NEWS

SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549
(202) 755-4846

HOLD FOR RELEASE 12:00 noon, Tuesday, June 4, 1974

"A FENCE ON THE CLIFF-- OR AN AMBULANCE IN THE VALLEY"

Address by

John R. Evans
Commissioner
Securities and Exchange Commission

68th Annual Municipal Finance
Officers Association Conference
Las Vegas, Nevada
June 4, 1974

I was pleased to receive the invitation to speak on the subject of "Proposed Regulation of the Municipal Debt Industry" at this 68th Annual Municipal Finance Officers Association Conference. Hopefully, my remarks this morning, along with the discussion that follows, will be meaningful and informative and will assist in the development of decisions regarding regulation which will be helpful to the governmental entities you serve.

The Securities and Exchange Commission has recommended and supports legislation providing for SEC jurisdiction over brokers, dealers and banks engaged in underwriting and trading in municipal securities.

Personally, I believe that an appropriate reaction to any government agency's recommendation to expand its authority is good, healthy skepticism, because there seems to be a tendency for some government bureaucrats to attempt to regulate anything that moves. Furthermore, when the recommendation might be considered to effect in some way the ability of state and local governments to finance their operations, it is natural that finance officials of such governments would have serious questions regarding the impact of any new federal regulation on those who market their securities, the possible effects of

---

such regulation on issuers, and the degree to which issuers will be able to participate in establishing these rules and regulations. In my opinion, this skepticism and the strong desire of state and local governments to preserve their autonomy in such matters is not only healthy and desirable, but is essential to the proper functioning of our political and economic system.

I support fully the concept that in a free enterprise system such as ours, federal regulation is appropriate only to the extent necessary to adequately protect the public interest, including the maintenance of an environment in which both public and private institutions may operate effectively.

Regulation to ensure appropriate conduct, of course, poses a different set of problems than punishment for wrongful acts. Unfortunately, there is no practical--or for that matter, legal--way to regulate only those who are not honest in their dealings. Regulation must be impartial and thus a relatively small number of problem cases can make things more difficult for many others. It is a fact, however, that the regulatory reports and procedures which may sometimes be burdensome and time consuming usually provide a sound basis for an environment in which honest individuals and government bodies, such as those you represent, can foster needed activities.

When the Securities and Exchange Commission was established in the Securities Exchange Act of 1934, the Commission was charged with the responsibility of protecting the interests of the public and investors against improper practices in the securities markets. Congress, however, exempted municipal securities activities from all but the fraud provisions of the Securities Exchange Act. Thus those dealing in municipal securities were not subject to the same regulatory structure as those dealing in non-exempt securities. It seems clear that municipal securities activities were exempted because at that time purchases and sales of such securities almost exclusively involved financial institutions and wealthy individuals who could fend for themselves in the marketplace.

This view of municipal securities markets was again expressed in 1945, when Mr. David Wood, representing state and local issuers of municipal obligations before the House Committee on Interstate and Foreign Commerce, stated that municipal securities "are not sold to persons of small means or to gullible persons who wanted to get rich quick . . . and the purchasers of these securities are the most sophisticated investors in the world."[1/] This may have been an accurate description in 1934, and in 1945, but since that time

---

1/Hearings on H.R. 693 Before the House Committee on Interstate and Foreign Commerce, 79th Cong., 1st Sess., p. 7 (1945).

significant changes have taken place and the statement does not accurately describe the market for municipal securities today.

The municipal bond industry has grown dramatically during the last thirty years, reflecting the increased demand by municipalities for funds to meet pressing social objectives. At the same time, the number of potential municipal bond investors has also increased as our society has become more affluent. In addition, income taxes have gone up markedly during the same period and are no longer significant only to the wealthy. Those with moderate incomes now find themselves in income tax brackets which make municipal securities, with their tax-exempt status, attractive investments.

The increased demand for municipal securities by individual investors has also resulted in the development of trading markets for relatively small units of these securities, and in the proliferation of persons performing broker-dealer functions in those markets. Unfortunately, the surge of investor interest in municipal obligations and the concomitant extension of municipal securities trading have been accompanied by the development of various municipal securities trading practices, such as unreasonable mark-ups, unsuitable recommendations and the "churning" of customers' accounts, which were formerly associated only with trading in nonexempt securities.

The Securities Exchange Act has brought about a pervasive system of regulation in the securities markets. But, as I indicated earlier, trading in municipal securities is, for the most part, outside this regulatory structure, and therefore, can be a refuge for broker-dealers who are unwilling to conform to the system, or are unable to meet the prescribed standards.

In the last year or two, the Commission has filed a number of cases against non-registered municipal bond broker-dealers. Most of you are probably familiar with those cases which involved seven firms and twenty-eight individuals in Tennessee[2/] and Paragon Securities Company,[3/] a large New Jersey firm. The effects of the wrongful activities of the defendants in these cases were not confined to any particular region. The scope of their activities is indicated by the fact that Paragon maintained offices in New York, Florida, and California and that one of the Memphis firms, Investors Associates, operated for some time in Arizona. Moreover, the practices which we have found in our investigations are not just borderline or sharp practices, but as the Court opinion indicated in the Charles Morris case, they include:

2/Securities and Exchange Commission v. Charles A. Morris & Associates, Inc., [1972-1973 Binder] CCH Fed. Sec. L. Rep. ¶93,756 (W.D. Tenn., 1973); Securities and Exchange Commission v. Investors Associates of America, Inc., W.D. Tenn., Civ. No. 72-367; Securities and Exchange Commission v. First U.S. Corporation, W.D. Tenn., Civ. No. 73-355.

3/Securities and Exchange Commission v. Paragon Securities Co., D.C. N.J., Civ. No. 1120-73.

> . . . all of the elements of a classic 'boiler room' operation: unqualified, improperly supervised salesmen; high pressure long distance telephone sales designed to induce hasty investment decisions by customers about whose financial conditions the salesmen knew very little; and heavy dealings in speculative bonds of issuers about whose adverse financial conditions there was very little disclosure.4/

As our enforcement cases demonstrate, the problems are not restricted to a few isolated dealers in one geographical area, but are indicative of a pattern which calls for appropriat federal regulation. The Commission is concerned that failure to provide such regulation could result in the erosion of a system which until recently has functioned very effectively with remarkably few abuses. The Commission is also concerned that if such abuses do not result in some form of municipal securities legislation expanding the protections afforded to investors in municipal securities under federal securities laws, the consequence will be a loss of investor confidence in municipal obligations and an adverse effect on the capital raising ability of state and local governments.

4/Securities and Exchange Commission v. Charles A. Morris & Associates, Inc. [1972-1973 Binder] CCH Fed. Sec. L. Rep. ¶93,756 at 93,306 (W.D. Tenn., 1973).

There are some who are not convinced that regulation of municipal securities activities is required, because they believe that enforcement actions under the antifraud provisions of the Securities Exchange Act are a sufficient curb to misbehavior in this area. While cases brought under our fraud powers may well have a deterrent effect on improper practices, it is all too easy to lose sight of the fact that a fraud case is not a substitute for a regulatory system designed to prevent abuses from occurring and to detect such activities well in advance of the occurrence of major investor losses. It is true that litigation can, and sometimes does, result in disgorgement of illegal profits or restitution; however, there are too many instances where effective remedies are not possible and the fraud conviction alone does not return the millions of dollars that investors may have lost.

Thus, consistent with our statutory responsibility to protect public investors, we believe that regulation is desirable and that it should be designed to maintain and enhance the strong markets we now have without an adverse impact on your capital raising activities. I believe that the desirability of such a preventive regulatory approach is well-illustrated in a poem by Joseph Nalius, which I learned as a boy:

Twas a dangerous cliff, as they freely confessed
Tho to walk its crest was so pleasant.
But over its terrible edge there had slipped,
A Duke and full many a peasant.
So the people said something would have to be done
But their projects did not tally.
Some said, "put a fence round the edge of the cliff."
Some, "An ambulance down in the valley."

But the cry for the ambulance carried the day,
For it spread through the neighboring city.
A fence may be useful or not, it is true,
But each heart became brimful of pity,
For those who slipped over that dangerous cliff;
And the dwellers in highway and alley gave
pounds or gave pence, not to put up a fence,
But an ambulance down in the valley.

* * *

Then an old sage remarked, "It's a marvel to me
That people give far more attention
To repairing results than to stopping the cause
When they'd much better aim at prevention
Put a stop at the source of the mischief," he cried.
Come neighbors and friends let us rally.
If the cliff we will fence, we might almost dispense
With the ambulance down in the valley.

* * *

Better close up the source of temptation and crime,
Than deliver from dungeon or galley.
Better put a strong fence round the top of the cliff
Than an ambulance down in the valley.

Having arrived at the conclusion that some form of additional regulation of municipal securities activities is necessary, there have been various proposals developed for that purpose during the last two years. One of the major

purposes that some of these proposals have attempted to achieve is an approach that would assure equal regulation of brokers, dealers, and banks engaged in municipal securities activities while preserving the self-regulatory concept of the securities industry and avoiding the establishment of such a structure in the banking industry.

The first proposal was a memorandum issued by the Subcommittee on Regulation to the Public Council of the Securities Industry Association in November of 1972. That proposal was an effort to satisfy bank and non-bank members by establishing a whole new regulatory structure. This structure included a new governmental agency composed of three members appointed by the President with the advice and consent of the Senate and a new self-regulatory body with rulemaking, inspection, and enforcement powers over all municipal securities underwriters and traders.

This noble attempt met with substantial criticism from government agencies and members of Congress, and was rejected by the dealer bank members of the Securities Industry Association. The non-bank members then recommended undivided SEC regulatory authority without any bank agency participation. The bank dealers responded by recommending bank agency

rulemaking and enforcement for bank municipal activities with no SEC participation.

In September of last year, at the request of Senator Williams, Chairman of the Securities Subcommittee of the Senate Committee on Banking, Housing and Urban Affairs, the Commission drafted straight-forward legislative language amending the Securities Exchange Act to simply delete the exemption for municipal securities for purposes of Sections 15 and 15A of that Act and to eliminate the exemption of banks (or their municipal securities departments) from the term "dealer" as used in that Act to the extent banks act as dealers in municipal securities. Thus the Commission would obtain full authority to regulate the activities of bond underwriters and dealers. Although we submitted our draft to the federal bank regulatory agencies, time constraints did not permit a full discussion of the issues involved, and in our transmittal letter to Senator Williams, we stated that because the bank agencies indicated a general preference for legislation contemplating more sharing of authority with the Commission, they would probably desire to make their views known to him. A few days later on September 21, Senator Williams introduced S. 2474 to regulate those trading in municipal securities.

S. 2474, in general, provides for a new industry self-regulatory body, subject to full oversight by the Securities and Exchange Commission, with a requirement that the Commission consult with bank regulatory agencies in its rulemaking and enforcement actions relating to banks.

At about the same time as S. 2474 was introduced, counsel for the Dealer Bank Association developed a proposal entitled the "Public Finance Act of 1973," which recommended registration by dealer banks with the appropriate federal bank regulatory agency and with the Commission for persons under SEC jurisdiction and required that the four agencies cooperate to minimize differences in registration requirements. The Commission would establish the rules and regulations but was required to hold a rulemaking proceeding on any proposal submitted by the bank agencies, and under certain conditions on rulemaking proposals suggested by recognized trade groups.

Enforcement would be primarily by the agency which had jurisdiction over a municipal securities professional for other purposes, but enforcement by another agency could occur if the primary agency declined to take action when requested by another agency. This proposal also included authority for banks to deal in revenue bonds.

On December 21, after several meetings with representatives of the DBA and the Comptroller of the Currency on this draft and amended versions of this draft, we told the Comptroller and his staff that we would try to draft legislation amending S. 2474 to accommodate his views and the views of all who had made their position on this legislation known to us, including broker-dealers and dealer banks engaged in the municipal securities industry, the bank regulatory agencies and the National Association of Securities Dealers, to the extent we considered their views to be consistent with our responsibility to protect the investing public and with provisions of other legislation already reported to the Senate by the Committee on Banking, Housing and Urban Affairs.

This was a major drafting project which involved members of the Commission as well as our staff. Andrew M. Klein, Assistant Director of our Division of Market Regulation, was responsible for combining the various views into a workable statutory framework. On March 12 of this year such a draft was discussed briefly with the Comptroller and distributed to other interested parties. I might add that most of the comments we have received on the draft have indicated substantial agreement with our basic approach.

On April 24, we received a letter from the Comptroller in which he expressed agreement with the draft except for the broad grant of authority to establish regulations in this area and the procedures to assure evenhanded enforcement. These procedures essentially granted the Commission overall enforcement responsibility for banks and non-bank brokers and dealers while not altering the existing authority which bank regulatory agencies would have to assure that bank municipal securities activities meet appropriate standards. On April 29, we met again with the Comptroller to discuss these issues and in testimony before the Securities Subcommittee of the Senate Committee on Banking, Housing and Urban Affairs on May 2, we offered an alternative enforcement structure which we believe could achieve uniformity as well as make much greater use of present bank and securities industry regulatory structures.

Under this alternative, enforcement authority over members of the National Association of Securities Dealers would be vested directly in the NASD, accompanied by direct inspection responsibility over its members. Similarly, both inspection and enforcement authority over bank dealers would be vested directly in the bank regulatory agencies. This

alternative has the obvious merit of uniting inspection and enforcement responsibilities in regulatory bodies which already exercise jurisdiction over bank and non-bank firms engaging in municipal securities activities. The Commission offered this alternative only on the condition that the SEC be granted broad, flexible power to review enforcement actions taken by the NASD or by any bank regulatory agency and to adjust any sanctions imposed to ensure evenhanded treatment of both bank and non-bank municipal securities professionals. The Commission also considers it essential that we be authorized to initiate enforcement action with respect to any municipal securities professional at any time, regardless of enforcement measures which might be taken by a bank regulatory agency or the NASD, if the Commission determines that such action would be in the public interest. Finally, the Commission would have the power to inspect any bank or non-bank municipal securities professional if it deemed such action to be appropriate.

One of the Commission's primary concerns in all of our conferences on proposed legislation was to assure that the effect of legislation would be beneficial to those who are served by the municipal securities industry, the issuers of municipal securities. Thus, we were most interested in the

testimony presented on May 6, in which Mr. William J. Reynolds on behalf of the Municipal Finance Officers Association stated that:

> Proposed regulation of the municipal securities market, while clearly geared to the recently perceived needs to protect investors and to ensure the long-run confidence in our market, will bring about certain changes in that market and thus we are concerned about it. These concerns should not be misread to be adversary or querulous. We simply wish to identify those areas where we see possible collateral or 'splash' effects on the issuers growing out of the regulation of brokers, dealers, and dealer banks, and to ask for your consideration and clarification of such points about which we are uncertain. Moreover, we wish to impress upon the Subcommittee our constructive interest in the proposed regulation and our desire that the viewpoints of the State and local citizen-taxpayers and us as their agents, enter into your deliberations.5/

In his statement, Mr. Reynolds mentioned four basic concerns, which I believe require careful consideration.

1. The first one was the possibility that requirements placed on dealers might result in restrictions on issuers and that documents or other materials promulgated by governmental units might be subject to review or approval

---

5/Statement of William J. Reynolds on S. 2474 and S. 1933 Before the Subcommittee on Securities of the Committee on Banking, Housing and Urban Affairs, 93d Cong., 2d Sess., p. 5 (May 6, 1974).

by a federal regulatory agency. As you know, present offering documents and materials are not subject to review or approval by a federal agency, but are subject to the antifraud provisions of the federal securities laws and must therefore not be fraudulent or misleading. This legislative proposal does not provide for any additional requirements on issuers.

2. The second concern was the possible suspension of underwriting or trading in municipal securities. Your concern over such a possibility is understandable. S. 2474, as introduced, contained authority for the SEC to suspend trading and we are not sure why it was included. I am unaware of any difficulties having ever arisen in the municipal securities markets since the SEC was established, that would have resulted in a suspension of trading by the Commission in the absence of disclosure and reporting requirements, and I cannot foresee such a situation. It should be noted that my judgement in this regard may be attributable partially to the fact that these securities are exempt for our regulatory structure, and thus the Commission does not have a complete knowledge of possible problem areas.

3. The third concern was the cost of regulation. As you can readily understand, our proposal including the alternative for inspection and enforcement by regulatory agencies which are presently inspecting and enforcing standards for all federally insured banks and most securities firms is by far the least expensive evenhanded regulatory approach. Late last Friday afternoon, we transmitted to the Senate Securities Subcommittee, legislative language which would implement the alternative which I recommended at the hearings. In addition, it would not appear that the Municipal Rulemaking Board, which does not have inspection and enforcement responsibilities, will incur substantial costs.

4. The fourth concern was that the rulemaking board or authority would have issuer representatives. Your testimony urged "that there be specific provision for mandatory and formal representation of state and local government issuers on the rulemaking body."[6/] The Commission agrees with this concern and our proposed amendments require representation of issuers on the Board.

6/Id. at 9.

The proposals for regulation of those underwriting and trading municipal securities presently pending before the Senate Securities Subcommittee are the result of nearly three years of effort by the Subcommittee staff, the Commission, other government agencies and participants in the municipal securities markets. I believe the few remaining issues can be resolved satisfactorily, thus providing the basis for efficient regulation of professionals in the municipal securities markets which should strengthen those markets to the benefit of municipal securities issuers and provide necessary protection of investors.

I encourage you to give your support to the resolution of the few remaining issues and to the enactment of this meaningful and important legislation; thus adding a rail round the cliff to the ambulance in the valley.