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I have a special bond with this audience -- as you may know, my father served for 24 years as New York State Comptroller. From my youngest days, he impressed upon me the duty to care for the assets of the people prudently. He considered it a sacred trust. I regard his profession -- yours -- as one of the most important to the ordinary citizen, who often knows nothing of its existence, beyond the fact that taxes are paid, schools are built, roads are paved, and the pension check arrives on time.

I trace to my father my abiding interest in the integrity of the municipal debt markets, and my concern over recent examples of public money management gone awry. I know these are your concerns as well, and that you've spent many hours thinking about and addressing them.

Of course, I have professional concerns as well. The municipal bond market is now worth about $1.2 trillion. It is of critical importance to our nation's future. And it's undergone a fundamental change in the last decade, from a market dominated by institutional investors, to one in which individual investors hold 70 percent of outstanding securities.

If you can put up with advice from an official of a government that is somewhat larger, if not always better managed than your own, I'd like to talk to you today about three key issues: the prudent management of public funds; the preservation of public trust, and the disclosure obligations of public officials.

PRUDENT MANAGEMENT OF PUBLIC FUNDS

The municipal bond market is of critical importance to our nation's future. It represents the schools that teach our children, the water we drink, the power that enhances our lives and drives our economy, the roads that take us where we need to go. American investors trust municipal bonds as they do few other instruments, and this has helped make them a popular investment.

And yet, this has been a tumultuous time for the municipal bond market. The Orange County bankruptcy and default followed the loss of an estimated 1.7 billion dollars in public funds through a risky investment strategy. There have been reports of other losses, fortunately less severe than Orange County. Nor are losses the only type of problem faced -- in the District of Columbia, for example, a financial control board has been established with control over spending.

I know the concern you have over these issues. And surely you know better than most the apprehension felt by local taxpayers.

The public has a right to expect that money will be available when needed to keep the schools open, to police the streets, and to meet the other civic needs for which taxes are paid. Such funds can generate additional revenue in the interim, and that is good.

Care must be taken, however, that the return received does not become a narcotic, inducing dependency by being built into annual budgets as a significant revenue source in and of itself. Such an addiction loses sight of the original purpose for raising the funds, and it courts disaster in the event of sudden market changes. Using the treasury function as a profit center has backfired on some sophisticated corporate managers in recent years; as we saw in Orange County, it is no less risky for public officials.

Our markets have undergone dramatic changes. Complex instruments have been developed that are capable of producing breathtaking returns -- or breathtaking losses. The three basics of public fund management, however, have not changed: safety, liquidity, and yield -- in that order.

In the complex markets of the 1990s, safety is no longer synonymous with credit quality. When investment terms and liquidity needs are mismatched, a volatile market can quickly eviscerate investments with even the most impeccable credit rating.

The harsh lessons of the markets have been visited over the past 18 months upon large corporations and dealers, as well as municipal governments. A factor common in many cases has been an absence or breakdown of internal controls -- the checks and balances of financial management that can help provide a measure of safety in complex and rapidly changing markets.

These developments offer an unprecedented opportunity to review the adequacy of financial checks and balances, to be sure that proper controls are in place. Every day, more and more treasurers, legislators, and government officials responsible for protecting the people's money are seizing that opportunity. I urge you, when you return home from this gathering, to do the same, if you're not already doing so.

There are three important steps that can help assure safety: a written investment policy, independent oversight, and periodic valuation or marking-to-market. A written and publicly available investment policy, coupled with current internal portfolio information, reinforces accountability. But without an independent review of actual performance on a frequent basis, a written policy can quickly be reduced to mere words on a piece of paper.

Your councils, boards, and oversight bodies should review lists of authorized investments regularly, and monitor the results closely. A thorough system of checks and balances might include outside oversight as well. As I noted, frequent valuation, or marking-to-market, is also useful, especially where a high degree of liquidity is needed. Surprising investment gains should set off alarms every bit as loudly as surprising losses.

At the same time, let us not be seduced by easy cures, such as narrowing lists of permitted investments to only the safest. Derivatives, for example, are something like electricity -- dangerous if mishandled, but also capable of doing enormous good. You wouldn't try to avoid the dangers of electricity by outlawing it. One of the most common ways to hedge against risk is to diversify, which is to increase choices. Instead of eliminating investment tools, we should be ensuring that they are well understood and wisely employed.

As local government finance officials, you are clearly aware of these points. In the wake of the Orange County bankruptcy, the National Association of State Treasurers formed a task force to update the 1989 guidelines on state-managed Local Government Investment Pools. The report of this task force, released last summer, recommends the exact methods I referred to a moment ago.

Much attention has been focused on derivatives and other volatile instruments. These turbulent times have produced some thoughtful advice, in particular the report prepared in 1995 by the Derivatives Policy Group, which is actually a series of commitments by six firms that are significant market participants. The report provides useful guidance for end-users -- such as local governments -- as well as for dealers and intermediaries.

Many others have examined the issues raised by derivatives. In 1994, the SEC, the Commodity Futures Trading Commission, and the British Securities and Investments Board issued a joint statement on oversight of the over-the-counter derivatives market. It stresses the importance of effective management controls and the need for regulatory authorities to encourage the development of such standards.

Soon afterward, both the International Organization of Securities Commissions (IOSCO) and the Basle Committee on Banking Supervision issued reports identifying management controls that regulators should seek to promote.

The recurring theme of all these reports is the need for internal control mechanisms to monitor and measure risks, and the need for an external audit and verification process. Their guidance may prove helpful to state and local governments that are end-users of derivatives.

All customers -- whether it's your neighbor down the street, your local municipality, or a large, international corporation -- must take responsibility for understanding what they are buying and how it fits their investment objectives. But we must never forget that responsibility is a two-way street.

Broker-dealers and their customers must understand the terms of their counterparty relationship, both at the outset and for its duration. This understanding should be based on several factors, including the products offered, the customer's understanding of the products, the associated risk, and the customer's capacity to value the products independently. All finance professionals must understand that market, interest rate, and liquidity risk can all play a powerful role in the safety of any investment.

I know that the GFOA has been active in expressing its views on the responsibilities of a broker-dealer to its customers, particularly those that may be classified as "institutional" investors. They have commented, for example, on proposals put forward in the past year by the National Association of Securities Dealers regarding the NASD's so-called "suitability rule."

I'm limited in what I can say about the NASD's most recent proposal, because the SEC has been presented with a rule filing on this issue. I <u>can</u> say, however, that the question of striking an appropriate balance between the obligations of broker-dealers and the responsibility of customers is critical.

Custodians of the public's funds have a responsibility to maintain the integrity of the municipal markets. I encourage those that are end-users of derivative products and other potentially volatile instruments to adopt internal procedures to safeguard against unanticipated risk, and to control overall exposure. Exotic instruments should only be used by those who have the required expertise and resources. If I may continue my analogy: electricity is a wonderful thing, but if you don't understand it, you have no business trying to wire a house by yourself.

Some have called on the federal government to intervene. I said in my testimony before the Congress last year that I believe the regulation of state and local investment practices is the responsibility of the states. If there's a role for the federal government in all this, it is to offer our support and to share any knowledge and experience we have that may be of use to you.

This federal-state dialogue is very important to the public markets. Treasury Secretary Rubin and I have been actively pursuing this dialogue for the past eight months. We've met with state and local finance officers throughout the country in an intensive outreach effort. It's in everyone's interest to publicize successful techniques for risk management, and to discuss the various approaches to protecting public funds. Independently and together, Secretary Rubin and I are working to address the problem through speeches, articles, meetings, and conferences such as this one.

The Commission is especially concerned because what is at stake here is not just the fate of one or two municipalities -- it is the entire mechanism of public finance, which is based on the public's trust. That trust has been eroded by the events of the last year, and that's the second item I'd like to talk to you about.

PUBLIC TRUST AND THE GENERAL OBLIGATION BOND

Americans trust municipal bonds as they do few other instruments. This has worked to keep costs low for issuers. The Orange County bankruptcy filing and default may therefore impose costs on public finance that will be felt for years to come, by issuers miles from Southern California. No one understands that better than this group.

There may be another cost imposed as well -- one associated with the phrase "willingness to pay," which has at its roots financing structures that avoid constitutional debt limits. This development is not unique to California -- it is a reality of municipal finance in almost every state, and has been for a long time. You'll forgive me if I again refer to my father.

In 1974, he released a study that examined New York State's debt obligations. The report emphasized the enormous power that governments wield when they issue debt, in effect committing taxpayers' dollars for years into the future. It emphasized the tremendous ethical responsibility borne by issuers of municipal securities. And it concluded that "debt is at the same time one of the most important of the fiscal mechanisms available to government -- and one of the most vulnerable to misuse." He raised special concerns about the propensity of his state to avoid constitutional limits on debt through the proliferation of debt-issuing agencies.

The problems in Orange County made me recall my father's warnings. The financing practices that were of such concern to him have become a mainstay for many communities. And now a large issuer has publicly put in question the validity of its own debts, including these very instruments. Whether sincere or a negotiating ploy, this expression of uncertainty may have added a new premium for legal risk.

Corporate debt and equity markets have had to cope with broken contracts time and again. But municipal bonds are different. Local government bonds typically carry the "full faith and credit" of the issuer -- a pledge that investors will be repaid before anyone else. So strong is this obligation that even during the Depression, virtually all the debt that defaulted was repaid with interest, and with interest on the interest.

Since the Depression, no general obligation bond of a major issuer has ever defaulted, until now. The consequences have been heavy for Orange County, but a default also severely unsettles a group just as important to local government as taxpayers -- the bondholders who lend it money, whether as individuals or through mutual funds -- hardworking women and men throughout America looking for a decent, secure investment for their savings, whether for their children's schooling; or to start a business someday; or perhaps for retirement.

This time of difficulty in municipal finance will doubtless produce lessons for all of us. One lesson we should <u>not</u> draw, however, is the wrongheaded notion that Chapter 9 may be an alternative to responsible but unpopular decisions to fulfill the obligations incurred by local governments. Chapter 9 should be a last resort -- not an easy way to avoid debts, or a safe haven for fainthearted officials.

It's been said that trust is won with difficulty and easily lost. Municipal bonds have enjoyed a solid reputation because of the valiant efforts of many in the past. We must all work to maintain public faith in the market.

<u>THE DISCLOSURE OBLIGATIONS OF PUBLIC OFFICIALS</u>

The third and final subject I'd like to discuss with you today has to do with the Commission's enforcement activities in the municipal market. I've mentioned the Orange County bankruptcy several times today. Local government officials who authorize the issuance of municipal securities have serious responsibilities under the federal securities laws. For almost 20 years now, the Commission has been stressing the critical role such officials play with respect to the representations contained in the official statements for those securities.

This is not overly complex; it requires neither an MBA nor a Ph.D. A public official may not authorize securities-related disclosure that he or she knows to be false; and a public official may not authorize disclosure while recklessly disregarding facts that indicate the disclosure may be misleading. That obviously includes facts that would bring into question the issuer's ability to repay the securities, for example.

While Orange County has received the lion's share of attention, it has not been our only municipal case. Over the past 18 months, our Division of Enforcement has brought nineteen cases involving the municipal securities markets. The enforcement actions filed so far have involved virtually every market participant: national and regional underwriting firms, national and local financial advisory firms, employees of those firms, bond counsel, underwriters counsel, and consultants as well as elected officials. These cases are all based on failures to disclose, whether issuer financial problems, facts and associated risks relating to the tax-exempt status of the obligations, or conflicts of interest, including pay-to-play. Virtually all involve violations of the basic antifraud sections -- Section 17(a) of the Securities Act and Section 10 and rule 10b-5 of the Exchange Act. In more than a few instances, there have also been parallel criminal proceedings, which should be a pretty good signal that the conduct involved was not "borderline."

This weeding-out process doesn't mean that the entire garden has gone bad. To the contrary, the vast majority of market participants have been playing by the rules. Weeding can only make the garden healthier, and these cases make it clear to any observer that discipline is being maintained.

My friends, as recently as a few years ago, for most Americans, municipal finance was a kind of sleepy backwater, misunderstood and underappreciated. The three subjects I've discussed today -- the prudent management of public funds; the need to maintain public trust; and the disclosure obligations of public officials -- would hardly have raised a stir.

Today, they've been catapulted into the headlines. Citizens have worked hard to pay their taxes, only to see them swept away like a losing bet on a roulette wheel. Investors have loaned their savings to municipalities in need of cash, only to see the very obligation to repay brought into question.

You and I can change these things -- but we can't do it alone. For the sake of our cities, our states, and our nation, let's <u>continue</u> to work together to create a municipal market that's worthy of the 21st century.

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