

TESTIMONY OF  
JOSEPH P. BORG

Director, Alabama Securities Commission

Before the

**United States Securities & Exchange Commission  
Municipal Securities Market Field Hearing**

Birmingham, Alabama

“Looking At Disclosures: Issuer and Investor Perspectives”

July 29, 2011

Chairman Schapiro, Commissioner Walter and Distinguished Officials:

On behalf of investors in Alabama and the Alabama Securities Commission (ASC), we would like to thank the U.S. Securities & Exchange Commission (SEC) for holding this hearing on “The State of the Municipal Securities Market”. My comments today will concentrate on issuer and investor perspectives with regard to disclosures in the municipal securities markets. It is not news that municipal bond market investors have been clamoring for more in depth information about the bonds and issuers they are investing in. Investors are demanding more disclosure and some have pointed out that the disclosures provided are not on par with corporate disclosures. And while this is a somewhat unfair comparison, lessons can be taken from the public disclosures for corporate bonds and stocks which are generally more consistent and released far more quickly. Increasingly, investors complain that they are not being kept up-to-date on changes in the financial status of issuers and that this lack of information raises serious concerns that these markets may have hidden dangers for “Main Street” investors. With significant pressures on state and local government budgets, timely and complete disclosure in this market is now of greater concern. And given the historical levels of predominately lax disclosure, there is room for improvement. The decision that an investor will make on whether to invest in a municipal or governmental bond must be based on good, solid, reliable and timely information. Disclosure is a primary component of that information.

I would like to digress a moment to compliment the SEC for creating a separate unit in its Enforcement Division focusing on the municipal bond markets and to applaud the more aggressive actions being taken for the protection of investors. In addition, the recent implementation of upgrades by the MSRB of the Electronic Municipal Market Access (EMMA) disclosure system is an example of a valuable and needed improvement. Even with these improvements, timely information concerning ongoing obligations is still lacking and the need to assist smaller issuers in understanding the value of communicating directly with investors is yet to be achieved. And while we all realize that many of the municipalities do not have sufficient resources to provide continuing up-to-date disclosures on their bond offerings, especially in these financially distressing times, investors rightfully continue to demand more accurate and timely information.

Historical data demonstrates that risk to investors is generally low with regard to municipal bonds, but recent SEC, state regulator and Financial Institutions Regulatory Authority (FINRA) actions clearly point to growing concern regarding the lack of current official filings, the lack of transparency and lack of continuity regarding financial records of some public borrowers. In a \$3 trillion market, weak disclosure raises the anxiety levels of investors where current and continuing financial information is absolutely necessary for investors to make informed investment decisions. While it appears that regulators, industry and investors agree that state and local governments should boost their continuing disclosure, the question then becomes whether this will be done voluntarily or will regulators need to continue to mandate improvements. Some issuers do provide current and timely information, but it is well known among regulators and market participants that many issuers do not comply with continuing disclosure agreements and, unfortunately, the broker-dealer community has not insisted on nor assisted in supplying this information.

In late May, the Government Finance Officers Association's committee on governmental debt management convened a conference in San Antonio with discussions on revising best practices on primary and secondary market disclosure. Discussed were suggestions such as: model short forms

for releasing information, unaudited monthly or quarterly financial data; treasurer's reports and other ideas; such as helping small issuers develop procedures key to providing continuing disclosure. Relatedly, the Bond Dealers of America in June unveiled guidelines designed to help dealers comply with suitability disclosure and pricing rules in dealing with retail investors. Clearly, some of this action is being made to stave off implementation of secondary market disclosure requirements being proposed by the SEC and FINRA. The marketplace is well aware that regulators on all levels have taken an interest in promoting investor protection in the muni bond market. I have already mentioned some of the SEC's actions and the creation of the new Municipal Bond unit in the SEC's Enforcement Division. FINRA launched a regulatory sweep of firms in June 2009 and through the joint efforts of FINRA's Enforcement, Member Regulation and Market Regulation divisions has filed some 200+ actions for MSRB violations according to recent reports. Recently FINRA fined four firms for failing to deliver official statements to customers who purchased new issue municipal securities required by the rules of the MSRB which rules FINRA enforces. This also brings home the point that matters of transparency, disclosure, and timely delivery of material information to investors, not only rests with the issuers, but with advisers and broker-dealers as well.

To understand the current state of the municipal bond market, perhaps it is appropriate to review municipal disclosure practices in an historical context. Prior to the 1960s, municipal bonds were sold without difficulty (even when disclosure was limited to a notice of sale) as the majority of tax-exempt issuers were general obligation bonds with a full faith and credit pledge, and the market consisted of predominantly institutional investors. After the '60s, the marketplace saw the creation of various types of revenue bonds and new varieties of municipal bonds with new bond features being introduced, such as advance refunding, specialized industrial development and housing bonds and new structures with terminology such as zero coupon, variable rate and credit enhanced. This diversity necessitated greater disclosure. Prior to the default by the City of New York in 1975, these municipal bonds were considered "risk free". During the '70's and '80's when our nation transformed

from a nation of savers to a nation of investors, the demand for municipal securities changed dramatically. Banks were no longer the primary buyers of tax-exempt bonds. Since the mid 80's, the public sector of individual investors and trusts has accounted for more than 50% of new issues. But unlike institutional investors, individual "Main Street" investors must depend upon an official statement as the primary source of information and require updated disclosure and financial information to determine the status, value and risk of their investments. When Washington Public Power Supply System defaulted on almost \$2.5 billion of tax-exempt revenue bonds in 1983, SEC Rule 15c2-12 was enacted which obligates underwriters participating in new offerings to obtain, review and distribute to investors copies of the issuers' official statement. But continuing concern with the adequacy of disclosure in the secondary market resulted in an amended SEC Rule 15c2-12 barring broker-dealers from buying municipal securities unless the issuer agreed to provide ongoing disclosure. The MSRB followed in 2008 establishing the Electronic Municipal Market Access (EMMA) System. Amendments to SEC Rule 15c2-12 made EMMA the single repository for continuing disclosure filings. With the SEC rules in place and guidelines such as those prepared by the Government Finance Officers Association, the SEC Interpretive Release and FINRA's releases, along with the "reportable events" to be filed with EMMA as of December 1, 2010, much progress has been made. The provisions of SEC Rule 15c2-12 should be read as setting a floor not a ceiling with regard to a common sense approach to disclosure. To accomplish what is needed in the initial and continuing disclosures demanded by investors; I quote from the May 4, 2011 speech by SEC Commissioner Walter:

"In order to achieve significant improvements ... especially in the near-term, I believe we need to employ a layered approach – meaning at the legislative, regulatory and industry levels and we all need to work together. In addition to any efforts by Congress or the Commission to improve the state of the municipal securities market, industry initiatives can be tremendously influential."

Issuers, investors and dealers have different perspectives on disclosure. While some are producers of information, others function as users or intermediaries. All disclosure initiatives must

weigh and balance the differences in the regulatory and industry efforts to protect investors, promote integrity and keep the market as efficient and fair as possible.

Regulatory, SRO and industry participants working together can achieve what cannot be achieved by a single entity. The recognized need for additional disclosures, continuing the flow of information to investors, and the timeliness of such information is of paramount importance. But as with any proposed regulation or policy, careful thought must be given to avoid unforeseen or unintended consequences<sup>1</sup>. But with input from all participants in the market, proposals to rules, regulations and industry standards can all come together to play an important part in making sure that investors are protected, thereby strengthening the municipal bond market arena.

With regard to issuers, the bottom line is that they need to be careful. Issuers must be certain that all material information is properly disclosed. Even if a municipality or other issuer hires outside counsel, the issuer is still responsible for making sure that all the material disclosures are correct. Bad news is always “material” and must not be dismissed lightly or hidden in fine print. Municipalities should also have an assigned person who has the primary responsibility for making sure that there is a clear list of responsibilities and a clear line of command. And while issuers may rely on outside counsel, it is important to note that they cannot do so blindly and as we have seen, the SEC has sued bond counsel for issuers.

By way of example, my office issues a “No Stop Order” with regard to certain types of bond issues, specifically Industrial Revenue Bonds, commonly known as IDRs. The No Stop Order must be in place before the bonds are permitted to be issued and sold. Some of the questions we and other state regulators ask issuers is whether or not they have asked themselves why they are issuing the bonds and for what purpose. Was it an idea of the industrial development board or did some private party approach the board to suggest the bond issuance? We also caution against suggesting

---

<sup>1</sup> On February 22, 2011, the ASC and the Alabama Attorney General commented on SEC Release No. 34-63576, and while most of the proposal is sound, one aspect causes concern with regard to the anticipated loss of “expertise” on certain boards and commissions as a potential unintended consequence.

friends, such as lawyers and underwriters that can handle various phases of the issuance. An issuer is duty-bound to assess the need for the bond issuance and be certain that they are getting good advice, good services and not over-paying. For investors, they need to remember that the days of “investing in stocks and bonds” as a simple diversification tool are long gone. With many more options and products available, many investors do not want to get into risky alternative complex instruments but still want to invest in traditional blue chip stocks and bonds. To quote my colleague, Illinois Securities Director Tanya Solov:

“In other words, when someone wants bonds, they want safety and they assume a municipal bond is about as safe as it gets. The duty then falls upon issuers, underwriters, advisers, stock brokers and everyone else involved in bonds issuance to disclose everything in an easily understandable way.”

Sales professionals need to make sure they understand the bond’s risks before they recommend and sell to investors. Some bonds are not tax-exempt and many investors do not know this up front. There can be no assumption that an investor is knowledgeable or sophisticated because they have an interest in bonds or have purchased bonds previously. We have found that even investors that have been in the market for decades are not aware of bond risks. In a recent investigation by the Arkansas Securities Department involving the sale of a series of fraudulent bonds, a significant number of which were pledged to various banks as collateral, Arkansas Securities Commissioner Heath Abshire made the observation:

“... The message here is due diligence, had any of the purchasers actually looked into the bonds before purchase, for example, looked for the mortgage that secured the bonds, they would have seen some issues.”

It is clear, that going forward, the regulators -- SEC, States and FINRA are going to hold accountable underwriters, accountants, lawyers, advisors, firms and sales persons for information they knew or should have known was material.

In summary, I again commend the SEC for holding these hearings and for its new initiatives. I also take this opportunity to compliment my fellow state securities regulators, FINRA and various

industry groups for recognizing the importance of transparency, complete disclosure and the need for timely, ongoing information that investors require to make intelligent and informed decisions.

I thank you for the opportunity to be part of these hearings and I look forward to working with the SEC, FINRA, and industry organizations to better safeguard our investors.