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SEC - Speech By Chairman Christopher Cox - 'Integrity In The Municipal Marketplace'

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Chairman Christopher Cox
 U.S. Securities and Exchange Commission
 Town Hall of Los Angeles
 Biltmore Hotel
 Los Angeles, California

July 18, 2007


Good morning, and thank you, Jim [Town Hall Chairman], for that kind introduction. I have to say, it was awfully nice, especially after a late flight from the East Coast, to wake up here with the sun peering over the San Gabriel Mountains, and to know that I'm back in the city of Hollywood dreams, summer breezes, and even the prospect of a Dodgers-Angels pennant race. For the record, while the SEC obviously takes no official position on baseball, I should note that we are always in hot pursuit of dodgers, and always on the side of the angels.

Given my topic today – integrity in the municipal marketplace – it's appropriate that I'm standing at the center of one of the great municipalities in the world. This city is an exceptional example of the demands that our urban environment necessarily makes on our capital markets. When you turned on the water this morning, or took your child to a public school, a local park, or a recreation center, or drove on a freeway, you tapped into public goods that are routinely financed with municipal bonds. To service the needs of so many millions of people in this city, not just millions but many billions of dollars in municipal debt are necessary.

At the SEC, we refer to all bonds, as well as notes and other debt securities – whether they're issued by a state such as California, or a local government such as the City of Los Angeles, or by any of their respective agencies and instrumentalities – as "municipal securities." The "instrumentalities" part of that definition is important, because municipal securities aren't just issued by governments. Beyond paying for a multitude of public projects and governmental needs, municipal securities often act as a conduit on behalf of private organizations that want to obtain tax-exempt interest rates to fund many kinds of non-governmental, private projects. Think National Football League and Major League Baseball stadiums,

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National Basketball Association arenas, convention centers, golf courses, and a host of other enterprises.



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and many others!

Taking all of this into account, the overall size of the municipal market is enormous. There now are nearly \$2.5 trillion of municipal securities outstanding. That's more than the gross domestic product of China. Last year alone, more than \$430 billion of new municipal bonds and notes were issued. That's roughly the size of the U.S. defense budget.

The municipal market affects the lives of every individual, and the business of every company in the United States. Whether you use facilities that are financed by bonds, or you're an investor who has municipals in your portfolio, or you're a taxpayer who pays higher bills when municipal finance isn't conducted properly, this topic is all about you.

When the federal securities laws were enacted more than 70 years ago, the municipal bond market was relatively small. And it was dominated by institutional investors. But times have changed – and not just because \$2.5 trillion is a lot of money. Today's municipal securities market is particularly favored by individual investors. Fully 36% of all municipal securities are owned directly by households. And up to another one-third of the total municipal market is held indirectly through money market funds, mutual funds, and closed-end funds.

Today's municipal market is different from the old days in other ways, too. Despite its reputation as a "buy and hold" market, municipal trading volume is substantial. Over \$6 trillion of municipal securities changed hands in 2006. That's a trading volume similar to what we see in the corporate bond market. And again, reflecting the dominance of the individual investor in this market, the median size of a trade in fixed-income municipal securities is only \$25,000. A whopping 87% of all customer trades are for less than \$100,000. Over half are under \$25,000.

One would think, given the size and importance of this market, and the prevalence of individual investors and older Americans in municipal trading and investing, that investors in municipal bonds can rest assured that their interests are fully protected by the same high standards that operate everywhere else in the U.S. capital markets. Not exactly. And not even close.

This is mostly for historical reasons – because the federal securities laws were adopted when municipal finance was a relatively small and uninteresting corner of

the nation's capital markets.

But today's market bears almost no resemblance to the relatively small and sleepy municipal bond activity of days gone by. Today's investors in municipal securities in many respects get second-class treatment under current law. While these differences might have been justified when the securities laws were originally enacted, the old justifications don't apply any longer. Investors, analysts, investment advisers, and broker-dealers deserve the same level of current, high-quality disclosure and protection in the municipal market as they do in the corporate market.

Southern Californians are acutely aware of why this is so. Orange County's foray into the derivatives market in the 1990s, which occasioned the largest municipal bankruptcy in American history, resulted in a number of enforcement actions by the Commission – and taxpayers are still paying the price.

Very recently the SEC sanctioned the City of San Diego for committing securities fraud. They failed to disclose to municipal bond investors important information about their pension and retiree health care obligations. San Diego's offering documents didn't tell investors that the city's unfunded liability to its pension plan was projected to grow dramatically – from \$284 million at the beginning of 2002 to \$2 billion by 2009 – or that the city's liability for retiree health care was projected to grow to more than \$1 billion. Investors had no way of knowing that the city knowingly under-funded its pension obligations so that it could increase pension benefits, while deferring the costs. If investors had known this, they could also have figured out that San Diego was bound to face severe difficulty funding its future pension and retiree health care obligations – a minor little piece of accounting business.

The SEC also determined that both Orange County and San Diego made misleading statements in their offering documents for municipal securities. They also gave this same misleading information to the credit rating agencies.

Yes, we've addressed these issues – after the fact. But it's not enough to punish fraud; we've got to work to prevent it. To an investor whose life's savings are at risk, it's small comfort to know that if things go wrong a punishment could be imposed. It's even less comfort when you consider that if a penalty were imposed as is the case in the corporate context, it would be the defrauded victims themselves who would pay the fine. Municipalities have no money of their own. If the SEC were to fine a municipal issuer, the penalty would be paid in tax dollars from the pockets of law-abiding citizens. Your pockets. In essence, victims would be

robbed twice. And then it wouldn't be just the original victims who would be out their money. It would be all of us.

So while the SEC has anti-fraud authority – allowing us to come in and clean up messes like these after the fact – neither we nor any other federal regulator has the authority in the municipal market that we have in the corporate securities market to insist on full disclosure of all material information to investors at the time the securities are being sold. It's a basic common-sense consumer protection that is way overdue.

Thankfully, Caltrans understands the concept. We'd all prefer a sign saying "Bridge Out Ahead" to an ambulance at the bottom of the canyon. Yet our current tools in the area of municipal offerings are more like the ambulance that arrives to pick up the pieces.

The kind of securities fraud that we saw in the case of the Orange County bankruptcy and the San Diego pension scandal not only jeopardized the interests of the many individual investors who placed their trust in the City's and County's bonds, but also threatened the pocketbooks of millions of taxpayers, and the security of every one of the municipalities' current and future retirees.

The taxpayers and citizens are still cleaning up these very expensive disasters. The saddest part is that they could have been prevented. If there had been a sturdy regime of full and fair disclosure and securities law compliance, the story would have been very different. But that kind of regime is still utterly absent in the municipal market. The City of San Diego only recently issued audited annual financial statements for 2003 and 2004, and it is still unable to access the public market to borrow for the ongoing capital needs of its citizens.

Unfortunately, the problems in municipal finance aren't localized here in Southern California, nor are they of only recent vintage. From the spectacular financial collapse of New York City in the 1970s, to the multi-billion dollar default in the 1980s by the Washington Public Power Supply System – whose acronym, pronounced "whoops," came to represent the shortcomings of municipal disclosure – there has been a steady drumbeat of consistent warnings. Our recent SEC enforcement actions in the municipal area, together with the expert observations of Commission staff, indicate an urgent need to improve the quality and the availability of disclosure documents and financial information for municipal securities. We need to take immediate steps to improve governmental accounting, and to insure that issuers make financial information available more quickly. And we need to increase the understanding and involvement of issuer officials in the disclosure process, so

that process becomes subject to appropriate disclosure controls and procedures.

Yet the trend seems to be in the opposite direction, which is why it's so necessary now for investor advocates to speak out.

Texas and Connecticut recently considered legislation to permit those states and their local governments to avoid following the rules of the Governmental Accounting Standards Board. In Connecticut, the governor vetoed the bill. But in Texas, it became law. These efforts are a clear and present danger to investors in municipal securities. The lack of uniformly applied, generally accepted accounting standards in the municipal market will undermine the comparability of financial statements, and ultimately the confidence of investors in the integrity of the municipal market.

Adherence to the Governmental Accounting Standards Board's standards by all issuers of municipal securities is just as important as adherence to the Financial Accounting Standards Board's standards by all corporate issuers. But under current law, the Commission does not have the same authority to require the use of proper accounting standards by municipal issuers that it does for issuers of corporate securities.

Lest you think attempts to defect from municipal accounting standards are limited to two states, there is more. Recently, a number of government issuer associations have decided to "reassess the GASB's continued role as the authoritative accounting standard-setting body for state and local governments." They want to freeze its current funding level, and consider making it go away altogether by merging it into the Financial Accounting Standards Board. Rather transparently, the impetus for this decision is the issuers' dissatisfaction with some of the standards GASB has recently set, and with a particular project that GASB has undertaken.

Like the wolf wearing grandma's nightcap and innocently addressing Little Red Riding Hood, the issuer associations assert that their initiative, which threatens the very existence of GASB, is not intended to undermine the Board's independence. But even if GASB were to continue to exist in the face of these so far relatively few defections, the fact that issuers feel free to threaten both the Board's budget and its status whenever they disagree with a rule or a project means that the Board's independence is in fact under full-scale assault.

The importance of the complete independence of accounting standard setters from the entities whose financial statements they regulate is a central precept of well

functioning capital markets. And the need for that independence is just as great in the municipal market as it is in the corporate market. Every participant in the marketplace needs to have confidence in financial statements, and that includes not only investors, but also rating agencies, auditors, analysts, and everyone upon whom they rely. By undermining this confidence, the assault on independent standard setting by the entities whose financial statements are provided to the public will damage the market as a whole.

There is every reason to worry about this erosion in current standards, because what we have today is already sorely lacking. For example, some municipal issuers include audit opinions and audited financial information in disclosure documents without obtaining the consent of the auditor. When that happens, you – the investor – need to know about it. That’s because in order to give its consent, an auditor must perform certain procedures. And some of those procedures are designed to detect events since the date of its audit opinion that may have a material impact on the issuer’s financial condition. If there is no auditor’s consent, then it is almost certain that no such procedures were performed. And that means the financial statements the issuer is asking you to rely on aren’t as reliable as you thought.

Among other things, auditor consents serve as a double check on the issuer’s representations about changes to its financial condition since the period covered by the audit. You will be comforted to know that in the corporate market, the auditor’s consent has to be obtained before its audit opinion can be included in an offering document. I dare say that most individual investors in municipal securities have no idea that this isn’t always the case in a municipal offering. At a minimum, shouldn’t issuers who don’t obtain auditor consents at least disclose that fact, and tell investors what it means?

I suppose you could make the argument that municipal issuers are merely saving taxpayer dollars by not having to pay the auditor for additional procedures. You could also save a bundle on pre-surgery medical evaluation by relying on last year’s MRI. Personally, I’d like to know the recent findings, and whether something has changed.

It is an unhappy fact that much of the information given to investors in municipal offerings is stale to begin with. As a general rule, issuers of municipal securities simply don’t issue their financial statements as promptly or as frequently as corporate issuers.

In the post-Enron world, we’ve all concluded that one of the best ways to prevent securities fraud is setting the right tone at the top. We have made CEOs and other

top officials sign their names to the financial disclosures they make to investors, and we've let them know they face criminal penalties if they don't responsibly execute that obligation. But nothing like this environment exists in the world of municipal finance. There is simply inadequate participation by public officials in the preparation of offering disclosures.

It has been 11 years since the Commission issued its investigation report on the Orange County debacle. Here's what we said:

"The Supervisors ... had a duty to take steps appropriate under the circumstances to assure accurate disclosure was made to investors regarding ... material information. The Supervisors, however, failed to take appropriate steps. For example ... they never questioned [the County's] officials, employees or other agents regarding the disclosure of this information; nor did they become familiar with the disclosure regarding the County's financial condition.

"Had they taken such or similar steps, it should have been apparent to each Supervisor, in light of his or her knowledge, that the disclosure regarding the County's financial condition may have been materially false or misleading."

Despite this explicit statement from the Commission, our experience in recent enforcement actions suggests that not much has changed. Too many municipal issuers – and in particular the members of their governing bodies – remain inadequately involved in disclosure.

So, for example, in our 2003 decision *In the Matter of the City of Miami*, the Commission found that Miami's officials ignored the City's disclosure responsibilities. The City Manager actually admitted that he wasn't familiar with Miami's disclosure requirements. And he dismissed the importance of the bond offering documents.

Here's another instance. In our 2004 cease-and-desist order involving the Dauphin County (Pennsylvania) General Authority, the Commission found that the county Authority not only didn't participate actively in the preparation of the disclosure, but Authority members had read little or none of it. (I should add that in its settlement with the SEC, the Authority neither admitted nor denied these findings.)

Sadly, this isn't even all that unusual. In another one of our cases, the business

manager for a school district testified she signed the non-arbitrage certificate “pretty much having no idea what the document meant.”

When the responsible officials of a municipal issuer don't know what's in their disclosure documents, it's often a symptom of an even broader problem: the lack of disclosure controls, policies, and procedures for municipal issuers. And the fact is, even large issuers of municipal securities generally don't have policies and procedures to ensure accurate disclosure.

In at least one case, however, the SEC is going to see to it that a major municipal issuer does adopt this kind of control over its finances. That's because our settlement with the City of San Diego requires it. San Diego's new procedures will cover disclosures it makes in its financial statements, its continuing disclosure agreements, and its disclosures to rating agencies.

But right now, the SEC can only ensure that these sorts of investor protections are put in place once a securities fraud has already been committed, and the damage has already been done. From the investor's standpoint, it's a little like assuring a skydiver who's now in the hospital in traction that, rest assured, next time that parachute is going to open. So, ready to try again?

How much pain and expense can be avoided if we simply take these steps in the first place? The problem is, the SEC simply does not have the authority to do that. As it is, the Commission is using every ounce of authority we have to try to deal with these concerns. The time has come to rethink and revamp.

There are two basic approaches that we might take, and they are not mutually exclusive.

The first and more straightforward approach is legislation. Currently, the agency is restricted to enforcing the antifraud provisions of the securities laws, and to regulating the brokers and dealers who engage in municipal securities transactions. The best way to address the problems and needs of municipal securities investors in a coherent manner is through legislation designed with the modern realities of today's \$6 trillion annual trading market in mind.

Any such legislation should start from the premise that, as in the corporate market,

most issuers are honest and do a fine job. A well designed regulatory regime considers the costs as well as the benefits. So the needs of municipal issuers to have access to capital at the lowest possible cost have to be kept firmly in mind. And while the regulation of today's highly efficient capital markets for non-municipal issuers offers a blueprint for balancing efficiency and investor protection, we should stipulate at the outset that the model of full registration and regulation applicable to private companies is not necessary for states and local governments.

Nor do I believe it would be appropriate for the Commission to review the disclosure documents of municipal issuers as it does those of public companies. The SEC's jurisdiction should not be extended there, both in recognition of the fact that municipal issuers are themselves U.S. sovereigns, and because the sheer number of municipal offerings would overwhelm the SEC, which after all has not been constructed with the idea of exercising that particular responsibility.

But there is a job for legislation to do. It is needed to establish a limited regulatory regime designed expressly for the needs of the municipal market. That limited regulation should be focused on ensuring that investors in primary offerings receive the information they need, prior to the sale – at the time they make their decision to invest.

Among other things, model legislation might provide that the offering documents and periodic reports provided to investors contain information similar to what they're accustomed to seeing for all of the other securities they own.

It could focus on making this information available on a more timely basis, for example, by tapping the power of the Internet to provide an easily accessible, free source for the display of that information, similar to the SEC's EDGAR system.

It could mandate municipal issuer use of generally accepted governmental accounting standards.

And on the subject of a sturdy, independent standard setter for municipal accounting rules, it could provide an independent funding mechanism for the GASB. Another sound step would be to require or permit Commission oversight of the GASB, just as the Sarbanes-Oxley Act provided SEC oversight for the FASB.

A cornerstone of reform in this area would be to ensure that private companies who access the municipal market indirectly by using municipal issuers as conduits will meet the same requirements that corporate issuers must meet.

And it should be established that at least for large, complex, and frequent issuers of municipal securities, the issuer should have policies and procedures for disclosure that are appropriate to its circumstances.

To address the recurrent problems that we have seen through our enforcement program, the Congress could clarify the legal responsibilities of issuer officials for the disclosure documents that they authorize. It could spell out the responsibilities of underwriters with respect to the offering statements in municipal offerings. And it could articulate the securities law responsibilities of bond counsel and other participants in offerings. Properly done, this could reduce the cost – to taxpayers, issuers, and their professional consultants – that arises because of today's uncertain liability environment.

Weighing the policy choices that I've outlined is not, of course, the responsibility of the SEC under current law. Policymakers in Congress are the right people to make these choices, not least of all because doing so requires taking into account the many distinctive attributes of the municipal market with which our elected representatives are so familiar, including the diversity of issuers, their unique status as governments, and the large number of municipal issuers – over 50,000 across America.

This won't be an easy task, but it is one that should, at long last, begin.

The second approach is more aggressive use of our existing regulatory authorities. And while this is certainly no substitute for the possible legislative steps I've outlined, it can be highly complementary. For example, in the coming months, SEC examiners will be conducting focused reviews in the municipal market. Their reviews will focus on broker-dealer compliance with the Municipal Securities Rulemaking Board's Rule G-37, also known as the "pay to play" rule. In brief, Rule G-37 prohibits broker-dealers from doing business with municipal issuers to which they have made political contributions.

Another example of how the SEC can use its existing regulatory authorities is the review that our staff will be undertaking of the system of Nationally Recognized Municipal Securities Information Repositories. In particular, we'll look at the role

these entities are playing in making municipal disclosures available to investors and brokers.

And some of the improvements we're seeking can be accomplished without either new legislation or new regulation. For example, when it comes to insuring that disclosure is timely, there are impressive private sector efforts underway to tap the power of technology to enable real-time financial reporting. The international consortium that is developing the open-source XBRL standard to make both textual disclosure and financial statement disclosure interactive holds great promise not just for the corporate market, but for the municipal market as well.

U.S. municipal issuers should consider the benefits of using XBRL in order to reduce their costs of disclosure, to stay competitive in the capital markets of the 21st century, and to insure that they're getting the best information to their investors in the most timely and useful way. Greater use of interactive data in the municipal market will benefit municipal issuers and investors alike.

Joel Kotkin, an Angelino and urban writer who's well known to many of you, once wrote that among the ingredients that make successful cities flourish is "an authority capable of administering contracts and enforcing basic codes of commercial behavior." At bottom, that's what securities regulators do in our capital markets. We do it well, and we do it aggressively, in the portion of our capital markets that's devoted to corporate finance. But for the \$6 trillion in municipal securities that change hands annually in our capital markets, we don't do it at all. That's not good for our cities, and it's certainly not good for their citizens, for their investors, or for our markets.

California has always been a trendsetter. Let's work to see that the next trend is as leaders of the reform of our municipal securities market. California has paid a steep price for its lessons in the municipal markets, and we're still paying. Let's not waste it. You can provide a template for the rest of the nation on how to do it. Let California be known for both the sunlight of its skies and the sunlight of its financial disclosures.

Thank you for focusing on these important issues this morning. This is an impressive group of leaders, and many of you work each day in our capital markets to ensure that those markets are the freest, most liquid, safest, and most secure in the world. To each of you, thank you for what you do to uphold the integrity of our markets. More than anything else, that's the heart of market confidence: integrity. America's investors depend on you. From all of us at the SEC, thank you. We're proud to be your partners.

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