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SEC Concerns With Municipal Derivatives

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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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SEC Concerns With Municipal Derivatives

I. **Introduction**

I appreciate the opportunity to participate in this conference. As the use of derivative financial products has increased, the concern of financial regulators everywhere, both domestically and internationally, has increased as well. Hardly a day goes by without a recent development pertaining to the topic of derivatives.

For example, during the second quarter of this year, several bond mutual funds and money market mutual funds received additional capital infusions or had some investments repurchased as a result of what now appears to be imprudent derivatives activities. While most of the problems experienced to date involve taxable funds, I do not believe that tax-exempt funds are immune from similar difficulties.

The derivatives activities of mutual funds have become so worrisome to the Commission that Chairman Levitt transmitted a letter to the chief executive officers of a number of large funds on June 16, warning these funds to utilize derivative financial instruments wisely. Further, in a subsequent letter to the Investment Company Institute ("ICI") on June 30, the Commission's Director of the Division of Investment Management, Barry Barbash, prodded money market mutual fund managers to dispose of their volatile adjustable rate investments, most of which fall into the category of products generally referred to as derivatives, in an orderly manner. Neither of these letters was limited in application to taxable mutual funds.

The necessity for this second letter comes as something of a surprise to me. In December of last year, the Commission proposed several amendments to the money market fund rule, Investment Company Act Rule 2a-7. Included in the proposing release, among other matters, was an interpretation which reaffirmed a Commission staff position taken in several no-action letters, that the maturity of an adjustable rate instrument, including a government security, can be determined by reference to interest rate adjustment dates only if the instrument can reasonably be expected to have a market value that approximates its par value upon adjustment of the interest rate. This reasonable expectation determination is a continuing duty and is not a one-time exercise to be performed solely when the instrument is initially purchased. To repeat, there must exist a reasonable expectation that the security will have a market value that approximates its par value at the interest rate adjustment date in order for the financial instrument to be an appropriate investment for a money market fund. This restriction applies whether the money market fund is taxable or tax-exempt.

While there should have been no confusion with respect to this matter in my opinion since this has been the historical position of the Commission for some time now, apparently there has been confusion in some quarters. The need to state this position again in a letter about six months after the money market fund rule amendments release was issued and after the market has clearly changed interest rate directions causes me to question the alertness of several money market fund managers.

In any event, the recent losses incurred by many segments of our capital formation system as a result of investments in volatile derivative financial instruments have led some to consider restricting the ability of various organizations to engage in certain derivatives activities. However, other than with respect to money market mutual funds, investment restrictions do not make much sense in the securities area where sales practice suitability standards, antifraud prohibitions and market discipline are largely the rule. I am inclined to believe that, as a general proposition, the marketplace and not the Commission should determine the success or failure of the various potential investment products available, even if they are highly volatile.

However, for the securities marketplace to be able to make efficient decisions and to employ the discipline I alluded to earlier, sufficient information must be provided to the marketplace in a timely manner concerning the derivatives activities of mutual funds and of publicly-held companies. This is not the case currently. Thus, enhanced disclosure of derivatives activities has become a very important regulatory issue at the Commission, both in the corporate area and in the mutual fund area.

Lack of clear disclosure notwithstanding, the ability to customize an investment product to suit issuers and investors has made the derivative instrument a valuable product. If used properly, derivatives are an important risk management tool. They can be used to hedge risks, to substitute for a direct investment in the underlying instrument, or to increase the potential yield and risk. Of course, the rule of thumb in the securities area is that the potential for high rewards is usually accompanied by an exposure to higher risks.

Some recently introduced municipal derivative products have been developed in an environment of falling interest rates and relatively favorable returns, with a view to leveraging market risks in order to achieve even higher returns or to hedge larger risks. The reaction of these products to a climbing interest rate environment was unknown, and there always existed at the Commission the sentiment that some of these products would not perform as advertised under adverse market conditions. This appears to have been the case thus far in 1994. Indeed, since the beginning of this year, as interest rates have spiked upward, I understand that both the performance and liquidity of many municipal derivative products have been challenged, and, as a result, the popularity of municipal derivative financial instruments has decreased as well.

II. Mutual Funds

Obviously, the Commission is very concerned with the current state of the disclosure by mutual funds, both taxable and tax-exempt, of their derivatives activities. I know that both the staff of the Commission and the ICI are working to improve the disclosure practices of mutual funds with respect to their investment objectives and their derivatives activities, including the risks pertaining thereto. Commission rulemaking activity in this area before the end of the year remains a strong possibility. In particular, I know that the staff is seriously considering developing a quantitative risk measure to more effectively convey to investors the risks in a bond fund, be it a taxable or a tax-exempt fund. Along these lines, I did notice recently that Standard & Poor's has devised a new system for rating the market risk of derivative products, including municipal derivative products. I anticipate that there will be other such developments by the private sector in this area in the near future.

Continuing with the topic of mutual funds, I wish to stress that the Investment Company Act of 1940 requires that mutual funds must stand ready to redeem shares daily and to pay redeeming shareholders within seven days of receiving a redemption request. In addition, a mutual fund must compute its net asset value each business day and give purchase and redemption orders the price next computed after receipt of an order. To compute an accurate net asset value per share, a mutual fund must be able to value each portfolio security accurately. Mutual funds must use market price to value securities for which market quotations are readily available, and the board of directors must make a good faith determination of the fair value of securities for which market prices are not readily available.

I understand that recently some mutual funds have encountered severe difficulties complying with the pricing requirements of the Investment Company Act with respect to their derivatives positions. I wish to caution all mutual fund managers to make sure that they are taking the reasonable steps necessary to adhere to the daily pricing requirements of the Investment Company Act. Further, securities firms that sell municipal derivative products to mutual funds, unless agreed otherwise, would be well advised to be prepared to supply secondary market liquidity for the product and to provide adequate pricing information for the product. One logically would question if a derivative security is a suitable investment for a mutual fund if the fund could not reasonably be expected to price the security daily in compliance with the Investment Company Act.

Moreover, on the fund side, I suggest that all investment companies include better and more useful information in their prospectus about their derivatives activities. The current disclosure is often of the boilerplate variety and is not very useful. Investment companies should more clearly explain what they are doing, particularly whether the investments are hedging or speculative in nature, or a combination thereof, and roughly what the combination is. They should disclose the objectives of their derivatives transactions, discuss the risks involved (including volatility), and quantify the percentage level of fund assets in derivatives, if the level is significant. This may help avoid problems in the future from regulators and from investors.

III. Disclosure

Since I have broached the topic of disclosure, at least as it pertains to mutual fund derivatives activities, I should probably discuss briefly the topic of disclosure in general as it relates to municipal derivatives. Of course, at a meeting earlier this year, the Commission approved publication of an interpretive release delineating the disclosure obligations of participants in the municipal securities market under the antifraud provisions of the federal securities laws, both in connection with primary offerings and on a continuing basis with respect to the secondary market. This interpretive guidance is intended to assist municipal securities issuers, brokers, dealers and municipal securities dealers in meeting their obligations under the antifraud provisions. While the Commission sought comment on the issues discussed in the release, which comment period expired last Friday, the interpretive release was effective when issued and contains no exceptions. This is because there are no exemptions contained in the antifraud provisions of the federal securities laws.

The members of this audience should be aware that the interpretive release discusses the specific topic of derivatives in two places. First, it stressed the growing complexity of the municipal marketplace and the need that investors have for a clear understanding of the terms and the particular risks arising from the nature of "derivatives and other municipal products." Thus, the disclosure obligations for derivatives are no different than with respect to other municipal products. There apparently exists some confusion on this latter point.

Further, the interpretive release indicated that "investors need to be informed about the nature and effects of each significant term of the debt, including credit enhancements and risk modifiers, such as inverse floaters and detachable call rights. Investors in these securities should be aware of their exposure to interest rate volatility, under all possible scenarios. In addition, any legal risk concerning the issuer's authority to issue securities with unconventional features needs to be discussed." The release went on to point out that the Public Securities Association "has identified disclosure that should be provided in connection with the offer of financial instruments that include such features as auction and swap-based inverse floaters and embedded cap bonds."

Second, in another place, the interpretive release contained disclosure advice for municipal issuers with respect to their activities as end users of derivative products. "For example, the use of non-exchange traded derivatives to alter interest rate risk exposes the issuer to counterparty credit risk. Disclosure documents need to discuss the market risks to which issuers are exposed, the strategies used to alter such risks and the exposure to both market risk and credit risk resulting from risk alteration strategies." The release also pointed out that the National Federation of Municipal Analysts "has published sector specific secondary market disclosure guidelines calling for a discussion of the issuer's use of derivative products, especially interest rate swaps."

I encourage each and every municipal issuer to follow the advice of the interpretive release with respect to its derivatives activities as an issuer and as an end user. In this manner, issuers can avoid running afoul of the antifraud provisions of the federal securities laws, and investors can better understand the complexity of today's municipal securities market, thereby increasing investor confidence in this market.

In a companion release the Commission proposed amendments to Exchange Act Rule 15c2-12 that would:

(1) prohibit a broker, dealer or municipal securities dealer from underwriting a municipal security unless the issuer commits to provide secondary market disclosure to an information repository; and

(2) prohibit a broker, dealer or municipal securities dealer from recommending a security unless it has reviewed the secondary market information made available by the issuer.

There was no distinction made in these proposed amendments between derivative securities and other municipal securities. The comment period for this release expired last Friday as well.

The proposed amendments do contain some exemptions that may be of interest to the members of this audience since some municipal derivative transactions would fall within the suggested exemptions. I will describe very quickly these proposed exemptions. First, consistent with other provisions of Rule 15c2-12, the proposed amendments are limited in application to primary offerings of municipal securities with an aggregate principal amount of $1 million or more.

In addition to the $1 million threshold applicable to Rule 15c2-12, an offering would be exempt from the provisions of the proposed amendments, if at the time of the issue, the issuer: (1) will have less than $10 million in aggregate amount of municipal securities outstanding, including the offered securities; and (2) will have issued less than $3 million in aggregate amount of municipal securities in the most recent 48 months preceding the offering. This exemption is designed to exclude from the application of the proposed amendments small issuers that do not frequently issue municipal securities.

Finally, the existing Rule 15c2-12 transactional exemption covering private placements also would apply to the proposed amendments. There are three parts to this exemption. This exemption covers a primary offering of municipal securities in authorized denominations of $100,000 or more:

(1) if such securities are sold to no more than thirty five persons each of whom the underwriter reasonably believes:

(a) has such knowledge and experience in financial and business matters that it is capable of evaluating the merits and risks of the prospective investment; and

(b) is not purchasing for more than one account or with a view to distributing the securities; or

(2) if such securities have a maturity of nine months or less; or

(3) if such securities, at the option of the holder thereof, may be tendered to an issuer of such securities or its designated agent for redemption or purchase at par value or more at least as frequently as every nine months until maturity, earlier redemption, or purchase by an issuer or its designated agent.

IV. Sales Practice Suitability Standards

There is one other area that I wish to mention today in which the Commission will be focusing quite a bit of attention that relates to municipal derivatives activities, and that is the sales practices area. The concern lingers at the Commission that some derivative products are being marketed more for the fat profit margin they make available to the securities firm than for their suitability for the potential customer. If I had only one suggestion for securities firms that sell derivatives, that suggestion would be to take all the reasonable steps necessary to ensure that the derivative products being sold are suitable investments for the prospective end user. This would apply to institutional customers as well.

My concerns in the customer suitability area have increased as the class of investors to whom derivative products are sold continues to broaden. I understand that this class now already includes some not-so-large municipal governments. I noticed recently that the Government Finance Officers Association, among others, has expressed substantial concerns about the suitability of some local governments and local government pension funds investing in certain derivatives.

In an attempt to head off trouble in this area, the staff of the Commission has included, along with capital standards and risk assessment information, in discussions now underway with the Securities Industry Association and the major securities derivatives dealers, the prospect of developing voluntary suitability standards to guide the sale of derivatives to users, such as cities, pension funds and mutual funds, in which unsophisticated investors have financial stakes. These discussions already have a great deal riding on them, and the assurance that customer protection issues arising from derivatives activities are appropriately addressed just raises the stakes higher. The purported goals of these discussions are laudatory, and I do hope that all of the lofty objectives sought can be achieved in a voluntary manner.

I should also point out that due to the general suitability concerns which exist specifically with respect to the municipal securities market, the Municipal Securities Rulemaking Board ("MSRB") filed with the Commission a rule proposal to strengthen the existing MSRB customer suitability rule. These rule amendments were approved by the Commission in April, and they apply to all municipal securities transactions, including ones involving derivatives. At the approval meeting, the Commission expressed its desire that the new municipal suitability rule should be more vigorously enforced than the old rule.

The revised rule, as did the old rule, generally requires that before making any recommendation to a customer, a dealer must first determine that the proposed transaction is suitable for the customer. However, the revised rule eliminates a provision of the old MSRB suitability rule that permitted dealers to make specific investment recommendations when a customer refused to provide information sufficient to permit the dealer to make a determination as to whether the recommended security was suitable for the customer. Further, the revised rule eliminates a provision of the old rule that allowed dealers to recommend specific municipal securities to investors even after being informed by the dealers that, based on their financial circumstances, investments in such municipal securities would not be suitable. Moreover, the Commission made it clear in the approval order for the rule that a suitability obligation exists for institutional customers as well as for retail customers. There are no exceptions to the suitability rule.

The revised MSRB suitability rule should impress upon dealers the necessity of having in place clear policies to ensure that sales personnel do not recommend securities to customers without proper regard to the nature of the security being recommended and to the circumstances of the customer to whom the security is being recommended. Of course, suitability is probably of greatest concern in the area of derivative municipal securities where, as I indicated earlier, dealers should be especially careful to take all reasonable steps necessary to ascertain that the securities being sold are suitable investments for the prospective purchasers, even if the prospective purchaser is an institution.

While the revised MSRB suitability rule may be sufficient to cover adequately the municipal derivatives area, it is my understanding that the MSRB is considering issuing a separate rule to cover specifically municipal derivatives transactions. Thus, the members of this audience would be well advised to be alert for further developments in the municipal suitability area.

IV. Conclusion

Unfortunately, time does not allow me to mention several other areas where the Commission is actively working which will have an impact on municipal derivatives activities. However, it should suffice to say that where there exists complexity, illiquidity and leverage, the Commission will remain concerned. Municipal derivative products have provided a great deal of flexibility to issuers and to investors, allowing them to structure a portfolio and to manage risks in a certain manner. I believe that it is important to allow market participants the freedom to meet customer needs with new and innovative financial products. However, I also believe it is necessary to adjust our securities regulatory system to provide the marketplace with the information necessary for it to function efficiently and to provide investors with reasonable and cost-effective investor protection safeguards.