NFMA POSITION PAPER ON

1994 AMENDMENTS TO RULE 15C2-12

NATIONAL FEDERATION
OF MUNICIPAL ANALYSTS

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The National Federation of Municipal Analysts (NFMA) is an organization composed primarily of research analysts who evaluate credit and other associated risks of tax-exempt securities. Established in 1983, the NFMA has roughly 1,000 members that represent, among others, broker/dealers, mutual funds, rating agencies and insurance companies. The constituent societies of the NFMA are the Boston Municipal Analysts Forum, California Society of Municipal Analysts, Chicago Municipal Analysts Society, Minnesota Society of Municipal Analysts, Municipal Analysts Group of New York, Pittsburgh Municipal Analysts Society, Southern Municipal Finance Society and the affiliated member groups.

Rule 15c2-12 was amended in 1994, with key provisions coming into effect in July 1995 (the "Amendments"). The Securities and Exchange Commission (the "SEC") stated that the Amendments were "designed to enhance the quality, timing and dissemination of [secondary market] disclosure in the municipal securities market." The SEC determined that providing for "current and reliable information in an even and efficient manner" would enhance market liquidity and would facilitate an investor's ability to make informed decisions while protecting itself from fraud.

The NFMA is proud to have been at the forefront of the initial development of the Amendments, responding to the call by SEC Chairman, Arthur Levitt Jr., for input by municipal market industry groups on ways to enhance secondary market disclosure. NFMA welcomes the opportunity presented by the third anniversary of the Amendments to re-establish the dialogue and

to evaluate collectively the extent to which the Amendments have had their intended effect. The purpose of this document is to offer constructive commentary regarding the effectiveness of the Amendments at this formative stage of their implementation. Since the NFMA covers a broad spectrum of analysts and the needs and philosophies of their firms may differ, certain analysts or their employers may have different views from those stated in this report.

The NFMA believes that overall the Amendments have been a positive development in the municipal market and have significantly enhanced access to secondary market information. The NFMA applauds the efforts of most municipal issuers to comply responsibly with the letter and the spirit of the Amendments. Their efforts have markedly improved the efficiency of the secondary market in municipal securities. However, as the Amendments have been implemented, several significant holes in the regulatory framework have been exposed. In some instances these deficiencies have resulted in no increase in the practical availability of timely, quality secondary market disclosure. In others, there has been an actual reduction in the information that had been previously available. This paper will address these specific troubling issues:

- The goal of increasing access to secondary market disclosure has been hampered by actual cut-backs by numerous issuers in the level of such disclosure in response to the promulgation of the minimum standards set forth in the Amendments.

- The SEC's goal of bringing the level of secondary market disclosure to the level of primary market disclosure, has resulted in numerous issuers paring back on their primary market disclosure.

- The goal of increased dissemination has been hampered by the cost and limited means of access to the information.

- The goal of increasing the availability of timely information has been hampered by the absence of a filing deadline in the Amendments.

- The July, 1995 effective date created an entire class of issuers not required to provide information.

1. The "Floor" Established by the Amendments Has Become a Limitation. Prior to the promulgation of the Amendments, many issuers made themselves available to the investor community to answer questions about their financial and operational results and to provide supporting detail. Ironically, since the promulgation, we have witnessed a resistance on the part of some issuers to communicate directly with analysts, citing the issuer's need only to comply with the annual filing requirements in the Amendments. Thus, while the Amendments were designed to enhance disclosure by establishing a "floor," they have become a shield used by some issuers to cut back on what they are now willing to provide. Some issuers have expressed concern about potential liability with respect to any disclosure which goes beyond the minimum regulatory requirements. Some issuers invoke federal securities law, such as insider trading rules, to avoid openly discussing their operations and finances with analysts.

The NFMA believes that the issuers' purported concerns about potential liability are largely self-serving and unfounded and are being used to thwart the spirit and intent of the Amendments. In the more heavily regulated taxable corporate market, investors are routinely invited to communicate directly with issuers either on open access conference calls or in one-on-one conversations. Certainly, investors in the municipal market should not be provided less direct access to issuers than that which is commonly available to corporate analysts.

The federal securities laws were not designed to prohibit a free flow of information between issuers and investors. In fact, they may create an affirmative obligation on the part of the issuer to be responsive to investor inquiries.

Rule 10b-5, as promulgated by the SEC, provides the basic framework regarding disclosures to investors and potential investors in securities. Generally, there is no affirmative duty under Rule 10b-5 to provide information to the market. However, if an issuer provides information either voluntarily or pursuant to some regulatory requirements (such as the requirements of the Amendments), then Rule 10b-5 states that such provided information must be full, accurate and

complete. To the extent that investors have follow-up inquiries to the information which has been provided pursuant to the Amendments, the issuer may have a duty to respond to such inquiries in order to make the information previously provided complete and accurate. As discussed below, this may be especially true since the annual information is often fairly out-dated by the time it is finally released.

Moreover, to the extent that an issuer is truly concerned that the provision of information to an analyst may be construed to provide the basis for "insider trading," these concerns should be answered by looking at the case law.

The elements of insider trading by issuers who provide information to analysts are the knowing dissemination by insiders of material non-public information in exchange for some personal gain by such insider. While corporate insiders in the equities market regularly provide clarifying information to analysts which is not provided in as complete detail in their SEC filings, so long as such information is provided pursuant to a corporate purpose and not for personal benefit, insider trading liability has not been considered to attach. The need for clarifying information in the municipal market becomes particularly pertinent where the filings required under the Amendments are both less frequent and less detailed than those required under the rules applicable to corporate equity securities. Where the issuer would make the same information available to any inquiring analyst, the information should not be considered "inside" information knowingly provided for personal benefit. This general availability serves to eliminate any claim of a "quid pro quo" relationship between the issuer and the analyst.

The NFMA believes that the insider trading issue is being used as an excuse to block the continual flow of information that the Amendments were designed to promote. The Amendments should not be allowed to be read as discouraging an issuer from responding to a diligent investor who seeks to develop informed investment decisions on the basis of generally available information. In keeping with similar recommendations by the Government Finance Officers Association

regarding investor relations programs, the NFMA urges issuers to designate a person to be responsible for handling investor inquiries in a centralized and uniform fashion. This practice of identifying a professional who is responsible for investor relations, which is common in the corporate market, would most effectively balance the needs of the market and the issuer.

2. Reductions in Primary Market Disclosure. In adopting the Amendments, the SEC specifically anticipated the possibility that defining the secondary market disclosure requirements by reference to the material included in the official statement might create the incentive for issuers to pare back disclosure in their official statements. Despite SEC admonitions about this possibility and the requirements of the anti-fraud provisions contained in the securities laws, it is NFMA's belief that official statement disclosure, in certain cases, has become significantly leaner since the Amendments became effective. The NFMA has provided and will continue to provide examples to the SEC.

The NFMA does not believe that this is a problem that necessarily requires further rule-making. The antifraud rules sufficiently establish primary market disclosure duties. However, the NFMA believes that the SEC should continue to use all of the tools at its disposal to ensure that issuers and underwriters meet their primary market disclosure duties in a manner independent of their secondary market responsibilities. Issuers and underwriters are urged to prepare their disclosure documents with reference to the guidelines contained in the GFOA Voluntary Disclosure Guidelines or The NFMA Disclosure Handbook, each of which has been commended by the SEC.

3. Barriers Presented by the Cost and Reduced Availability of Information. The corporate market is notable for the wealth of information available instantaneously and at no cost through the EDGAR system. The Amendments implemented a purportedly parallel system of NRMSIRs and SIDs to achieve public dissemination of information in the municipal market but with three significant differences: (i) investors and potential investors must pay to get the information; (ii) the information takes time to procure; and (iii) the information is not routinely available over the Internet. These differences have the effect of substantially slowing the flow of information into the market, of

placing the cost of obtaining information largely on the investor and potential investor, and of seriously inhibiting secondary market liquidity. This dissemination system has created an uneven playing field for smaller institutions and retail investors who do not have easy access to NRMSIRs and SIDs.

This dissemination system does not provide municipal market investors with the ease and timeliness of access available to all corporate investors. In those frequent situations when an investor has a limited time period to evaluate a potential bond purchase or trade (sometimes as little as fifteen minutes), information which is not readily available is as useless as information which is not available at all.

The current system is elitist and needlessly burdensome for the investor. To remedy this situation, the NFMA believes that access to secondary market information in the municipal market should be democratized by making it available on the same basis as in the corporate market: over the Internet and free of charge. In addition, the NFMA believes that issuers should be strongly encouraged to provide information directly to bond trustees, bondholders and other interested parties, and not just to NRMSIRs and SIDs. Since the adoption of the Amendments, some issuers who previously had made their information directly available to investors, have now chosen to make their annual data available only via the repositories. In this way, the Amendments have had the effect of limiting rather than expanding access to secondary market disclosure.

The NFMA urges each issuer to state up-front in its preliminary and final official statements its policy and procedures on secondary market disclosure, including: (1) whether the issuer plans to disseminate its 15c2-12 related reports directly to investors upon request and whether a permanent mailing list to receive this information is maintained; (2) the name, title and telephone number of the officers or representatives of the issuer who will be available to discuss the contents of the secondary market reports and reply to other pertinent related matters; (3) whether any fees will be

charged to receive relevant credit related information; and (4) whether the issuer has formally covenanted to follow these procedures.

4. Staleness of Information. The Amendments do not specify a deadline for the provision of annual financial and operating information. The SEC had suggested in its releases that such information should be provided within 180 days of the end of the fiscal year. However, in the absence of an SEC-mandated deadline for annual disclosure, issuers have established deadlines as late as 330 days into the following fiscal year. Annual information which is released that long after the close of a fiscal year will almost certainly be stale. This lack of timeliness thus thwarts the SEC's goal of providing timely secondary market information upon which good investment decisions can be based. Information which is so dated is, at best, worthless, and, at worst, materially misleading with respect to the current condition of the issuer. In this regard, note that, in September 1996, the SEC brought an enforcement action against Maricopa County, Arizona, alleging that the County violated the antifraud provisions of the federal securities laws because it used year old financial information in its disclosure document which, due to intervening events, had become materially misleading.

In actuality many issuers do voluntarily file their annual information prior to their self-selected deadline, but others do not. Moreover, the fact that the issuers can effectively choose from year to year when to deliver their information, introduces a high level of uncertainty into the market about whether there will be access to timely, material information about the issuer in any given fiscal year. This variability in the release dates also invites the market to draw conclusions (correctly or not) about the financial status of an issuer based on the timing of the disclosure.

The NFMA strongly recommends that the Amendments be modified to require annual updated information to be filed within 180 days of fiscal year end for tax-supported governmental bond issues and within 120 days for revenue bond and private activity bond issues. In the unanimous opinion of accounting professionals we have polled, this deadline should be easily

achievable and, in fact, is nearly twice the amount of time that is afforded to public companies to produce their annual information.

In the absence of changes in the Amendment requirements, we urge issuers to commit voluntarily to provide their annual information on a more timely basis. This commitment should remain in place so long as the bonds remain outstanding. Additionally, if information is stale when it is finally released, in accordance with federal securities law requirements, it should be supplemented to make the information currently complete and accurate.

5. Extending the Minimum Requirements to all Issuers. Issuers of securities sold prior to the effective date of the Amendments, and of securities sold to thirty-five or fewer sophisticated investors, are not required to comply with the secondary market disclosure requirements. This has created an awkward two-tiered market which presents difficulties for investors and which greatly hinders secondary market activity with respect to those securities. The NFMA urges voluntary compliance by issuers of securities otherwise exempted from the provisions of the Amendments.

In addition, in its 1994 companion release to the Amendments (Interpretive Release No. 33-7049: "Statement of the Commission Regarding Disclosure Obligations of Municipal Securities Issuers and Others"), the SEC firmly established the secondary market disclosure obligations of *all* municipal issuers under the antifraud provisions of the federal securities laws, regardless of the applicability of the Amendments. The SEC stated:

> "These issuers and obligors are at times advised by their professional advisors that there is no duty under the federal securities laws to make disclosure following the completion of the distribution. At least some municipal issuers thus appear to believe that silence shields them from liability for what may later be found to be false or misleading information. As a practical matter, however, municipal issuers do not have the option of remaining silent. Given the wide range of information routinely released to the public, formally and informally, by these issuers in their day-to-day operations, the stream of information on which the market relies does not cease with the close of a municipal offering. . . . As market participants have urged, in order to minimize the risk of misleading investors, municipal issuers should establish practices and procedures to identify and timely disclose, in a

> manner designed to inform the trading market, material information reflecting on the creditworthiness of the issuer and obligor and the terms of the security."

In summary, the NFMA believes that the Amendments have had a largely positive impact on the disclosure practices in the municipal market. Virtually every issuer to come to market since mid-1995 has been required to provide financial and other material information on an annual basis. However, in some instances, information is now harder to access, is lower in quality, is more costly to obtain, and has come at a price of reduced access to a flow of information from the issuer.

The Amendments have moved us towards, but have certainly not yet achieved, a secondary market disclosure system which truly meets the needs and concerns of all municipal market participants. Access to the public markets and the low cost of capital it provides carries with it certain obligations and responsibilities. Most issuers conscientiously and willingly discharge these obligations and responsibilities. The NFMA urges all issuers to work in a good faith to accommodate the reasonable needs of investors in order to ensure the operation of a fair and effective municipal capital market.

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