talk about how these developments changed the options for issuers. Since we are getting historic background, let's start with the academic. Bart, will you give it a shot?

W. Bartley Hildreth: First, I would point out that the 1986 Act was an evolution. We had seen a lot of Congressional changes to the municipal market leading up to '86, which was significant change. We cannot forget the changes in '68, '82 and '84 that led up to it. The market is going through continuing evolution now and I would echo the notion that history is important to examine. We also have to remember that, in '86, we were coming out of very high inflation. I had gone in as Finance Director of the city of Akron on January 1, 1984 to the summer of '85 to solve a technical default of a waste-to-energy facility, and I remember issuing bonds at 10 ½ % tax-exempt, and we beat the market by 50 basis points. We were proud of that. But wouldn't you love to own 10 ½ % tax-exempt bonds? We have to look at a lot of the factors in the market, not just the municipal market, but the capital markets, –inflation, the evolution of statutory changes, and, bank interest deduction. We start seeing some changes in '82 and '84, and leading up to '86. I would emphasize the prelude to '86.

Lynn Hume: I would like to add that the Tax Reform Act of '86 created enormous restrictions and complexity in the municipal bond market. It limited demand by putting restrictions on former big buyers of tax-exempts, like insurance companies and banks. It sought to limit supply through state volume caps on private-activity bonds, and by making private activity bonds subject to the alternative minimum tax, severely limiting advanced refundings and introducing arbitrage rebate to the market. I joined *The Bond Buyer* after the '86 Act, and some dealers left the market right after that, like Salomon Brothers. I remember everybody saying, "There goes the municipal market." There was a lot of consolidation, and muni volume took a big hit. It had surged to \$101.9 billion in '84 and then it went up to a record \$207 billion in '85 as everyone rushed to market to avoid those restrictions that were coming into place. Then it fell back to \$150.6 billion in '86 and did not rise above that level until 1991.

Marcy Edwards: This is interesting because a lot of our history overlaps. I joined the municipal market with Moody's Investor Service as an entry-level analyst in 1986, just as we were getting ready for the tax act to go into effect. As you said, there was a rush to the market that year, and I think I got about three years of experience in my first year, because it was a madhouse. I think for the most part we were seeing a lot of general obligation bonds and that is

what investors knew and what they understood and what they trusted. I think in looking for other ways to enter the capital market, movement towards revenue bonds and using negotiating sales to sell those revenue bonds was a big change for everyone. As an analyst at Moody's, we would often meet with issuers, and it was a great experience talking to them. But when we started seeing the negotiated sales coming in, we were also sitting at the table with the bankers who were structuring these things. It became apparent it was a critical part of access to the market because the bankers and broker-dealers were able to explain this directly to investors. We did not have the wonderful technology means that we have today. Things were pretty much done by telephone calls and we didn't even have big conference calls or webinars in terms of spreading the news about what a new revenue bond might be. There were new revenue bonds coming in, and any time you saw a stream of revenue, a good broker-dealer would find a way to securitize it. It was an interesting period of time in those years. I'm thinking back to solid waste bonds, we don't see a lot of now; passenger facility bonds came in at that time; tobacco bonds somewhat later. All those revenue streams took a great deal of time and study, and I don't think they would have been possible under competitive bidding situations.

Kenneth Durr: Was there a sense that revenue bonds were the way of the future, and that they were moving to supplant general obligation bonds at that point, or did that come later?

Marcy Edwards: I'm not sure it has come. I think general obligation bonds, despite disruption from the Detroit experience and the rulings that came out of the bankruptcy, generally investors are continuing to be comfortable that they have the opportunity to ask questions about, in my state, what does a general obligation bond mean? Certainly there are states that are pretty much putting their foot down that nothing will come above our general obligation pledge and it is a very emerging process as we go along. I would not rule that out. On the other hand, as you find a new revenue stream, I think there is always a way to securitize that and help build infrastructure in the U.S. in a wise and cost-effective way.

W. Bartley Hildreth: I think Marcy is correct. The evidence is that different revenue streams produce a variety of securitized borrowing against the sales tax, income tax, and fees and charges. The growth of that area was amazing over this time period as public officials became aware of what they could do. I think it was a learning process and part of the professionalization of public finance, through the Government Finance Officers Association and other associations, where the finance officers learned from others what they would do, and not so much reading *The Bond Buyer* on what more-sophisticated investors were doing, but in the networking in the profession. That fostered innovation across the country. I am sure it happened with the broker-dealers also, but they were not the only ones who were fostering this movement towards revenue bonds. I think it was the chief financial officers of cities and counties and special districts and states. That has accelerated but not so much in market percentages. Also, the anti-tax movement and the pressure on the property tax started with Proposition 13 in 1978. If you go back again to the history and see the anti-property tax focus, you can see the evolution towards coming up with some other way to get a lien on future revenue.

Kenneth Durr: You mentioned participants in the market, and of course one can overgeneralize about the old days, and bond dealers and bond counsel being around for some time. As we see the market starting to change over this period, are we seeing new roles for advisors?

Lynn Hume: There were also changes for bond counsel. Bond counsel initially were giving opinions that bonds were valid and tax exempt. They also helped structure deals. Their roles expanded, but as the laws became more complex, a lot of specialized counsel evolved – special tax counsel who would hone in on complex tax issues, and disclosure counsel who checked issuers’ disclosures after the disclosure rules were adopted. Underwriter counsels took on the responsibility of reviewing disclosures in bond documents for the underwriter, though that did not negate the underwriter’s duties. I think that limited the role of some bond counsel, the development of specialized areas of practice. At the same time, malpractice insurers played a role in limiting bond counsel responsibilities. Early on, the bond counsel was seen as representing the issuer, the transaction, or all the transaction participants. The malpractice insurers started saying, “You have to specify your limited responsibilities in bond documents because every time there is a legal issue, you will be the one that will be sued and you have to limit your legal liability.”

I think that most financial advisors initially were dealers. They would go in and talk to issuers and suggest ways to structure deals and help with the issuers’ capital problems. That dynamic shifted in the ‘80s as banks and broker-dealers streamlined their operations. We had the Black Monday stock crash and the SEC ramped up its enforcement actions against underwriters. Issuers began to see that the interests of underwriters were different than their interests. While many market participants have worried that the new regulatory regime for municipal advisors – requirements and qualification test – implemented under new authority from the Dodd-Frank Act will knock a lot of small municipal advisors out of the market, I also think it will be a bonanza for municipal advisors. Under the SEC’s registration rule, an underwriter can provide unfettered advice to an issuer if the issuer has an independent registered municipal advisor (IRMA).

Kenneth Durr: Marcy, you have a first-person perspective of the role of advisor during this transition period.

Marcy Edwards: Let me note, I was never regulated as a financial advisor. This was before Dodd-Frank was envisioned. As a former financial advisor and a partner in a firm, I think one thing I am bringing to the MSRB is the ability to look at it as a former business owner. We were very concerned, as Lynn said, about the possibility of making things more difficult for those businesses. There will be some consolidations but I think things will spring up as a result of Dodd-Frank, such as one-person firms who assist in compliance activities. I think there will be a potential for a whole new industry. I think it does not change the way I always felt about my client. I always felt I had a fiduciary responsibility to my client. No one ever sat me down and said you have a fiduciary responsibility, and I never saw it in writing, but there was certainly a loyalty and an understanding that we had a long-term relationship with the client. If it was a long-term three-year contract, we wanted to renew that contract and make it another three years. That means that you always have to invest in the best interest of your client without question. I wish I could literally have documented the number of times that we had to say to a client we would love to tell you to do this transaction. It’s great and exciting but not in your best interest. Even though my company would have made money on that transaction, it was not in the best interest of the client. That is one reason that it is probably good that financial advisors will be regulated, because it needs to be specific, and many financial advisors who have not recognized that long-term commitment as effectively will come under regulation by the MSRB.

W. Bartley Hildreth: If I can go back to the bond counsel topic, in the old days, an issuer would deal with the bond counsel firm for a long period. I agree with Lynn that malpractice insurance had an impact, but the American Bar Association had an impact, too. In the old period, you could turn to the bond lawyer when you had a problem and it was in their interest to help you find a workout, a way to deal with the environment that had emerged once a deal had gone sour. They had that long-standing interest and the network – political, legal and other settings. So there was an informal ability that the bond lawyer firm brought to the table that was very advantageous. I don't know the extent that it is continuing. I have seen working papers that say the more lawyers involved, it drives up the price. Certain research says bond counsels bring a network of working with underwriters and financial advisors. I don't think we know enough empirically about the role of the bond counsel in municipal markets. It is a rich history.

Kenneth Durr: We talked about market participants and generalized with GO-bonds and revenue bonds but I think one of the things that is coming out during this period of transition is a lot more new products. Lynn do you want to give us a capsule of those products and maybe the drivers that are moving these things?

Lynn Hume: In the '80s, variable rate bonds were developed because of the craziness of the interest rates and the growth of money market funds. An issuer could issue long-term bonds at rates at the shorter end of the yield curve. Money market funds could buy them and ensure the preservation of capital. Variable rate demand obligations were backed by letters of credit and other similar types of credit enhancement. We saw the development of commercial paper and tender option bonds, a secondary derivative product, in the early 1990s. Tender option bonds essentially repackage long-term municipal obligations into a money market eligible class of floating rate securities, which may be tendered at par plus accrued interest, and a residual certificate. The financial crisis resulted in a huge hit on the VRDOs and auction rate securities. The ARS markets froze because no one would bid. Dealers, who had previously backstopped the auctions by bidding on ARS if no one else did, stopped doing so. Banks stopped providing affordable credit enhancement. Bond insurance tanked. The insurers had invested a lot of mortgage-backed securities because they said the credit rating agencies wanted them to diversify. They suffered huge losses. Bond insurance had been a huge part of the market. Insurance grew above 50% of the new issue market at one point, and now it is only about 6%. I don't think anyone thinks we will get back to even close to 50%. It may grow to about 10% to 20% at most. Also, the recalibration of ratings has resulted in higher ratings for munis. You don't have as many BBB minus or AA minus munis that are the core market for insurers.

Kenneth Durr: We talked about the transition, and we've given a good perspective on the market developing during this period, but we haven't talked about regulation and, of course, that is the big task. Given all this upheaval, one would expect regulation to be stepped up pretty quickly. Do you think that was the case or did the regulators – the MSRB and the SEC – step back and evaluate and track behind all these changes?

W. Bartley Hildreth: Going back to my earlier point, it is an evolution in the market. The long-standing tension between state and local governments and central government plays a part. The South Carolina case clarified the constitutional status, getting Congress to preserve the

municipal market. The original Securities Act provided an exemption. The Tower amendment added some other restrictions on the SEC and the newly-created MSRB. I think it is understandable that there was a slow evolution towards the central or federal government getting involved in the municipal market. It took some very serious events - New York City, Washington Public Power Supply System – to galvanize the focus to exercise what power did exist in the SEC and in the emergence of the MSRB. Then we saw Orange County, California, a very rich county; Jefferson County, Alabama; Detroit; Puerto Rico; and the evolution of institutional investors buying a lot of the market. As your introductory comment suggested, the focus is on investor protection. When you start thinking about investor protection, you get the SEC hot and heavy on protecting municipal investors. I think it is quite understandable that we are seeing this evolution in regulation, with Rule 15c2-12, first with the primary market and then the secondary market, and then enforcement actions by the SEC having an impact. We talked about more recent events, and then you have Dodd-Frank adding the Municipal Advisor regulation. It is understandable that we have evolution going on in the municipal market. We haven't talked about the Tower amendment, but we are getting close to the point where that will be the last brick to address.

Marcy Edwards: You went way back in history and came up to Dodd-Frank. I think, having been in the market for 30 years, our most recent experience with the recession, and what caused the great recession, largely was based on how damaged confidence was in the market and that was on many levels. It was at a level where people generally had respect for the rating agencies and certainly as a result of the mortgage securities debacle, that changed very fundamentally; they missed it. There was bad confidence disruptions. The problem came first and then Dodd-Frank came in and it has gone a long way to help rebuild especially with adding things like investor protection or issuer protection to the MSRB task. We had a good time interpreting what that means and in a way that is welcoming to them, but I think it has been a slow process in rebuilding confidence because of the degree of effect that manifested itself in the great recession. Is that what we are calling it officially?

Lynn Hume: I think the securities and tax regulators were really slow to pay attention to the muni market. We were aware of abuses long before the enforcement programs were developed and we wrote about alleged violations, but the regulators were passing on bringing muni cases. I don't think you can minimize the impact that Arthur Levitt had. For the first time, you had a SEC Chairman who had a huge impact on the muni market. His father had been Comptroller of New York State; his mother had bought municipal securities and she couldn't figure out what she had. Levitt called the municipal market "an Oriental bizarre." He set up the Office of Municipal Securities. The MSRB had been drafting a pay-to-play rule before he came into office, but you can't understate the importance of a SEC Chairman pushing hard for something and galvanizing people. He selected Paul Maco to head the Office of Municipal Securities, and Paul and other SEC lawyers trained people in the regional offices on how to do enforcement. Levitt pushed the MSRB to pass a rule against pay-to-play practices, which was a huge issue. He urged not only dealers to prevent pay-to-play practices, but also tried to get lawyers and even the financial advisors to do something. He worked hard to improve price transparency and continuing disclosure rules. He was helped by then-SEC Commissioner Rick Roberts, and by Elisse Walter, who was in the SEC Corporation Finance division. You saw people at the SEC get involved with muni bonds because Levitt cared so much. I think that had a huge impact. It

was Elisse who oversaw the writing of the muni market report in 2012. That was a seminal document, and you can see that most of the regulatory recommendations were followed through.

Kenneth Durr: When the SEC is becoming more activist under Arthur Levitt, what is the MSRB doing and can we separate out the regulatory roles and differences between the two institutions?

Lynn Hume: If you listen to former MSRB Executive Director Kit Taylor, the MSRB had the lead role, but they were pushed hard by the SEC. I think the MSRB had a tough time, doing things for the first time. MSRB was vilified for G-37 by the industry. Eventually, dealers came to love it, and that was the initial premise, that the dealers didn't have to listen to issuers and could say, "No, we cannot contribute to your campaigns anymore." But when the first G-37 enforcement cases started coming in, the dealers realized how draconian the two-year ban on underwriting was, and there was a lot of pushback from the dealers. You had to give the MSRB credit for pushing to create a new regulatory regime.

Marcy Edwards: I think Mr. Levitt will be gratified, if he was pushing for it, to know that municipal financial advisors are being regulated, and that it is likely that G-37 will be expanded to cover that. It takes a few years, as you said, but that is something that will be happening.

Lynn Hume: The MSRB and the SEC work hand-in-hand. The MSRB proposes rules; they get comments; they take it to the SEC. They'll file a proposal with the SEC. The SEC does not just let the MSRB go ahead with the proposal. The SEC has a lot of input. A lot of the rules change before the MSRB gets final approval from the Commission. There were many years during which Rule G-23 was debated. Initially, it started as a rule that said dealers can't be financial advisors and underwriters in the same issue, unless potential comments were disclosed to issuers. Non-dealer financial advisors said this is wrong because there are clear conflicts, and the underwriters don't have the same objectives as the issuers. The MSRB reconsidered the rule, but took no significant action. It took Mary Schapiro, when she was SEC Chairman, to say this has to stop; this is a clear conflict, and that made a big difference. Now a firm cannot be underwriter and financial advisor in the same transaction. So I think the two regulators have each been important and have worked together from necessity.

Kenneth Durr: Let's shift gears and talk about technology. We all know where the MSRB has come today with EMMA, a huge change from where it started in 1975. The path along the way is incredibly complicated for a lay person like myself, and I would like to talk about some of the steps, the history behind them, and some of the things that were pushing the steps forward. Can we go back to the beginning, to the 15c2-12 amendments, where we are thinking about the idea of secondary disclosure?

W. Bartley Hildreth: Taking it farther back, you could not get information. First, we started producing official statements of some significance. Then it was the broker-dealer who would have to distribute to the investor. But, as a researcher, it was very hard to get access to those documents. You could purchase a document and have it emailed to you, but you couldn't do any research on just one document, you needed multiples. The evolution was towards some type of collection repository. We started seeing through Rule 15c2-12, that the Nationally Recognized

Municipal Securities Information Repository had to get qualified under the SEC and hence disclosure documents had to be distributed to these various firms. There was incomplete and inconsistent posting. Again, there was no central place for it. Then we move forward, the evolution is that when we find the first step doesn't work, we go to another step, and when we find that it does not work, we go to a third step. The Texas Municipal Advisory Council, which had been set up since the Great Depression, along with the Ohio, South Carolina and Michigan councils, would collect documents from those particular states, funded by the broker-dealers. Texas then said, we will collect them all, a central post office concept. That worked for a while, and it led to MSRB stepping out front, with Lynnette Kelly being the force to push that through in her new job as Executive Director of the MSRB. I think that transparency is enhanced by EMMA, and as a researcher, it is critical that we have secondary trading data available through EMMA. That is fostering a whole new range of research, and will help move the market. It is an evolution whose time has come, and there are some remaining steps, such as pre-trade price transparency that has to be dealt with. I think we are making tremendous progress in getting the municipal market data sources available for individual investors, market participants, and those of us doing fundamental research.

Lynn Hume: I remember when we were investigating the underwriter, Matthews and Wright. The firm had rushed to market at the end of '85 and was a relatively small firm in New York. It didn't have the capital to close all of the transactions it had underwritten by the end of the year, so it created the fictitious Commercial Bank of the Americas, which had a fake address: an empty lawyer's office in Saipan. To look at the bond documents from the transactions it underwrote, we had to go to the bond counsel's office; they were the ones that had the transcripts, as the documents were not easily publicly accessible.

There were some ironies in the development of the secondary market disclosure rules. There was enormous suspicion from the MSRB, as it was already the repository for official statements. The issuers were just so sure that this was nose under the camel's tent, that this would lead to them being regulated by the MSRB. There also were some personality conflicts between some of the issuers and the then-Executive Director. In addition, the information vendors were unhappy and worried that MSRB would take disclosure data, add value, and then sell products and compete with them. Ultimately, there was agreement to create these nationally recognized municipal securities information depositories, or NRMSIRs, which would collect all the secondary market disclosure information. Most of the NRMSIRs were information vendors. No one at that time thought of standardizing a form to get the information. The NRMSIRs were needed for the dealers to comply with the SEC's Rule 15c2-12. They had to make sure they could get issuers' material event notices. Both dealers and the SEC soon realized that the NRMSIRs had different disclosure information and labeled it differently. They couldn't use one NRMSIR; they had to sign up for several, maybe all, of the NRMSIRs.

The MSRB created the Muni Council to bring together market groups and try to come up with a solution, but the issuers kicked out the MSRB pretty soon in the process. Lynnette, then at The Bond Market Association, took the lead in getting everyone to work together. The Muni Council approached the Texas MAC, which operated a central post office for secondary market disclosure documents for a while. The CPO didn't store documents but it would obtain them in a standardized format and make them available to all of the NRMSIRs. The Texas MAC was sued

by Digital Assurance Certification over patent violations. Eventually, the SEC designated the MSRB's EMMA system as the sole central repository in 2007, and it opened in 2009.

Marcy Edwards: We're in year six of EMMA, and that's pretty young. When I have spoken in front of industry groups and attended industry meetings, and I know every time Lynnette Kelly speaks, she gets kudos from virtually everyone about how great it is to go to one place and find your bond, relatively easily, and find out the most recent disclosure filing, and find what the comparables are as well, how does Chicago compare to Minneapolis. You can do a lot with EMMA and the people who have discovered this think it is the greatest thing that ever happened. The other part of EMMA, and I hope that I am not jumping ahead, but the most important thing going on is the dissemination of trade information and it has absolutely worked to level the playing field among people who are on different sides of the trade. There was a point where the issuer and even the financial advisor were very much at the mercy of the underwriters in a negotiated transaction, because they were the only source of information. You could look at what happened three days ago, but we have the information now posted on EMMA about trades that are happening in the market, new issues, that are virtually immediately available to everyone. Investors like it, and they say very good things about it. We get terrific feedback from issuers, which is ironic, as they were concerned about the whole concept of municipal market electronic dissemination systems.

W. Bartley Hildreth: If you look at the MSRB public financials, it would confirm in terms of the amount of money devoted to it, that MSRB is an information technology firm. It's much more than a regulator in terms of the allocation of resources.

Kenneth Durr: Historians say that they don't like counterfactuals, but they really do. Did we have to go through NRMSIRS? Lynn, you laid out this tortuous process.

Lynn Hume: Everything has a process. People have to learn what works and what doesn't.

Marcy Edwards: I agree. Let's try this; that's okay but it's not perfect. There are a lot of smart people in this business who come up with ideas, and I think that is exactly what happened. They would say it's okay and better than what we had before, but it can be better. At the same time, technology in general was taking off at an unbelievable pace. Before, we couldn't email official statements because there was no email. That alone has made things much faster and much more efficient for investors to receive official statements. It is not unusual for an investor to wake up in the morning and say, what might I buy today, and not have an official statement, but by 10:00 am, he has all the official statements he needs and can pull them up and have them readily available.

Lynn Hume: The SEC did an amazing job. They met with all the market groups to come up with the secondary market disclosure rules. They really tried to come up with a rule that all of the muni market groups could live with and would work. I believe if there had not been NRMSIRS, then there might not have been any repositories.

W. Bartley Hildreth: I think it is consistent with fundamental precepts. One is federalism, that is a decentralized market that de-emphasizes the central government; the second is deregulation

or letting the private sector solve the problem. So it is consistent with letting the players try to solve this disclosure dissemination issue, and let the private sector solution work. We found out that, by both standards, we failed. The private sector could not work together, could not serve the interests of the investors, much less the market participants. I think the issuers, which are the state and local governments, realized it was not working for them either and complicating their life. It's part of the evolution but consistent with federalism and private market solutions, and in both cases, it was market failure.

Kenneth Durr: We have come up to the Great Recession and we will call it that. EMMA is just coming out, and we have secondary market regulations, indirect issuer regulation and effective disclosure. One can think that we have entered the bold new world of municipal securities regulation. At the same time, we have the market falling apart all over the place. Can we talk about what the weak points were in 2008, and moving from there, what kind of changes we saw in the aftermath?

Lynn Hume: Credit enhancement, bond insurance, we talked about that. State and local issuers were hurt financially. They lag behind everyone else, because the Great Recession was slower in showing up as reduced property and other tax collections. There was a lot of distress in state and local finances. A lot of issuers hard-pressed to issue bonds. The Great Recession hit everyone and led to Dodd-Frank. It was a real wake-up call.

Marcy Edwards: Insurance companies, on the muni side. There was the joke about how do I get AAA insurance. It was simple and back in that day, the rating agencies did not generally publish the underlying rating of those issues. I was at the rating agencies at the time, and more and more investors were saying, I don't know how to rate an insurance company and that's what you are asking me to buy. They wanted the underlying rating, and sure enough, the market reacted. Rating agencies then said, we will publish the underlying rating. Thank goodness they did because it did not come as such a surprise when the insurance company AAA began to fall under AAA and to go away altogether. Part of the fundamentals of what an investor needs to be interested in is what is there to pay my bond and the underlying security for the bond; to really understand that, you need full disclosure, not just the wrap of an insurance policy, but who is actually going to pay the bond. You have to assume the insurance company doesn't plan to pay the bonds. Clearly, the rating agency has a great deal of more revelatory presence in their lives as a result of failures in the past.

Lynn Hume: It changed the focus to the underlying credit quality of the issuer. With Dodd-Frank, we had a new focus on the rating agencies and what the ratings were, and whether munis were fairly rated in comparison to corporates. We saw rating recalibrations as a result of that. We have an interesting situation in the municipal market today. Ratings used to fall in line; I don't think we see that so much today. There is quite a bit of discrepancy with the ratings.

Marcy Edwards: I think also investors and large investment firms are relying more on the in-house credit analysts. As a former rating analyst, I could get a job for life. I think truly the emphasis on underlying credit quality is absolutely critical and people want to know what they are buying.

W. Bartley Hildreth: Greed is an amazing thing in the capital markets. Bond insurers had a cash machine. They would get an upfront premium and they would be able to assume they would not have to pay off the bonds. They may have to pay a debt service for one or two periods until there is a workout, and because a lot of municipal bonds were refinanced, they then accrue the entire premium to the bottom line. It was an amazing business, but they blew it up. Bond insurance provided what we would call certification in the academic lingo, which is some other type of entity, certifying the issuer was better than the name suggested, some name in Kansas or Nebraska that you never heard of. This certification or signaling effect was impacted into bond prices and the cost benefit for issuers leaned toward buying bond insurance and paying the premium upfront. It did segment the market into those with bond insurance or underlying credit AAA, versus those without. Since the great recession, we see that lower-rated bonds are being punished. It goes back to the fundamentals of the capital market, the rich get richer and the poor get poorer. Those who don't have success are the ones who have a very hard time in life. We see that with issuers; those that need bond insurance cannot afford it because it's not available. It's unfortunate that what incremental value they could gain from having bond insurance available in a competitive market, it's not there.

Lynn Hume: I remember at a National Association of Bond Lawyers meeting, a lawyer came up to me and said bond insurers don't not paying anyway. I cover so much litigation, and I think we have seen in the filings, insurance companies will go to great lengths to avoid having to pay out. There is often litigation involved.

W. Bartley Hildreth: It's a great market.

Kenneth Durr: Marcy, you said that in place of this patina of bond insurance, we get full disclosure and that has really stepped in to take the place.

Marcy Edwards: The goal is full disclosure. In speaking to investors, we all say that we want more full disclosure. I think the reaction that issuers have to the constant demand is tell us what you want to know. There has been some greater level of discussion at that level, and certainly the GFOA has taken on trying to decide what exactly it is that investors need to know and how quickly do they need to know, and what are the examples when you need to post something on EMMA that may be a material event. Material events are subject to interpretation and that is good for the bond lawyers. I'm just so impressed with the MSRB's ability to rise to the need to at least disseminate what is available. I think it depends on who you talk to.

Lynn Hume: There is some tension in the market. The National Federation of Municipal Analysts has released disclosure recommendations, saying what they think they need as analysts, and issuers don't always agree. There has been some legal debate. The MSRB asked for voluntary disclosure of material event notices on communication with the IRS, whether or not something had occurred that would affect the tax-exempt status of the bond. The lawyers' view was that, if you know you're going to enter into a closing agreement with the IRS and pay for lost tax revenues to preserve the tax exempt status of the bond, then you don't have to disclose a thing. Some issuers disclose communications with the IRS and many do not. The IRS may have gone through all sorts of permutations with an issuer, and finally close the audit without change

to the tax-exempt status of the bonds – then and only then will the issuer put out a material event notice saying everything is resolved.

W. Bartley Hildreth: An interesting thing in disclosure is the “e-speaking to the market.” I’m not an attorney, so I’m sure not presenting the SEC enforcement generalities, and I apologize for that. When issuers speak to the market, they put disclaimers on the website and say don’t pay attention to this part of the website for the city, go through this portal and only the things that are in this portal part of the website is “speaking to the market.” I believe it was the Harrisburg case where enforcement action said, absent providing timely information to the market, any of the comments by issuers in their budgets is speaking to the market. It reminded me of going in an expert witness case against a big city mayor, who kept saying to the market, we are in pretty good shape. But back home, she was saying, if we don’t do the following things with pension reform, we will be bankrupt. I said, you can’t do that. You are speaking to the market and not going to the bond rating agencies and giving consistent information. As a politician, she had a great newspaper comment after that: that is why we don’t have professors running cities.

Kenneth Durr: We have just a few minutes left, and I want to get to one more significant question. We talked a bit about post-Dodd-Frank, MSRB issuer protection, and financial advisors, but what we haven’t talked about is price discovery and the fact that the bond market does not trade like the securities and equities markets. Given that, the fact that the MSRB has recently done the best execution rule, what are the implications? Will it be a tough row to hoe, or is there promise for this?

Marcy Edwards: I think, like many things, something that complex takes a little time. You have to see how things are working, with laws at the federal, state and local levels, as well as regulation, the MSRB rules, the direction the SEC provides – it takes time to see how things are working. You want to fix it and you want it to be right, but you only want to fix it once. You don’t want to have to go back and tweak it constantly. A little patience may be needed. Lynn has said that industry groups are very active in discussing these issues. I think the issuers, the investors and the dealers are very much participating in the discussion on what is working and what can work. The feedback that we get on comments is invaluable.

Lynn Hume: I think we have a way to go on a lot of things. I was disappointed recently that the board didn’t move forward with special demarcation for conditional trading commitments. Dealers often make conditional trading commitments with institutional investors, but they are not considered trades until the bond purchase agreements are signed. All of those prices go on EMMA at the same time, the conditional trading commitment, which can occur days or perhaps a week before the bond purchase agreement is signed, as well as the prices of the bonds initially sold. You cannot distinguish between the two types of transactions. I think there is a lot to do on price transparency and disclosure. It is definitely a work in progress.

Kenneth Durr: The other issue that we have not discussed, and it is really breaking at this point, is MCDC, and this is another work in progress. Any thoughts on that one before we wrap up?

Lynn Hume: I know the SEC is getting a lot of grief from dealers and issuers for this program, but you have to remember the whole disclosure system has been worked through the dealer communities. The SEC can't regulate the issuer except through the securities laws' anti-fraud provisions. It can do enforcement, but not regulation. All of the disclosure rules are: "A dealer can't underwrite to sell the bonds unless the issuer does something." The thing we don't think about is there was never a good enforcement mechanism for Rule 15c2-12. A continuing disclosure agreement is a contract between the issuer and the bondholders. The theory is that, if the issuer breaks the contract, the bondholders can sue. But bondholders don't even know who each other are, and unless some are institutional investors, they don't have the money to sue. The continuing disclosure rules have been taken for granted to some degree, with the exception of enforcement cases which pointed out things that needed to be taken care of. This was a novel way to make both the dealer community and the issuer community pay attention.

Kenneth Durr: Not that novel, as we had seen it before in the Foreign Corrupt Practices Act – the prisoner's dilemma. We are heading to the end of the discussion, so I want to give the presenters a chance for final thoughts.

Marcy Edwards: I would like to look back at the municipal bond industry as a whole. We moved quickly over the last hundred years from an almost exclusively federally-financed infrastructure system to today. We now have three-quarters of public infrastructure financed on the state and local levels, and that's a huge shift and very unique in the world. The municipal market exists because that is the way the financing of our infrastructure has worked out. I think we actually have a great market, very low default rate, some big exceptions recently, but I don't think it is something sustained. It's been an honor to work in the municipal industry for thirty years, and to serve on the MSRB Board.

W. Bartley Hildreth: Going back to the last question, no one likes to be reminded of what they agreed to do that they haven't been doing, and that is my answer for MCDC. I would like to put a plug in for fundamental research on the municipal market microstructure.

Lynn Hume: I am excited about the future. I'm excited about technology developments and what the future will bring with alternative trading systems, more price transparency, and where the MSRB is going with its Long-Range Plan for Market Transparency Products.

Kenneth Durr: Thank you all for joining us today. Our program can be viewed again anytime on www.sechistorical.org; an edited transcript will be added later. I want to thank again the MSRB for its generosity and friendship in making today's program and the Gallery possible. Good afternoon.