



Remarks Of

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"Transparency for the Municipal Market"

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***/ The views expressed herein are those of Commissioner Roberts and do not necessarily represent those of the Commission, other Commissioners or the staff.**

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"Transparency for the Municipal Market"

I. Introduction

The municipal securities industry has experienced extraordinary scrutiny in recent months, both from regulators and from the media. Much of this attention has been focused on two issues: the need for improved disclosure in the municipal market, particularly in the secondary market, and the existence of political influence peddling in the municipal market, including the use of political contributions by underwriters and other securities professionals to obtain municipal securities business. There are, however, a number of other problems in the municipal market that warrant serious attention. Among these problems, in my view, is the need for increased transparency in the municipal market.

II. Need for Increased Transparency

As Chairman Levitt has indicated recently on more than one occasion, the principal way to improve the integrity and fairness of the issuance and trading of municipal securities is with more information. More information about issuers so that investors can better evaluate their securities. More information about the market so that investors can obtain fair prices. And more information about transactions so that regulators can do their job better. Investors will benefit from greater knowledge and confidence in their investments by a more informed marketplace. Consequently, the public at large will benefit from a stronger and healthier source of funding for local governments. It is my intention today to focus on the need for greater transparency in the municipal market.

Of course, transparency is defined as the degree to which real-time trade and quotation information and other market-related information (such as information about the depth of the market) is available to all market participants. In a completely transparent market, all market participants have equal and immediate access to all

quotations (including the size of the quotations) and to reports of prices and volumes on all trades effected in the market.

Transparency in the municipal securities market today is inadequate. Improving the level of transparency in this market would not only benefit investors and regulators -- it would also increase the overall efficiency of the market which should benefit issuers as well. While the voluntary efforts made in this area by market participants are laudable, regulators (including the Commission, the Municipal Securities Rulemaking Board ("MSRB"), the National Association of Securities Dealers, Inc. ("NASD"), and perhaps Congress) should strive to expand the availability of real-time municipal information to the fullest extent practicable. Of course, any improvements in the level of information dissemination will not be without cost, and this cost of improvement must be carefully considered as well.

Although it serves several important functions in the market, transparency is especially significant in creating efficient pricing mechanisms. Currently, municipal market participants, including investors and municipal securities dealers, lack access to indications of buying and selling interest (in the form of firm bid and ask quotations and last sale reports) for most municipal securities. Without this information, market participants cannot properly assess the value of their securities -- either securities they already own or securities they may wish to purchase in the secondary market.¹

Moreover, transparency supports the integrity of the market and boosts investor confidence in that integrity. For example, transparency permits investors to evaluate the performance of their dealers. By comparing the price paid by other market participants for the same security, investors can determine whether the price they paid (or received) was fair. By the same token, real-time quotation and last-sale data permit investors to determine whether the price quoted by their dealer is the best price

available in the market at that time. In addition, accurate quote and trade reports allow investors to better monitor the size of dealer mark-ups on their transactions.

Transparency also assists regulators in performing their oversight responsibilities. Although the antifraud provisions of the federal securities laws apply to transactions in municipal securities, the lack of published quote and trade data makes surveillance in the municipal market more difficult to accomplish than in other securities markets. Abuses may go unnoticed; and even when discovered, abuses generally can be investigated only by collecting data from multiple sources. This inefficiency impedes regulatory coordination, and thus hampers agency efforts towards investor protection. Alternatively, consolidated quote and last sale reporting -- transparency -- facilitates the reconstruction of market activity which is so critical in these investigations.

A. Methods of Disseminating Information

Currently, there is no widely available mechanism for the dissemination of quotation or transaction information for municipal securities. Thus, municipal securities market principals -- both dealers and investors -- have access to only limited quotation information, which is available to some but not all market participants, from a number of private services.² While these services furnish some information to the market, they do not include firm prices or sizes, nor do they include reports of executed trades.

Another source of market data are "broker's brokers," which act as intermediaries between dealers (and thus effect trades among their dealer/customers as agents). Dealers may enlist the aid of broker's brokers when they cannot obtain bids for securities in their inventory, or when they want to maintain anonymity.³ Conversely, a dealer also may use a broker's broker to locate certain securities (or types of securities) that the dealer wishes to buy. Because of the anonymity they

provide, broker's brokers generally have access to more market information than dealers.⁴

Nonetheless, even market participants using a combination of quotation services and broker's brokers⁵ may not have a comprehensive view of municipal market activity. Because these methods are voluntary, the information obtained through them may be skewed. For example, trades between a dealer and its customers, as well as trades between two dealers simply are not reported. Moreover, dealers may be unwilling to provide the market with information on their trades if they feel such disclosure will deny them the advantage that being the sole possessors of this information may bring them in other trades. Because the information available to investors may not represent the current market in a particular security (or other securities with similar maturities, interest rates, and credit risks), it is of limited use to market participants.

While private initiatives to increase transaction reporting in municipal securities should be encouraged, such initiatives should not give the dealer community discretion over what information is made available to the market, or when it is disclosed. Last sale reporting needs to be implemented for transactions in actively traded municipal securities. The distribution of price information would aid brokers, dealers, and investors in judging actual or potential market transaction prices, particularly because much of the pricing in the municipal securities market is done in reliance on pricing of similar issues trading in the secondary market.⁶

B. Municipal Market Characteristics

In considering how the level of transparency can be increased in the municipal securities market, a number of the municipal market's unique characteristics should be kept in mind. First of all, the secondary market for municipal debt is quite different from other markets. While over one million municipal securities issues are

outstanding, only an average of 180 issues actively trade in the secondary market at any given time.⁷ Further, most of the trading activity in a municipal security occurs shortly after its issuance.

Due in part to the sporadic nature of their secondary trading, and in part to their nature as debt securities, municipal securities are priced quite differently from equity securities. While these differences should not preclude the implementation of last sale, volume, and real-time quote dissemination to investors and market participants, these differences may indicate that increased transparency should only be sought for that segment of the market consisting of actively traded municipal securities.

C. Importance of Transparency to the Individual Investor

The profile of the typical investor in municipal securities has changed dramatically over the past decade. While, historically, institutions were one of the main investors in municipal bonds, today individual investors are by far the largest holders of municipal debt.⁸

Individual investors, however, have even less access to market data than dealers and institutional investors have. Generally, dealers and institutional investors have access to sophisticated research, either from in-house research departments or from external sources. Moreover, dealers and institutional investors usually have sufficient market share to be able to command fair prices.

Increased transparency would go a long way toward placing individual investors on a more equal footing with the other market participants. Further, because increased transparency would make the pricing of municipal securities more efficient, it also would benefit dealers and institutional investors who currently must expend significant resources searching for the best available quotation for a particular security.

D. Methods of Increasing Transparency

There are a number of alternative methods through which transparency could be increased in the municipal market. One such alternative is the pilot program, proposed by the MSRB last June, to collect and publish information on transactions occurring in the inter-dealer market for municipal securities.⁹ This program would make public on a daily basis certain aggregate information on National Securities Clearing Corporation ("NSCC") compared inter-dealer transactions for approximately 180 frequently-traded issues. The information would not be reported on a real-time basis, but rather would be available two days after the trade. While this proposal evidences an effort to develop municipal market transparency and would provide useful information for purposes of market surveillance and market analysis, it is not enough at least in my view.¹⁰ More needs to be done to provide investors with real-time quotation and transaction information.

Another approach to increasing transparency in the municipal securities market would be to encourage broker's brokers to disseminate last sale information on a timely basis to private services for transmission to their subscribers.¹¹ While this approach may be relatively simple to accomplish, it probably would not provide a reliable, long-term solution. Overall, such a system would not consolidate broker's brokers activity. Moreover, this approach would be voluntary, for all practical purposes. Dealers (who may be concerned that the use of broker's brokers to disseminate last sale reports could cause their market positions to be identifiable) could choose to conduct their business without the help of broker's brokers, and thus to circumvent this system.

When seeking to increase transparency in other markets, the Commission traditionally has taken incremental steps and initially required quote or trade reporting for only the market's most active issues. In the equity market, for example, the Commission initially imposed quote and trade reporting only in the most liquid

securities (such as those listed on the national exchanges and on Nasdaq/NMS).¹² This incremental approach gives the market an opportunity to adjust its trading mechanisms and gives market participants and regulators an opportunity to fairly balance the benefits and burdens imposed by increased transparency.

The Commission recently applied this approach to increase transparency in the market for high-yield debt securities by approving a proposal by the NASD to establish and operate an electronic facility, referred to as FIPS, to collect, process, and disseminate, real-time, firm quotations and transaction reports for between 30 and 50 of the most liquid high-yield bonds in the market at any given time.¹³ Moreover, FIPS will require transaction reporting in all high-yield bonds traded in the over-the-counter market within five minutes after the trades occur -- *i.e.*, in "real time".¹⁴ Expected to be operational in early 1994, FIPS is a major first step toward increasing transparency in the high-yield market.¹⁵

FIPS suggests two possibilities for increasing transparency (and liquidity) in the municipal securities market. One alternative would be to expand FIPS to include municipal securities. Another possibility would be to develop a system for municipal securities patterned after FIPS. While, under either alternative, the system would likely need modification to comport with the distinctive characteristics of the municipal market, these possibilities appear not only feasible, but also cost effective.¹⁶ For example, the cost of reporting municipal securities transactions to FIPS (or a FIPS-like system) would be minimized because municipal securities dealers and broker's brokers (as well as pricing services) already have access to systems that are capable of reporting these transactions.¹⁷ In addition, an MSRB committee could easily be formed to designate the criteria on which securities would be selected for inclusion in FIPS (or the FIPS-like system), and to determine the frequency with which such selections should be reviewed.¹⁸

Moreover, requiring the reporting and dissemination of market information through the NASD (in cooperation with the MSRB) is consistent with the obligations of the NASD as a self-regulatory organization. Such a system would facilitate the NASD's obligation to monitor the compliance of its municipal securities broker-dealer members with the federal securities laws and with the rules of the MSRB.

Because the NASD does not have authority over all municipal securities dealers, any effort to require dissemination of municipal securities transaction information through FIPS would require the cooperation of the MSRB and the NASD.¹⁹ It seems clear that the MSRB has the authority to require dissemination of quotation and last sale information by municipal securities brokers and dealers. The Exchange Act grants the MSRB broad authority to govern the form and content of quotations disseminated by municipal securities dealers.²⁰ Moreover, the Exchange Act directs the MSRB to adopt rules designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with other regulators and market participants, and, in general, to protect investors and the public interest.²¹ In my judgment, this authority appears sufficient to compel the use of a system designed to collect and disseminate quotation and transaction information.²²

E. Rulemaking Alternatives

In the absence of another viable solution, the Commission could attempt to increase municipal market transparency through rulemaking. In particular, the Commission could adopt a rule requiring municipal securities brokers and dealers to report for dissemination quotation or last sale information.²³ Alternatively, the Commission could (pursuant to Section 19(c) of the Exchange Act) require greater transparency through an addition or amendment to the MSRB rules.²⁴ Such action

would also likely stimulate private sector efforts to increase transparency in the municipal securities markets.

Chairman Levitt has emphasized, in discussing other issues pertaining to the municipal bond market, that the Commission's first choice would be for the industry to move ahead on its own and not wait for (or rely on) regulators to impose new rules or even new laws. This appears to me to be a reasonable course of action. Accordingly, the industry should be thinking about alternative methods for improving transparency in the municipal securities market. I encourage the industry today to do so.

III. Conclusion

Regulators and market participants soon must begin addressing the problems stemming from the lack of transparency in municipal securities transactions. The municipal securities market in 1993 is immense -- and predominantly retail. These investors need the protections that greater transparency can provide them. I believe that the technology is available and affordable to give investors in municipal securities somewhat similar protections to those which they receive in other securities markets, and it is my intention to provide these protections at a reasonable and appropriate level to municipal securities investors.

ENDNOTES

1. Because more widely available quotation and price information would raise dealers' incentives to quote competitive markets, it would also encourage competition between dealers.
2. For example, Standard & Poor's provides a computerized subscription service to dealers, through Telerate, known as the "Blue List Bond Ticker." Providing approximately 8,900 listings per day with an 18% turnover for new listings and deletions, the Blue List Bond Ticker disseminates municipal market information, including the price at which a dealer may be willing to sell a particular security. Other securities information vendors, such as Bloomberg, Quotron, and Bridge Data, provide services primarily designed to list securities for which bids are sought by dealers.

The municipal securities market is a "negotiated market;" for most municipal securities issues, dealers publish a statement indicating "bid wanted" (in other words, dealers list securities, without quotations, that they are willing to sell). Dealers willing to buy the security then negotiate with the dealer that published the bid wanted.
3. Dealers believe that anonymity is important to prevent their competitors from trading against them.
4. One well-known broker's broker is J.J. Kenny Co., Inc. ("Kenny"), which developed an automated communication system through which it disseminates voluntarily provided two-sided dealer quotations for approximately 40 actively-traded municipal securities. Kenny requires dealers to be firm for 250 bonds at their published bids and offers. For inactively traded securities, dealers willing to sell securities may have Kenny list the security or may ask Kenny to locate a purchaser without listing the security. Direct access to Kenny data is limited to broker-dealers. Although institutions are permitted to subscribe to the Kenny screen, they may not enter quotations.
5. For example, dealers may subscribe to one vendor (such as Kenny) to receive quotation information, and another (such as Bloomberg or Bridge Data) to publish interest in a particular security. Dealers also send by fax to their institutional customers daily quote sheets detailing the price and size of securities they are willing to trade.
6. For example, Kenny provides a municipal securities pricing service to dealers. Through this service, Kenny prices many securities by evaluating, among other things, the prices of other securities with similar maturities, interest rates, and credit risk.
7. Public Securities Association. See also Division of Market Regulation, U.S. Securities and Exchange Commission, Staff Report on the Municipal Securities Market, (Sept. 1993) at 18.

8. **American Banker, The Bond Buyer 1993 Yearbook, (1993) at 62. As of 1992, of the total debt outstanding of \$1,145.6 billion, households held \$598.4 billion, or 52% of total debt outstanding; mutual funds held \$164.7 billion or 14%; property and casualty insurers held \$138.8 billion or 12%; commercial banks held \$98.9 billion or 8%; and money market funds held \$91.6 billion or 7%.**
9. **MSRB Reports (June, 1993), at 3-6. This program is known as the Inter-Dealer Transaction Information program. Note that, to date, the MSRB has not filed this proposal with the Commission.**
10. **Specifically, the MSRB proposal would not provide sufficient information for investors to monitor the execution quality of their transactions, to value their municipal portfolios, or to assess volatile credit market conditions.**
11. **For example, Kenny could make last sale information available to Bloomberg or Telerate, in much the same way that Cantor Fitzgerald conducts its thirty-year Treasury bond service.**
12. **The Commission used this approach hoping to avoid the widening spreads and reduced liquidity that it feared could result otherwise.**
13. **The securities selected to be reported in FIPS will be reviewed by an NASD Committee on a quarterly basis.**
14. **Securities Exchange Act Release No. 32091 (March 19, 1993), 58 FR 16428.**
15. **Once it is operational, FIPS will disseminate bids and offers from brokers and dealers, and will also calculate the "inside market" (which will include the best bid and the best offer for each security listed on FIPS). NASD members will be able to view FIPS quotations through FIPS terminals. Quotations will be disseminated to non-members through securities information processors, or vendors. Thus FIPS quotations generally will be available to investors. In addition, the NASD is authorized to disseminate through FIPS (and to make available to vendors) high/low trading ranges and accumulated volume in each bond quoted in the system on an hourly basis.**
16. **This will allow the Commission time to examine the effects of increased transparency in the municipal securities market, and to assess whether dissemination of firm quotations also should be required. Because two-sided quotations currently are disseminated through broker's brokers for actively traded securities, quotation information for these securities should be easily disseminated through FIPS. FIPS also would allow dealers to submit quotations through a broker's broker, and thus, maintain anonymity.**
17. **Registered open-end investment companies must price their holdings of securities at the end of each day, in order to sell and redeem shares at their net asset value. In pricing these holdings, investment companies rely on various pricing services which, in the absence of actual transaction information, rely on matrices that estimate prices based on the trade prices of similarly situated and rated bonds.**

18. Using the criteria used by the NASD for selecting high-yield bonds for FIPS inclusion as a guide, a similar MSRB committee could be established. Among the factors that should be taken into account are the rating of the issue, the size of the issue and issuer, and the yield. Since relatively few municipal securities trade actively in the secondary market, and since most trades occur soon after the securities are issued, the MSRB committee would likely need to review its FIPS selections quite often, perhaps as frequently as twice a month. The MSRB committee could determine an appropriate review cycle and continue to modify the cycle as warranted.
19. The NASD has enforcement authority over non-bank securities firms registered with the Commission. Exchange Act Section 15A(b)(7) requires the NASD to have rules providing for the discipline of members who violate the MSRB's rules.
20. Section 15B(b)(2)(F) of the Securities Exchange Act of 1934 ("Exchange Act"), authorizes the MSRB to adopt rules governing (a) the form and content of quotations relating to municipal securities distributed or published by municipal securities brokers, dealers, or their associated persons, and (b) the persons to whom such quotations may be supplied. Such rules must be designed to produce fair and informative quotations, to prevent fictitious or misleading quotations, and to promote orderly procedures for collecting, distributing, and publishing quotations. To date, the MSRB has not used this authority to adopt rules governing quotations.
21. Exchange Act § 15B(b)(2)(C). Specifically, Section 15B(b)(2) provides that:

The [MSRB] shall propose and adopt rules to effect the purposes of this title with respect to transactions in municipal securities effected by brokers, dealers, and municipal securities dealers. . . . The rules of the Board, as a minimum, shall: . . .

(C) be designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in municipal securities, to remove impediments to and perfect the mechanism of a free and open market in municipal securities, and, in general, to protect investors and the public interest;
22. In approving the MSRB's Municipal Securities Information Library ("MSIL"), the Commission stated that Section 15B provided the MSRB with authority to operate systems designed to collect and disseminate official statements provided by municipal securities underwriters. The Commission cited authority by the NASD under Section 15A of the Act to operate systems such as NASDAQ. Similar to the MSRB's authority under Section 15B, Section 15A provides the NASD the authority to adopt rules designed to prevent fraudulent and manipulative acts and practices without explicitly granting the NASD authority to run a system such as NASDAQ. Securities Exchange Act Release No. 29298 (June 13, 1991), 56 FR 28194.

Moreover, Congress (in the legislative history accompanying the Securities Acts amendments of 1975) explicitly acknowledged the NASD's authority to adopt rules for collecting and publishing quotations, and did not question the NASD's authority to develop and implement the NASDAQ system. S. Rep. No. 75, Securities Exchange Act of 1975; Report of the Committee on Banking, Housing and Urban Affairs, to Accompany S. 249, 94th Cong., 2d Sess. 42 (1975).

23. Exchange Act Section 17(a) provides, in pertinent part, that:
[Every] registered municipal securities dealer ... shall ... make and disseminate such reports as the Commission, by rule, prescribes as necessary or appropriate in the public interest, for the protection of investors, or otherwise in furtherance of the purposes of this title.

See also Exchange Act §§ 10(b), 15(c)(1), and 15(c)(2) (containing additional supporting authority).

24. Exchange Act Section 19(c) authorizes the Commission (as it deems necessary or appropriate to further the purposes of the Exchange Act) to abrogate, add to, and delete from the rules of a self-regulatory organization. In this situation, the Commission could find such a rulemaking regarding transparency necessary or appropriate to implement the goals and objectives of Section 15B of the Exchange Act (particularly those enumerated in Sections 15B(b)(2)(C) and (F)).