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"SEC APPROACH TO MUNICIPAL SECURITIES REGULATION"

Address by

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I always welcome and appreciate the opportunity to participate in banking conferences where the problems, disagreements, and possible solutions to banking matters will be discussed. I hope that my remarks this afternoon concerning present conflicts between the banking and securities industries will contribute to meaningful discussions between these two industries, their regulators and the Congress and will assist in resolving these conflicts.

Since today is a holiday commemorating the birth of George Washington, I thought it would be appropriate to begin my remarks with a relevant quote from our first President. After much searching, I came to the realization that if the Father of our Country gave consideration to either credit or equity financing, he didn't say very much about it. He did, however, support Alexander Hamilton in establishing the First Bank of the United States with branches from Boston to New Orleans and was a stockholder in the Bank of Alexandria near his home; so I guess it could be argued that he must have been in sympathy with a concept of innovative banking to which I fully subscribe.

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A lot of history has been written since those early days and Hamilton's dream that the United States would become a great industrial nation with international financial institutions has been fulfilled. This history clearly demonstrates that banks have played a dominant role in the growth and development of this nation despite periods of incompetence, excesses and occasionally outright fraud which were sometimes followed by panic and recession.

One of these crisis periods occurred in the late 1920's and early 1930's when banks were heavily involved in the stock market speculation of that time through underwriting and dealing in securities as well as granting loans to purchase securities on margins as low as 10 or 20 percent of the market price. The response to this banking crisis brought substantial government regulation which, for the most part, restricted bank activities while generally allowing them flexibility to innovate and adjust to needs and demands of the times. Among other things, Congress reorganized the Federal Reserve System, authorized the imposition of minimum margins, established a deposit insurance system for banks, and prohibited them from paying interest on demand deposits. In addition and perhaps more pertinent to

my remarks today, Congress enacted the Glass-Steagall Act of 1933 to prohibit commercial banks from participating in certain securities activities. As you are well aware, what Congress did at that time is today the subject of serious controversy. Forty years have elapsed and there are strong disagreements over what Congress intended and whether, in any event, the restrictions of that Act are meaningful in today's world.

There are disagreements about what type of securities Congress intended banks to underwrite when it authorized them to deal in "general obligation" bonds. There are disagreements about whether the provision of the Glass-Steagall Act providing that banks may purchase and sell securities without recourse, solely upon order, and for the account of customers should be interpreted to prohibit banks from engaging in certain securities activities such as automatic stock investment plans. There are disagreements about whether banks should be allowed to expand their securities activities to include underwriting of revenue bonds, and just recently it has been suggested that banks should not be restricted in any way from dealing in and underwriting corporate securities. A related issue is whether the exemption

provided for banks from certain provisions of the securities laws providing investor protection are appropriate in light of present bank securities activities.

There have been strong differences of opinion expressed regarding these issues, and it is imperative that such disagreements be resolved. It seems reasonable to suggest that bank exemptions in our securities laws were provided because it was not expected that banks would engage in other than very narrowly restricted securities activities. Moreover, the banking industry was already regulated by Federal bank agencies, and thus perhaps it was believed that banks should not be subjected to the requirements of the securities laws other than those pertaining to fraud or manipulative schemes.

Today, however, banks are involved in many activities involving securities which, it is safe to say, were not even dimly foreseen in the early 1930's, and therefore could not have been considered in legislation enacted at that time. Furthermore, regardless of what was intended in the Glass-Steagall Act or the reason bank securities activities were not fully subjected to securities laws and regulations, the changes of the past forty years may well have made those decisions

obsolete and inappropriate. The time has come when the public interest requires the Congress, the Securities and Exchange Commission and the Federal bank regulatory agencies to thoroughly review our present laws authorizing or restricting bank securities activities and the regulatory scheme over these activities and make whatever changes are warranted to clarify the many areas of controversy, to assure the protection of investors, and to assure that bank and non-bank competitors engaging in the same activities are subject to equal rules and regulations. On prior occasions I have discussed the major areas of direct bank competition with non-bank securities industry firms such as automatic stock investment plans, investment advisory services and mini-accounts and have expressed the concern of the SEC over the fact that bank securities activities are exempt from regulations imposed on non-bank competitors. Today I will limit my remarks to the narrower issue of banks underwriting and dealing in municipal securities.

In what would appear to be one of the more explicit provisions of the Glass-Steagall Act, banks are prohibited from underwriting other than ". . . obligations of the United States, or general obligations of any State or of any

political subdivision thereof . . . ." Such securities are also exempted from various provisions of the Securities Exchange Act. Each of these provisions has resulted in problems. The first is one of definition as to what is a general obligation and thus appropriate for bank underwriting. A recent example of this problem is the view of the Comptroller of the Currency set forth in a letter dated December 18, 1973, asserting that the New Jersey Sports Exposition Authority Sports Complex Bonds "are eligible for purchase, dealing in, underwriting and unlimited holding by national banks."

This view is troublesome because the Authority's Official Statement indicates that "The 1974 Bonds shall not be in any way a debt or liability of the State of New Jersey or of any political subdivision of the State and shall not create or constitute any indebtedness, liability or obligation of the State of New Jersey or of any such other political subdivision or be or constitute a pledge of the faith and credit of the State or any such other political subdivision. The Authority has no taxing power."

The Comptroller's letter concludes that the establishment by the New Jersey legislature of a debt service reserve fund for the bonds committed the full faith and

credit of the State including its powers of taxation. The validity of such a determination by the Comptroller has been questioned not only by investment bankers but also by the Federal Reserve Board and banks dealing in municipal securities. An earlier ruling by the Comptroller of the Currency was the subject of litigation in the Baker Watts case (Baker, Watts & Co. v. Saxon, 261 F. Suppl 247 (1966), aff'd sub nom. Port of New York Authority v. Baker, Watts & Co., 392 F. 2d 497 (D.C. Cir. 1968)). The court opinion in that case discussed the scope of the term "general obligation" and construed it as being limited to those obligations "that are issued by a Governmental entity endowed with the general taxing powers, and that are based on the full faith and credit of the issuing entity."

It is interesting that the Court of Appeals in the Baker, Watts case noted that the legislative history alone was too imprecise to clearly demonstrate the intended applicability of the term "general obligation" to the type of bonds in question. While Federal bank regulatory agencies and the Commission may express views and the courts may decide individual cases, I believe that only the Congress can resolve this issue. It is encouraging that apparently both

the Senate and House may undertake a review of the Glass-Steagall Act this year. In its review, Congress would also be expected to resolve a long-standing controversy over whether banks should be authorized to deal in revenue bonds.

The second problem which I would like to discuss concerns the exemption for municipal securities from the provisions of the Securities Exchange Act. In recent years, the Commission has undertaken investigations which have uncovered numerous abusive practices including misrepresentations, excessive charges, and boiler room tactics in the sales of municipal bonds. We believe that these abuses clearly demonstrate the need for regulation.

If there is to be regulation of municipal securities activities, it is important that such regulations apply equally to all competitors; yet banks which deal in municipal securities are subject to Federal bank agency regulation, some non-bank dealers are subject to Securities and Exchange Commission regulation and others who deal in municipal securities only are not subject to regulation by either bank regulators or the SEC. Furthermore, the regulatory structure of the securities industry utilizes industry self-regulatory bodies which have quasi-governmental powers of regulation and

enforcement subject to SEC oversight while banks are subject to direct government agency regulation.

It is only natural that bank dealers do not want to be subject to an additional Federal regulator nor do they desire to be part of a self-regulatory body and particularly one controlled by securities industry members. Securities firms, on the other hand, desire to retain a self-regulatory structure and thus preserve greater private industry decision making authority over municipal securities activities. Bank regulatory agencies want to regulate banks directly as they do now and not work through a quasi-governmental, self-regulatory industry association. They also desire that any regulation of bank municipal securities activities not be inconsistent with other bank regulation and that examination of banks be kept to a minimum. Another consideration is that the enforcement of present bank regulation is not public, and the bank agencies argue that public knowledge of bank enforcement proceedings would result in a loss of confidence in banks. On the other hand, enforcement in the securities industry is disclosed to the public and there is no question that this difference in enforcement would give banks a competitive advantage even if banks and non-banks were

otherwise subject to the same rules and regulations. The regulation of municipal securities activities must take these factors into consideration and minimize, to the extent possible, additional regulatory burdens.

With regard to these diverse views, the Commission believes that some basic principles should apply to all institutions which engage in securities activities. First, all persons engaging in the same activity should be subject to the same rules and regulations. Second, the enforcement of rules and regulations should be equal. Third, Federal regulation of private institutions should not exceed the minimum necessary to assure the protection of investors and the public interest. Fourth, regulation of securities activities should consider and be consistent with the regulation of non-securities activities.

Last September, at the request of Senator Williams of New Jersey, the Commission drafted straight-forward legislative language amending the Securities Exchange Act of 1934 to delete the exemption for municipal securities and thus give the Commission full authority to regulate municipal 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.

The Williams bill provides for an industry self-regulatory body subject to full oversight by the Securities and Exchange Commission. The Dealer Bank Association and the Securities Industry Association have recommended alternative proposals. Over the past several months, the Commission has had numerous discussions on municipal securities legislation with officials and representatives of the Congress, bank regulatory agencies, and representatives from both the banking and securities industries. I believe these meetings have been very beneficial in reducing some of the misunderstanding, uneasiness and distrust which exist between the banking and securities industries and have helped clarify possible means of resolving differences.

It is important that the structure to regulate municipal securities activities be carefully framed because it may well establish a pattern for the regulation of all future securities activities by all institutions. The Commission has discussed this issue on several occasions and, taking into consideration the views of interested parties, we have agreed on what we believe to be a workable framework. During the past few weeks our staff has been drafting and redrafting language to transfer such a framework into a legislative proposal which would be in the form of an amendment to S. 2474. It has been difficult to assure that the proposal is properly drafted considering the result we are trying to achieve. Although we have not developed final language, I would like to discuss what we consider to be an acceptable regulatory pattern.

We have come to the conclusion that an industry Municipal Securities Rulemaking Board should be established. This Board would be representative of the bank segment, the non-bank segment and the public in equal proportions and would establish rules and regulations, including those requiring records and reports,to be complied with by all persons engaging in municipal securities activities as brokers or dealers.

All rules and regulations issued by the Board would be subject to Securities and Exchange Commission approval. The Commission would also have rule-making authority to initiate, abrogate, alter, or supplement rules of the Board.

The Board would have no inspection or enforcement authority nor would brokers and dealers in municipal securities be required to register with the Board. Instead, all bank dealers and non-bank brokers and dealers in municipal securities would be required to register with the Commission. The Commission would inspect and examine non-bank municipal securities brokers and dealers and would have authority to delegate that responsibility for its members to the National Association of Securities Deálers or any other future national securities association. Regular examinations or inspections of bank municipal securities departments or divisions and bank subsidiaries of bank holding companies would be performed by the appropriate bank regulatory agency. The Securities and Exchange Commission would also have authority, after notice and consultation with the appropriate bank regulatory agency, to conduct such inspections and examinations of bank municipal securities dealers as necessary to carry out its responsibilities under the legislation.

The Commission would have the authority to enforce all municipal securities rules and regulations promulgated by the Board or the Commission and would have authority to delegate such enforcement as it deems proper to the appropriate bank regulatory agencies for banks and to an appropriate national securities association for its members.

We believe this proposal balances the interests of all municipal securities participants, would insure equal regulation and enforcement, is compatible with the different regulatory structures of the banking and securities industries and maximizes the use of existing regulatory agencies and associations while providing for coordination of all municipal securities activities by one Federal regulatory agency. We believe we have formulated an approach which is consistent with the thrust of the Senate bill on this subject and in line with the philosophy expressed in the statement of Public Policy for American Capital Markets published by the Treasury Department on February 7, 1974, which stated in part:

> All institutions which participate in any aspects of the process of buying and selling securities and effecting transfers of ownership should be subject to the authority of the SEC. Whether the institutions be broker-dealers, banks, depositories, non-bank transfer agents, or

> others, the SEC should have the authority to impose their rules, ascertain their degree of compliance, and impose appropriate sanctions. In the future, as at the present, many of the tasks of rule-making, surveillance, discipline, and enforcement will be delegated by the SEC to self-regulatory bodies or perhaps to other governmental agencies (e.g. the Comptroller of the Currency). Each of these bodies or agencies would be consulted in the SEC's rule-making process so that they could contribute their unique knowledge of the organizations they regulate. It would be the SEC's responsibility and purpose to insure that the rules of the various self-regulatory bodies provide equivalent protection for the investing public and that standards of surveillance and enforcement are equivalent.

This statement resulted from a series of discussions with leaders in the financial community on the complex issues involved in supplying the rapidly increasing demand for capital. According to the Secretary of the Treasury, George Shultz, although the statement does not represent an official Treasury position, the Treasury supports its basic conclusions.

As you might expect, we at the SEC were anxious to know the Treasury's thinking regarding the securities markets, our efforts to bring about changes in the markets, and the role of banks in the securities business. The Commission favored the Treasury discussions, although there

were others who voiced concern that the Administration was trying an end run on SEC and Congressional initiatives. Because Congress established the Securities and Exchange Commission as the Federal agency to administer the securities laws for the protection of investors and to insure the maintenance of fair and honest securities markets, the Commission was pleased that the Treasury statement appears to clearly support the view that securities activities of all persons should be regulated by the Commission.

The regulation of municipal securities which I have discussed today is one area where we believe this concept should be implemented. I want to assure you that we are not interested in becoming involved in non-securities activities of banks. We have benefited greatly from our discussions thus far with bank regulatory authorities and industry representatives. We need and request your continued assistance so that we can properly regulate securities activities for the protection of investors without adversely affecting other banking operations.