Bond Case Briefs

Municipal Finance Law Since 1971

SEC: Investor Protection in the Municipal Securities Markets.

Rick A. Fleming, Investor Advocate

U.S. Securities and Exchange Commission [1]

MSRB Municipal Securities Regulator Summit
Washington, D.C.

Aug. 25, 2016

Thank you, Lynnette [Kelly], for that kind introduction and for inviting me to participate in your event today. It has been a pleasure to spend time with a variety of regulators who are on the front lines of investor protection, and I appreciate the opportunity to provide some closing remarks for your conference. Of course, I need to remind you that the views I express are my own and do not necessarily reflect those of the Commission, the Commissioners, or Commission staff.

I have been the Investor Advocate at the SEC since early 2014, and since day one, I have actively supported a variety of reforms in the municipal securities markets. My interest in these issues is explained, in large part, by the high concentration of individual investors within the muni market. As of December 2015, approximately 41 percent of municipal bonds are owned directly by individual investors, and another 29 percent are owned indirectly through mutual funds or other pooled investment vehicles.[2]

However, if you drill beneath those statistics, some interesting—some might say disturbing—patterns emerge. First, we've seen a narrowing of the market. A mere 2.4 percent of households hold any municipal debt (either direct or indirect), and that figure is about half of what it was in 1998.[3] Second, as we've seen in other areas of wealth concentration, the wealthiest households own an increasing share of total municipal debt. The wealthiest one-half percent of U.S. households now own 42 percent of all municipal bonds, as compared to ownership of 24 percent in 1989. The bottom 90 percent of U.S. households, as measured by net wealth, now hold less than 5 percent of muni bonds, falling from almost 15 percent in 1989.[4]

How did muni bond ownership become a lifestyle of only the rich and famous, as opposed to an investment option for the middle and upper-middle classes? Ironically, the answer appears to lie with the tax advantages of muni bonds. Given the favorable income tax treatment of muni bonds, households in higher tax brackets have always had more incentive to invest in muni bonds—this is not news to this audience. However, the shift from defined benefit pension plans to defined contribution retirement plans seems to have significantly deteriorated the incentive for less wealthy persons to invest in munis.

As you are no doubt aware, the interest on municipal bonds is exempt from federal income tax, and often from state and local taxes. However, given these tax benefits, which make muni bonds attractive as compared to other investments, the interest rate for muni bonds is usually lower than the interest rate on other taxable fixed-income securities such as corporate bonds.[5]

This lower-yield for lower-tax tradeoff may be attractive for certain investors, but it tends to lose its appeal within the context of a tax-advantaged retirement account, where all holdings are tax-deferred. It usually makes little sense to hold tax-exempt munis within an IRA, 401(k), or 403(b),[6] and, as we might expect, research suggests that people who direct their savings into tax-advantaged retirement accounts are unlikely to hold munis.[7]

As employers have shifted away from defined benefit pension plans, there has been a significant increase in tax-advantaged defined contribution plans such as 401(k)s.[8] One outgrowth of this trend, however, is that muni bonds may no longer be attractive for the average investor. Today's muni investors are likely to be those who are wealthy enough to have fully funded their retirement accounts and, unfortunately, recent data suggests this may be a relatively small proportion of the population.[9]

More study is probably needed, but I think it is worth asking whether the tax benefits of municipal bonds, which were presumably intended (at least in part) to incentivize investment in munis, are actually accomplishing that objective. Competing tax policies that favor retirement savings may actually drive most investors away from muni bonds, given their traditionally lower yields. But whatever the cause, if the current trends continue and we see fewer and fewer investors holding an ever-larger proportion of muni bonds, the traditional retail-oriented muni market will change dramatically in the not-too-distant future.

Personally, I hope we can reverse this trend toward concentration of assets among fewer investors. Regardless of our views on income or wealth inequality, I think we can generally agree that the projects funded by municipal securities improve the quality of life for all Americans, so we all have an interest in making sure the marketplace is attractive to investors of all stripes.

Notwithstanding the current concentration of assets, we still have a big job to do. Even though only a small percentage of U.S. households hold municipal securities, that is still millions of people, and it represents a lot of hard-earned money—approximately $3.71 trillion, in fact.[10] And, because the average age of the muni investor is 62 years old,[11] it means that a lot of those investors are seniors, whose vulnerabilities may increase as they age.

This is why I, and many of you, have been fighting for reforms in the muni markets. Although there is still plenty of work to be done, the past few years are evidence that regulators can take strides toward an innovative, flexible market while continuing to protect investors. The MSRB and FINRA have continued to enhance Electronic Municipal Market Access (EMMA) and Trade Reporting and Compliance Engine (TRACE), respectively, so investors would have better access to pricing and other important market information. The MSRB finalized its best execution guidance for dealers and the best execution rule took effect on March 21, 2016. Additionally, FINRA and the MSRB continue to collaborate on a markup disclosure rule and the MSRB is considering interpretive guidance to assist bond dealer in establishing "prevailing market price." These are important initiatives that will make the markets a better place for investors, which will in turn make it a better place for issuers to get the funds they need for important projects.

As I close, I would like to take advantage of the fact that I am speaking to a group of regulators, and just extend my thanks, on behalf of America's investors, for the jobs you do. Many of you have been on examinations of dealers, making sure they abide by the rules of the road and treat customers appropriately. Others have been involved in rulemakings that will improve those rules of the road. Some of you have worked to inform consumers about investment products or warn them away from scams, or you have personally talked to them and tried to give them whatever help they need.

Most days, you probably are not thanked for the work you do, but this is not one of those days. Thank you for all you do, each and every day, with little recognition or reward, on behalf of the American public.

[1] The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication or statement by any of its employees. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission or of the author's colleagues upon the staff of the Commission.

[2] Federal Reserve Board, Financial Accounts of the United States: Flow of Funds, Balance Sheets, and Integrated Macroeconomic Accounts, Fourth Quarter 2015, Table L.212 (Mar. 10, 2016, 12:00 PM), http://www.federalreserve.gov/releases/z1/current/z1.pdf.

[3] See Bergstresser and Cohen, Changing Patterns in Household Ownership of Municipal Debt: Evidence from the 1989-2013, (Current draft June 2015), at Figure 1; https://www.brookings.edu/wp-content/uploads/2016/07/Bergstresser-Cohen-with-tables.pdf.

[4] Id., at Figure 2.

[5] See https://www.investor.gov/introduction-investing/basics/investment-products/municipal-bonds.

[6] See, e.g., https://www.alamocapital.com/investment-products/bonds-and-fixed-income/municipal-bonds/ ("The placement of tax-free municipal securities into a qualified account is deemed to be an anomaly because (1) historically the yield on tax-free municipal securities is less than the yield on taxable securities, (2) the normally lower yield on municipal securities is justified by comparing its yield to the after-tax yield on taxable securities, and (3) the tax-free benefit is lost when "tax-free" securities are placed into a qualified account. The interest received from a "tax-free" security is taxed at ordinary income tax rates at the time it is withdrawn from the qualified account. Therefore the normal rule is that, given a choice, tax-free securities should be placed in a non-qualified account to retain their tax-free treatment.").

[7] Id., at 3.

[8] See Rick A. Fleming, Protecting Elderly Investors from Financial Exploitation, Feb. 5, 2015, https://www.sec.gov/news/speech/protecting-elderly-investors-from-financial-exploitation.html ("Up until 1985, the aggregate value of defined contribution plans was less than half the value of defined benefit plans. By 2012, however, defined contribution plans were more than 50 percent larger than the aggregate size of defined benefit plans.").

[9] According to the Employee Benefit Research Institute, 74 percent of American workers have saved less than $100,000 for retirement. 2016 RCS Fact Sheet #3, Preparing for Retirement in America, at Figure 3, https://www.ebri.org/files/RCS_16.FS-3_Preps.pdf.

[10] Federal Reserve Board, supra note 2.

[11] Bergstresser and Cohen, supra note 3 at Table 10.