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THE NEW DAY FOR MUNICIPALS

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Address

by

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Commissioner

Securities and Exchange Commission

First, I would like to thank the officers of your Section for the opportunity afforded me to gain a somewhat broader view of the world than I have had before. For the last ten or twelve years, my American Bar Association participation has been totally with the Section on Corporation, Banking and Business Law. Oh, I knew that out there somewhere there were other Sections and lawyers with other problems, but I'm afraid my parochialism steadily deepened and those outside became ever less distinct shadows. You have now become flesh and blood people and you have dented severely my isolation. For that I am grateful.

To some extent, of course, my presence here is evidence of a trend, not universally welcomed by any means, for the

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federal securities laws to have wider and wider application, with many, like yourselves, who may previously have been relatively unconcerned with them, now caught up, sometimes uncomfortably, in their maze.

This expanding pervasiveness of federal securities law concepts has many sources. First, the Securities Acts Amendments of 1975, legislation that was finally passed by Congress and signed by the President on June 4 of this year, changes the definition of exempted securities to remove municipal securities from this category for certain purposes of the 1934 Act. Further, this legislation adds a new Section 15B to the 1934 Act which imposes a new and comprehensive scheme of regulation on dealings in municipal securities - a term, I might add, which I will use throughout as it is now defined in the 1934 Act as a consequence of the 1975 Amendments, namely, securities which are

> "direct obligations of, or obligations guaranteed as to principal or interest by, a State or any political subdivision thereof, or any agency or instrumentality of a State or any political subdivision thereof, or any municipal corporate instrumentality of one or more States, or any security which is as an industrial development bond...."

Another source, which has been on the scene now for a third of a century, is Rule 10b-5 under the 1934 Act. In fact, Rule 10b-5 has such potency that there were those during the long arduous process leading up to the enactment of the 1975 Amendments who suggested that amendments pertaining to municipal securities were unnecessary since the Commission had abundant power in Rule 10b-5 to deal with the abuses that had been manifested in the municipal securities area.

Accenting the relevance of these expansions of federal securities law, of course, has been the plight of poor, beleaguered New York City. As a consequence of its problems, perhaps never since the depression, and perhaps not even then, has so much attention been bestowed upon the financial situation of our cities, the worth of their securities, the validity of their disclosures and the whole process of municipal financing. With the ink barely dry from the President's pen on the 1975 Amendments, questions have been raised whether indeed even these new restraints are sufficient to protect investors against the dangers of misconduct in the marketing of municipal securities.

As I'm sure you know, central to the system of securities regulation developed by Congress in 1933 and 1934 was the registration of securities prior to their distribution. Under the Securities Act of 1933, before a "distribution" (and I'll leave until another day and a longer session the nuances of that term) of securities can occur, the issuer has to file with the Securities and Exchange Commission a so-called registration statement containing extensive and detailed information about the issuer. A portion of this registration statement must be furnished to investors. Oddly enough, the statutory scheme requires the delivery of this prospectus, not in advance of the investor's commitment, but after.

It was contemplated that the registration statement would become effective and the securities commenced to be sold 20 days after the filing unless the filing was so deficient as to justify a so-called "stop order" proceeding to prevent the effectiveness and the sale. Ingenious informal procedures, however, have obviated the need to use the "stop order" approach save in fairly extreme circumstances.

The 1934 Act added another registration requirement, this one of brokers and dealers, that is, those who engage in the business of effecting securities transactions for others or engage in the business of buying and selling securities for their own account.

In some measure because of the desire for governmental comity, in part because of the absence of "recurrent demonstrated abuses," and mostly because of a belief that the typical purchaser of municipal securities would be, as it had been in the past, the sort of investor which did not need the protections of securities or broker-dealer registration - banks, insurance companies and other institutional investors - municipal securities were exempted from the registration requirements of the 1933 Act, and dealers who confined themselves exclusively to municipal securities, as well as banks which frequently were dealers in them, were exempted from the broker-dealer registration requirements of the 1934 Act. And indeed, the scenario contemplated was largely borne out through the years: the typical purchasers of municipal securities continued to be institutions; with only limited individual participation. More than that, the number of defaults was very limited and it appeared that the practices by which these securities were sold were, for the most part, legitimate and proper and free of abuses.

Toward the end of the 1960's and in the early part of this decade, those patterns began to change significantly. There was a great increase in public participation in the purchase of municipal securities: between 1960 and 1974 the amount of securities held by individuals went from $30.8 billion to $62.3 billion (although institutions, which also increased their purchasing during this period, represented a growing percentage of the ownership of total municipal securities outstanding). Unfortunately, however, this increase in terms of individuals purchasing municipal bonds was accompanied by the development of marketing practices which resembled those which had brought about the enactment of the securities legislation of the 1930's. The "boiler shop" moved from the equity side of the street to the municipal side, and Memphis became a bad word. Now, it is true that in large measure these activities were confined to a small segment of the market. However, there was some reason to believe that,even among reputable institutions and dealers in municipal securities, practices existed which were undesirable. It appeared that frequently there were conflicts of interest between the roles of commercial banks as underwriters of municipal securities and as purchasers of them; various "swapping" practices flourished; dealers were less than diligent in ascertaining the facts about issues; and stories erupted about the games being played.

Notwithstanding the absence of requirements under the 1933 and 1934 Acts for registration of municipal securities and banks and dealers who dealt exclusively in them, the Commission was not totally powerless in the face of these abuses. While,in addition to the exemptions mentioned, municipal securities were also exempted from the provisions of Section 12 of the 1933 Act which specifically provides a private remedy for a defrauded investor, Congress chose not to exempt municipal securities from the broad antifraud provisions of Section 17(a) of the 1933 Act which outlaws the use of fraudulent or deceptive acts or practices in connection with the offer or sale of any security in interstate commerce.

At the time of its enactment, Section 17(a) was regarded primarily as a basis for Commission enforcement action and possible criminal prosecution for fraudulent and manipulative conduct. In 1942, however, the Commission, in order to forestall a fraud being committed by a business executive in purchasing securities, adopted the now-famous Rule 10b-5 under the powers given it by Section 10(b) of the 1934 Act. Rule 10b-5 simply incorporates the language of Section 17(a) which is limited to the <u>sale</u> of securities and makes it applicable to the <u>purchase</u> of securities as well. As with Section 17(a), there is no exemption for municipal securities - or for that matter, any security - from Section 10(b), and thus, from Rule 10b-5. Rule 10b-5 was again, like Section 17(a), conceived as a tool to be used by the Commission in administrative and injunctive proceedings to enforce the federal securities laws. However, in 1946, this purpose was expanded when a Pennsylvania District Court determined that Rule 10b-5 gives an implied cause of action to private litigants, a position now confirmed beyond argument, and since then some courts have similarly interpreted Section 17(a) Thus was loosed the tremendous flood of litigation under the federal securities laws which, at least until the Blue Chip Stamp case decided by the Supreme Court during the last term, seemed to be all engulfing.

The Commission has brought under Rule 10b-5 and Section 17(a) a number of actions against dealers and others who have engaged in fraudulent or fraud-like conduct in connection with the sale of municipal securities. In the words of the Report of the Senate Committee on Banking, Housing and Urban Affairs on S. 249, which was the Senate version of the 1975 Amendments, the pattern disclosed by this litigation was:

> "characterized by unconscionable markups, churning of customers' accounts, misrepresentations concerning the nature and value of municipal securities, disregard of suitability standards and scandalous high-pressure sale techniques. The selling practices of these firms involved all the characteristics of the classic 'boiler room' operation. These practices were intended to induce hasty investment decisions with respect to securities unfamiliar to potential customers. Furthermore, it appears that certain firms exerted extraordinary pressures on their salesmen to increase sales without regard to the welfare of the firms' customers. In some instances bonds have been promoted as general obligations of the issuer whereas, in fact, they have been revenue bonds, sometimes in default."

Largely as a consequence of the significantly larger numbers of individuals who invested in municipal securities, a circumstance in part attributable to the fact that an escalating economy pushed more people into tax brackets which made the tax-free characteristic of municipal securities desirable, and also largely because of scandals such as those which surrounded the activities of certain Memphis bond dealers and Paragon Securities in New Jersey, the industry itself in the early years of this decade recognized the need for enhanced regulation and began exploring the means of achieving it. Senator Harrison J. Williams and the Commission undertook to develop legislation to assure adequate investor protection. The drafting and enactment process began, as I recall it, just about the time I joined the Commission in 1973. Our first proposal for dealing with the problem was simple, if not simplistic: merely remove the exemption from registration as a broker-dealer for those who engage only in the business of being a broker or dealer with respect to municipal securities and specifically require dealer banks to register with the Commission. This simple approach, of course, would have placed the entire jurisdiction with regard to these matters in the Commission, regardless of whether the broker or dealer was a bank or a member of the securities industry. Not unexpectedly, this approach met with hostile reactions, largely from the banking community. A number of proposals were developed before the one which finally became law in June of this year was agreed upon.

Under the legislation as enacted, banks which act as dealers in municipal securities and those non-bank entities whose only activity with respect to securities consists of acting as dealers or brokers with respect to municipal securities are no longer exempt under the 1934 Act and hence must register with the Commission; in the event a bank has an identifiable department or division which performs the functions of a dealer in municipal securities, only that entity needs to be registered, once the Municipal Securities Rulemaking Board, to which I will refer later, has defined the standards for determining which entities are sufficiently separately identifiable for purposes of enforcing the provisions of the 1934 Act. As a correlative of the registration provisions the Commission is given the power through administrative proceedings to censure, limit the activities of, suspend for up to twelve months or revoke the registration of, any municipal securities dealer (including a bank or its identifiable department or division), or any municipal securities broker, if it finds it has violated specified provisions of the securities laws or that other specified grounds exist. The Commission has similar powers with respect to those associated with such brokers or dealers; in the case of banks, these powers pertain to those who engage in or

The difficult problem of delineating the jurisdictions of banking authorities and the Commission was resolved in a unique fashion. The primary responsibility for investigation and enforcement with respect to banks and their separately identifiable departments or divisions lies with the banking authorities; with respect to national banks, that authority is the Comptroller of the Currency; with regard to banks insured by it, that authority is the Federal Deposit Insurance Corporation; with respect to a state bank which is a member of the Federal Reserve System or a bank holding company, or a subsidiary of a bank holding company, that authority is the Federal Reserve Board. The Commission has primary responsibility with respect to non-bank brokers and dealers. However, the Commission has the full right to conduct investigations of municipal securities dealers which are banks and take enforcement action with respect to them, provided however, that it shall have consulted with the banking authorities prior to the commencement of such investigation or enforcement action. Similarly, the banking authorities, when they propose to investigate a bank's activities as a municipal securities dealer, must consult with the Commission. However, the Senate Committee made the Commission's primacy clear in its report: "...the Committee believes the Commission must have the ultimate authority to enforce the Exchange Act as well as the rules of the Board, as to both bank and non-bank dealers."

Obviously, in our estimation, it would have been cleaner, simpler, and more flexible if the entire responsibility had been reposed in the Commission; however, we believe the manner in which the conflicting concerns were resolved is a workable solution and there should develop a satisfactory cooperative program between the banking authorities and the Commission.

The most interesting aspect of the legislation is the establishment of the Municipal Securities Rulemaking Board. This Board, which will have 15 members, must consist of five members from the bank side of the business, five from the securities dealer side, and five from the public. Of these last five, one must be representative of investors in municipal securities, and one of issuers of municipal securities. The Commission must designate the initial members who shall serve for two years, after which the Board itself shall conduct the nomination and election of members in accordance with rules to be adopted by the Board. This Board is given extensive powers to adopt rules with regard to trading in municipal securities. It can, for instance, adopt rules with regard to standards of training, experience and competence of those in the business; classify municipal securities brokers and dealers; provide for periodic examinations of municipal securities brokers and dealers to determine compliance; adopt rules to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaging in regulating, clearing, settling, and processing information with respect to municipal securities; establish procedures for the arbitration of claims under certain circumstances; regulate the form and content of quotations with respect to municipal securities; and establish reasonable fees and charges on municipal securities brokers and dealers to defray the costs and expenses of the Board. In brief, this Board is given much the same sort of power that the National Association of Securities Dealers and the various exchanges have. As in the case of other self-regulatory organizations, the rules adopted by the Board must be approved by the Commission before they may become effective and the Commission has the power to alter or amend the Board's rules. However, as indicated previously, unlike the NASD and exchange mode of self-regulation, the Board has no enforcement powers; those rest only with the bank regulatory authorities and the Commission.

The Commission has received innumerable suggestions for membership on the Board and is in the process of reviewing these carefully so that the initial Board may be strong, competent and dedicated to the principles that underlie this legislation.

One of the most significant parts of this legislation provides that neither the Commission nor the Board is authorized to require any issuer of municipal securities, directly or indirectly through a purchaser or prospective purchaser of securities from the issuer, to file with the Commission or the Board prior to the sale of securities by the issuer any application, report or document in connection with the issuance, sale or distribution of such securities. Furthermore, this section goes on to state that the Board is not authorized to require any issuer of municipal securities, directly or indirectly through a municipal securities broker or dealer or otherwise, to furnish to the Board or to a purchaser or prospective purchaser of such securities any application, report, document, or information with respect to such issuer, with the proviso that the Board may require municipal securities brokers and dealers to furnish to the Board or purchasers or prospective purchasers, applications, reports, documents, and information with respect to the issuer which is generally available from a source other than the issuer. This provision was urged by municipal financing officers because of the expense they feared would be imposed on issuers if they were required to in effect register their securities.

Largely as a consequence of the New York tragedy - or fiasco, depending on your viewpoint - new questions are already being raised concerning the integrity of municipal financing and whether perhaps the legislation stopped short of providing all the protection investors in municipal securities need. These concerns are not with the "boiler shops" or the grosser kinds of fraud that spawned the Congressional concern which resulted in the legislation, rather the questions now center on the integrity of municipal financial statements and the extent to which issuers are properly informing investors in both the primary and secondary markets with regard to their affairs. The reasons for this concern were evident in the July 1 issue of The New York Times which carried a story to the effect that the Controller of the City of New York, Harrison J. Goldin, had disclosed that New York City had a "hidden deficit" that might amount to $600 million. The article continued, "Mr. Goldin's report further discloses that the city's total hidden deficit, caused by overstating Federal and state aid and the use of many other bookkeeping gimmicks, comes to at least $1.8 billion and possibly as much as $2.1 billion. In another instance, not too long ago a suburb of a major American city sold bonds to a dealer at a time when the city was unable to meet its payroll and was in a form of receivership - and yet not a word of its plight was in the prospectus used in connection with the offering!

The Congress, in barring the Commission and the Board from requiring the issuers of municipal securities to furnish information to investors or the Board, did so with full realization of the broad powers the Commission has under the antifraud provisions of the securities law; in fact, the very section itself contains the language, "Nothing in this paragraph shall be construed to impair or limit the power of the Commission under any provision of this title." For that matter, the Municipal Finance Officers Association acknowledged the Commission's antifraud powers when it wrote Senators: "...state and local governments are already subject to the antifraud provisions of the Securities Act." Thus the powers of the Commission to move against fraud in connection with the offering and the sale of municipal securities have been preserved intact.

I would suggest that the public - and those who speak to and for the public - will, as a consequence of the New York experience, be less and less tolerant of the disclosure practices that tell less than the whole story about issuers and their affairs. In June of this year Business Week predicted that the New York City and the Urban Development Corp. problems "promise to produce major changes in the municipal bond market." Other publications have similarly suggested that there should be imposed stricter disclosure requirements, either by a governmental agency or through the voluntary adoption of standards that would be followed by issuers. I would suggest that if the restraint imposed by the 1975 Amendments on securing information from issuers makes it unduly difficult for dealers and underwriters to inform investors adequately in municipal securities offerings, several consequences will follow. For one thing, investors, now having been alerted to the inadequacies of past disclosure practices, will be more demanding and will shun bonds of issuers which do not level with them. There is already some evidence of this trend among underwriters. A partner of one large underwriting firm has said, "If issuers don't supply the information we need on general obligation bonds, then we won't make bids on them and investors won't buy them." An officer of another said, "It's just going to cost state and local government more on their bonds if we don't have adequate information."

Second, the Commission may have to use its antifraud powers more aggressively than before to assure adequate disclosure to investors. This of course does not mean that the Commission would - or could - impose filing requirements, but it does mean that in situations where it appears there is a serious deficiency in disclosure the Commission should move against the dealers involved and, if appropriate, against the issuers themselves and others responsible for the deficiency. The very willingness of Congress to impose new restraints on municipal financing and to forego limiting the Commission's antifraud activities is, I think, a signal that the Commission should use its powers to assure integrity in the markets for municipal securities.

In discussing responsibilities with respect to offerings of municipal securities, of course, it is impossible after the Commission's recent disciplinary proceeding against a bond counsel to ignore the lawyer and his role. You will recall that that proceeding arose out of an offering of revenue bonds by the City of Covington, Kentucky, the proceeds of which were to be used for construction of a nursing home. In its enforcement proceeding against the principals, the Commission charged that there had been a number of deficiencies in the disclosure document prepared and used in connection with the offering: it had not been disclosed that there had been two adverse feasibility reports; what the amount of the spread between the price of the facility to be charged to the corporation which would own and operate the facility and that which the promoters expected to pay to have it erected was; that the promoters and the purportedly independent consultant on the feasibility of the project had various conflicts of interest and that an independent securities dealer could not be found to underwrite the bonds.

Although the District Court rejected the Commission's allegations in some particulars, nonetheless, it did find that there had been violations of the antifraud provisions of the securities laws in connection with the offering of securities and granted the Commission a preliminary injunction.

The Commission, in addition to authorizing an injunctive proceeding against the principals in the matter, also authorized a disciplinary proceeding against bond counsel under Rule 2(e) of the Commission's Rules of Practice. Under this Rule, the Commission may bar a person from practicing before the Commission (and in the case of a lawyer, that is construed broadly to include the filing of opinions with the Commission, participation in conferences at the Commission, appearance at administrative proceedings and other conduct as well) if it finds that the person (i) does not possess the requisite qualifications to represent others, or (ii) is lacking in character or integrity or has engaged in unethical or improper professional conduct, or (iii) has willfully violated, or willfully aided and abetted the violation of any provision of the federal security laws or of the rules and regulations thereunder. The Commission found that counsel had, in addition to acting as bond counsel for the City of Covington, "assumed principal legal responsibility for reviewing the prospectus (or 'official statement')" used in connection with the offering, and that because of his review of the prospectus, his pre-existing relationship with the developer on other offerings of municipal bonds, and other factors which had come to his attention, respondent should have known, if he did not know, that the prospectus omitted material facts. Simultaneously with filing the charges, the Commission and the attorney entered into a settlement under which the attorney agreed that his firm would adopt certain procedures to forestall a repetition of the complained of conduct.

This decision has had, we are told, a profound and disquieting impact upon those of you who act as bond counsel. It has been said that prior to this decision, bond counsel did not conceive it to be a portion of their responsibility to assure that the disclosure by an issuer or others involved in municipal securities offerings was adequate or complied with the federal securities laws. It has been suggested that the addition of this responsibility to bond counsel might result in prohibitively high fees with consequent hardship upon governmental entities making offerings.

Of course, this is a part of a much larger problem that the Commission has been wrestling with, that of the responsibility of attorneys generally in securities matters. That subject has been thoroughly and fully ventilated in innumerable articles, institutes, speeches and fora. Suffice it to say for these purposes that the Commission does not believe that an attorney carries out his responsibilities when he shuts his eyes to what is occurring about him and acts as if his role were merely that of a scrivener, unconcerned with the accuracy or validity or integrity of that which he undertakes to prepare or review.

I think you should bear carefully in mind the fact that the Commission in its finds, stated specifically that the attorney had "assumed principal legal responsibility for reviewing the prospectus..." Obviously, when the attorney undertook to review those documents, he was doing more than simply expressing an opinion on the legality of the bond issue. I would not conjecture what the Commission might have done had the attorney had nothing whatsoever to do with the offering circular, if he had not assisted in preparing it, if he had not reviewed it, if he had undertaken to revise it. But certainly, when a professional reviews documents with respect to an offering, it is not in my estimation unreasonable to expect that he be more than a cipher, that he exercise reasonable care to assure that the offering document, to the extent that he has knowledge or reason to know, accurately and completely sets forth the information which may be of importance to investors in the security. Obviously, the information that is of importance to an investor in a municipal security is different from that which would be of significance to the investor in an equity security of a private corporation. I daresay that municipal bond counsel, as a consequence of their experience, have pretty sound notions of what that information is. It may well be that the Municipal Securities Rulemaking Board will, notwithstanding the prohibition against requiring issuers to furnish information, develop guidelines which dealers and brokers should follow in connection with disclosures relating to municipal securities. Hopefully such guidelines may also be utilized by issuers and bond counsel.

It is obvious that the demand for better disclosure in connection with municipal financings is not limited to individuals. Institutional investors as well have expressed concern with respect to the accounting practices of municipalities and the extent to which they adequately disclose in connection with their offerings their affairs. As this concern grows, it is imperative, in my estimation, that steps should be taken, and taken promptly, to allay these concerns which could, if not dealt with constructively, seriously hamper the ability of many municipalities and other taxing authorities in this country to secure the funds necessary for the development of their communities. I would suspect that as the Rulemaking Board undertakes its duties and confronts the problem of assuring adequate disclosure by the power it has over communications by brokers and dealers, it will become increasingly apparent to municipal and other public officials that they jeopardize their future financing opportunities if they resolutely remain behind the shield afforded by the statute and resist efforts by underwriters, dealers and investors to gain greater insight and information.

It is not enough, in my estimation, only to require full disclosure. As was indicated in the quotation earlier from The New York Times with respect to New York City's finances, there are serious gaps in the way in which municipalities maintain their books and account for their monies. A recent study by the Advisory Commission on Intergovernmental Relations indicates that only about half of the 30 largest cities in this country have any sort of audit by independent auditors and only about half maintain their accounts on the basis of national standards. I understand efforts are being made by various groups to remedy these deficiencies. I would say these efforts should have an extremely high priority. As the American public reads increasingly of the problems of the cities, the confusions that attend their affairs, the difficulties that are encountered not only by outsiders but insiders as well in determining accurately the financial position of the authority, the demands will mount for better accounting as well as better disclosure.

Like just about everything in our society, the manner in which our governments finance their activities is undergoing intensive review and criticism. Old practices, long taken for granted and tolerated, are not enough in these days to satisfy the expectations of the American people. The recent publicity concerning the practices of multinational companies overseas indicates clearly that the old ways of doing business are offensive to most of our people and that more is expected of our leaders, both business and political, than before.

I would hope that those concerned with municipal financing would raise their sights higher than the technical and the mandated and approach the problem in terms of integrity, honesty, and forthrightness. There is a rising impatience in this nation with those in responsible positions who seek to do the minimum to carry out their responsibility and carefully parse the metes and bounds of their duty. The public expects more and will visit its ire upon those who refuse to give more.

The purpose of this exercise in legislation and regulation is not to chart a narrow course along which lies safety; rather it is to achieve through the law greater protection for investors. I would hope that that goal will be kept clearly in sight and that everyone concerned with this problem will be guided by the goal and not by the narrow bounds of the course.