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Gallagher: Focus on Pension Disclosure, Add More Muni Staff.

WASHINGTON — The Securities and Exchange Commission needs to come up with new ways to address public pension reporting problems and obtain more staff for municipal bonds, Commissioner Daniel Gallagher told The Bond Buyer on Monday.

In a wide-ranging interview conducted in his 10th floor SEC office, Gallagher focused in on the need for regulators to protect the huge majority of retail investors who populate the bond market.

A commissioner since 2011, Gallagher, a Republican, has been outspoken on muni issues for much of his tenure, particularly since the departure of SEC Commissioner Elisse Walter in 2013. He has publicly advocated for various muni market reforms, and remains particularly concerned that less sophisticated investors are not getting the disclosures they need to make informed decisions about the muni securities they buy or sell.

In May, Gallagher spoke to self-regulatory officials about his dissatisfaction with muni pension and other post-employment benefit disclosure, including recent Governmental Accounting Standards Board standard changes that he viewed as less than ideal. In that speech he called for a "disclosure baseline" based on a low-risk discount rate such as the U.S. Treasury yield curve.

This week, Gallagher said the SEC needs to figure out a way to get around the fact that it cannot force issuers to adhere to GASB standards.

"I think the commission more generally needs to think past GASB," Gallagher said. "What other things can we do to incentivize muni issuers to use GASB standards? Because that's one of the other maddening things, you can get GASB exactly right, and everyone can agree that the pension accounting standards are terrific, but not every issuer is going to use them."

Gallagher said muni securities may still be a great product, but that many retail investors are buying bonds under woefully inadequate disclosure documents with undisclosed underfunded pensions.

"I just find that deplorable," Gallagher said. "I think there's just more that we can be doing with these issues."

Asked about repeal of the Tower Amendment, Gallagher said, "I'm not going to hold my breath on that one. I'm more pragmatic."

The Tower Amendment, which was added to the Securities Exchange Act of 1934 in the mid-1970s, prevents the SEC or the Municipal Securities Rulemaking Board from directly requiring issuer disclosures in connection with a bond offering. The SEC's 2012 Report on the Municipal Securities Market recommended legislative action to grant the commission some authority to directly dictate aspects of issuer disclosure, and former SEC enforcement division lawyer Peter Chan said earlier this year that issuers might be better off if Tower were repealed.

Gallagher said that he would be hesitant to pile on more regulation of underwriters and other muni intermediaries, but remains confident the SEC can do something to improve disclosure of issuers' major financial liabilities.

He is also a major advocate, along with fellow commissioner Michael Piwowar, of requiring dealers to disclose their markups in so-called "riskless principal" transactions. Last month the Municipal Securities Rulemaking Board and Financial Industry Regulatory Authority released complimentary proposals that would require dealers to reveal a "reference price" of a same day transaction for trades of retail size. Gallagher said that approach is not as good as true markup disclosure, and will need to be analyzed carefully.

"I think this is an improvement on the status quo," Gallagher said. "I do think it'll bring, on some level, more transparency to retail. But I do think we'll need to analyze [it]. Assuming that these rules become final largely as proposed, I think we'll have to monitor their impact and see if it's really giving the benefit to investors that we're looking for."

"Is it exactly what I thought it should be? No. Is it a positive step forward? Yes."

There are good arguments from dealers about why such disclosure could be problematic, including different views about how to define riskless principal trades, Gallagher acknowledged. But he added that broker-dealer representatives have personally shown him how they can, and in some cases do, disclose their markups on trade confirmations, proving that it can be done.

Enforcement The last two years have included several precedent-setting enforcement actions by the commission, including its first ever financial penalty extracted from a municipal issuer and multiple cases targeting muni officials directly. SEC Enforcement Chief Andrew Ceresney has publicly promised to ramp up muni enforcement even more, a move Gallagher said will be beneficial for market behavior.

"Once every ten years doing a couple muni cases I don't think is going to send the right message to the community," he said.

Targeting public servants for their roles in fraudulent offerings is tricky, Gallagher acknowledged, but it is a more powerful enforcement tool than a simple cease and desist order and will probably happen more and more often.

"You can't go from zero to 60 on this kind of issue," Gallagher said. "There's been a pattern and practice for decades where the commission has focused on intermediaries. Traditionally we've afforded [public officials] some deference, which I think you're seeing a move away from that. It's really got to be the exceptional case where we can bring a fraud case against somebody. But you've seen obviously, recently, that we're willing to do it. We clearly have shifted into that mode and I would think that would continue to increase."

At the end of the day, the commission needs to devote more staff to munis, Gallagher said.

"We have five and a half people that cover, from a policy perspective, markets that combined are around $15 trillion," Gallagher said of the SEC's combined resources for both muni and corporate bonds. "And hugely retail."

"We have 150 or so people focused on equities and options markets every day," he pointed out.

"We all need to recognize that the fixed income markets have been on a bull run for decades," he said. "Things have been going very well. But if they didn't, if something happened, we'd be illprepared."

"I think we need to resource these things here," Gallagher continued. "Not because I think we need to regulate more. Not because I think we need to overlay the equity market structure into the fixed income market. We need to be savvier."

Gallagher said criticism of the SEC's oversight of asset managers has been largely driven by a perception that the SEC is not expert enough in that space to do that job effectively.

"The same thing applies in fixed income markets," he said. "We're just not sophisticated enough. As an institution, we don't know enough about how the products trade, where they trade, what the incentives are in the market right now, what retail investors understand and what they don't."

The SEC's muni office is in a transitional state, with five lawyers remaining following the departure of muni chief John Cross to the Treasury Department last month. Gallagher praised Cross' work in attracting talent to the muni office, which was reconstituted as independent and reporting to the SEC chair under Dodd-Frank, but said such a small staff is too little to focus on munis.

"If we don't have the staff looking at it, then the ideas aren't going to float up," Gallagher said. "Some people have said this seems like a top-down initiative. I've been talking about it a lot, Commissioner [Michael] Piwowar, [SEC chair Mary Jo White]. It seems like it's coming top down. It's not like the staff is resisting. We just don't have 150 people that come in every day and think about these markets."

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