Testimony of Commissioner John R. Evans
Securities and Exchange Commission, Before the
Subcommittee on Securities of the Senate Committee on Banking,
Housing and Urban Affairs on S. 2474 and S. 1933 (May 6, 1974)

Mr. Chairman, members of the Subcommittee, I appreciate the opportunity to appear before this Subcommittee today to present the views of the Securities and Exchange Commission on S. 2474, which would amend the Securities Exchange Act of 1934 to provide for the regulation of brokers, dealers and banks engaged in the business of underwriting and trading municipal securities and S. 1933, which would authorize national banks to underwrite certain municipal revenue bonds. With me today is Andrew M. Klein, Assistant Director of the Division of Market Regulation, who has been primarily responsible for drafting the Commission's suggested amendments and comments.

At the outset, I would like to describe some of the background which has led to the consideration of S. 2474.

Municipal securities, which for present purposes may be defined as securities of state or municipal governments or agencies, are defined in the Securities Exchange Act of 1934 as "exempted securities" and are thereby exempted from practically all of the provisions of that Act with the exception of the Act's general antifraud provisions. This exemption was probably provided in 1934 because municipal

securities were then dealt in almost wholly by financial institutions and a few wealthy individual investors in high tax brackets. Indeed, a representative of state and local issuers of municipal obligations stated in testimony before the House of Representatives Committee on Interstate and Foreign Commerce in 1945 that "municipal securities are not sold to persons of small means or to gullible persons who want to get rich quick" and that "the purchasers of these securities are the most sophisticated in the world."

Even if that were true in 1934 or 1945, it is no longer true today. There has been a vast growth in state and municipal financing to meet pressing social objectives, and it is apparent that in the course of this growth, thousands of relatively unsophisticated individuals are investing in these securities. Income taxes have gone up markedly 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. Interest on such obligations has constituted the principal source of tax-free income available to the average investor since the corresponding tax exemption for federal government securities was removed.

The increased demand for municipal securities by individual investors has 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 effecting trading in those markets. Unfortunately, the surge in investor interest in municipal obligations and the concomitant extension of municipal securities trading have been accompanied by the development of numerous sharp trading practices formerly associated only with trading in nonexempt securities such as unreasonable mark-ups, unsuitable recommendations and the "churning" of customers' accounts.

The enactment and subsequent amendment of the Securities Exchange Act created a pervasive system of regulation in the securities markets. But, trading in municipal securities is, for the most part, outside this regulatory structure and, therefore, can be used as a refuge for broker-dealers who are unwilling to conform to the system, or are unable to meet the prescribed standards, perhaps because of prior misconduct. In other words, there is a regulatory gap in this area.

For this reason, the Commission believes, and there seems to be a general consensus, that some form of municipal

securities legislation expanding the protections afforded to investors in municipal securities under the federal securities laws is appropriate at this time. The Commission is concerned that failure to provide such regulation could result in a loss of investor confidence in municipal obligations and consequently, an adverse effect on the capital-raising ability of state and local governments.

Devising an appropriate system of regulation, however, presents problems. Perhaps the major difficulty in devising such a system is the need to accommodate it to the fact that banks are a major factor in the municipal securities markets. Although Congress generally separated the banking business from the securities business in the National Bank Act of 1933, this separation does not apply to municipal securities which are underwritten and dealt in very extensively by banks.

In addition, banks as defined in Section 3(a)(6) of the Securities Exchange Act are exempt from the definition of the term broker and dealer contained in that Act. One reason for this exemption, no doubt, was the belief that the National Banking Act of 1933 largely excluded banks from the securities business and, therefore, it was considered unnecessary to subject banks, as a federally regulated industry,

to the statutory pattern established for securities dealers. This existing exemption for banks, creates difficulties in framing an appropriate regulatory framework for the municipal securities markets.

Several possible approaches to regulation have been considered. One of these would be to make the Securities Exchange Act fully applicable to dealings in municipal securities, whether by banks or by broker-dealers. This could be done quite simply, by revoking the exempt status of municipal securities for purposes of Sections 15 and 15A of the Securities Exchange Act, and by eliminating the exemption for banks to the extent that they engage in the business of buying and selling municipal securities otherwise than in a fiduciary capacity. In addition to its simplicity, this approach would subject the municipal securities business to a proven and successful regulatory structure oriented to the protection of investors, and would ensure equal regulation of all participants in the municipal securities markets. For these reasons, the Commission initially proposed amendments along this line, and we still believe that this would provide an effective means for protecting the public and ensuring fair competition in these important markets.

Another approach would be simply to subject all non-bank brokers and dealers dealing in municipal securities to the full range of requirements of the Securities Exchange Act, while preserving the existing exemption from the regulatory provisions of that Act for banks, relying on the present pattern of bank regulation to prevent abuses by banks in the municipal securities area. This approach would also have the virtue of simplicity and it would provide some additional investor protection as to non-bank brokers and dealers. But I think it has few, if any, other virtues.

It would certainly create unequal regulation in an aggravated form. Banks already have important advantages over non-bank dealers in the municipal securities markets. These include not only the prestige which banks as financial institutions currently enjoy but also the fact that banks, both directly and in a fiduciary capacity, are very important investors in municipal securities and have large capital resources available for such investments. This gives them an advantage in bidding for new issues of municipal securities and in dealing in these securities for their own accounts, since they can hold such securities until they wish to sell them, while non-bank dealers generally must turn over their inventories fairly rapidly.

Moreover, the regulation of bank dealings in municipal securities is to some degree outside the "main stream" of bank regulation which has been traditionally oriented toward the regulation of banks in their capacity as depositories for savings and as a principal source of credit for American business, industry and for the public generally. This orientation has naturally produced a significant difference in regulatory approach between bank regulatory authorities and the Commission, particularly in the area of enforcement, where bank regulators have great concern that enforcement action be taken discreetly to ensure public confidence in banks and thus protect banks from adverse depositor reaction. Securities regulation, on the other hand, has promoted investor access to all material information including information about enforcement action taken by the Commission in the interests of investor protection.

If the advantage of unequal regulation were added to the existing economic advantages of banks in the municipal securities field, non-bank dealers might well find it even more difficult to survive. Yet the preservation of these dealers as competitors in the municipal securities markets is desirable, particularly from the viewpoint of the states

and municipalities issuing these securities which must look to those markets for necessary financing.

S. 2474 would provide a more complex approach which is intended to accommodate banks and bank regulation while protecting investors and avoiding inequities in regulation. We believe that S. 2474, particularly if the Commission's suggestions for amendment are accepted, would provide a satisfactory framework for regulation of municipal securities professionals and of the trading markets for municipal securities. We have set forth our views in detail in our written comments on S. 2474 submitted earlier to this Subcommittee, and we have included as an exhibit to those comments our suggestion for a regulatory structure reflecting changes that the Commission believes should be made in the original text of the bill.

In preparing our written comments, we have diligently sought to accommodate the views of those who have made their positions 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 believe their views to be consistent with the interests of the

investing public and with provisions of S. 2519, as reported to the Senate by the Committee on Banking, Housing and Urban Affairs. Later, I will discuss an alternative not included in our written comments which would establish a new cooperative relationship between the SEC and the bank regulatory agencies and would make it possible to use, to a much greater extent, the present bank and securities industry regulatory structure.

I will not attempt in this testimony to describe in any detail either the provisions of S. 2474 or our suggested changes; instead I refer you to our written comments.

Despite our extensive consultation with interested parties, we have been unable to reach complete agreement on some major issues but we believe we have identified three principal issues, which remain for this Subcommittee to resolve. These are: (1) the scope of needed regulation; (2) the role of self-regulation; and (3) the uniformity and placement of enforcement powers.

With regard to the scope of regulation needed in the municipal securities markets, the Securities Exchange Act currently provides comprehensive regulation of the markets for non-exempt securities. As you know, this regulation

addresses such broad areas as qualifications for entry into the business, capital requirements, fair dealing with investors, reasonableness of mark-ups and other charges, prohibition of fraudulent conduct, maintenance of records, filing of reports, inspections and examinations of securities professionals, and enforcement. It has been suggested that not all of these things are needed in the municipal securities markets and that we should have a so-called "laundry list" of specified and limited regulatory objectives. While we completely agree that unnecessary regulation should be avoided, we believe that the statute authorizing regulation should afford maximum flexibility to deal with unforeseen future needs. Specific regulations proposed to be adopted pursuant to that authority, of course, would be required to stand on their own as responses to demonstrated need, after being subjected to public and governmental scrutiny. Consequently, we believe the regulatory authority provided in legislation should be adequate to provide that protection which is necessary under the time-honored standards of the Securities Exchange Act, including "the public interest and the protection of investors."

Under the federal securities laws, self-regulation plays an important role. Self-regulatory bodies, such as exchanges and national securities associations, are charged with the duty of establishing standards of both ethical and legal conduct. One of the basic objectives of self-regulation is to bring to bear the judgment of businessmen as to good and fair business practices. Self-regulatory organizations also conduct inspections, examinations, and assume certain enforcement functions thus relieving the government of those responsibilities. Self-regulation does not exist in the current framework of bank regulation. As an accommodation to the banks and the bank regulatory agencies, therefore, we suggest a modified role for self-regulation in the municipal securities area utilizing existing regulatory capabilities to the maximum extent consistent with uniform treatment of bank and non-bank participants, and provisions contained in S. 2519 with regard to limitation of the Commission's power to modify sanctions imposed in disciplinary proceedings.

Our proposed changes in S. 2474 would provide in proposed Section 15B, for the creation of a municipal securities rulemaking board to be comprised of members representing broker-dealers, bank municipal securities dealers,

and investors in and issuers of municipal securities, instead of a membership self-regulatory association as now provided in S. 2474. The function of this board would be to exercise extensive rulemaking power over those engaged in the municipal securities business. It would not, however, have inspection or enforcement powers. Thus, the securities industry self-regulatory function of establishing standards would be preserved, but bank dealers would not be subjected to inspection or enforcement by any self-regulatory body.

Providing for uniform enforcement is one of the most difficult objectives of this proposed legislation. It has been suggested that enforcement should be divided between the Commission and the bank regulatory authorities. But, as a practical matter, such a division of responsibility would most likely result in unequal enforcement. As the law presently stands, the Commission has enforcement authority over both bank and non-bank dealers in the important area of fraud, and we see no basis for reversing or cutting back the decision to grant such power to the Commission made by Congress in 1934. Consequently, we believe that the Commission should have ultimate authority to enforce the Securities Exchange Act, as amended by this proposal, as well as the rules of the

proposed rulemaking board, as to both banks and non-bank dealers. The Commission's authority in this area, of course, would not impinge on the disciplinary powers of bank regulatory agencies under other laws to discipline banks for improper conduct, including conduct violative of the securities laws governing municipal securities.

Should legislation such as S. 2474 become law, the Commission quite naturally would become involved in a continuing dialogue with bank regulatory agencies to ensure coordination of its efforts with those of the bank regulators. The Commission believes, however, that the statutory imposition of a requirement that the Commission "consult" and "cooperate" with bank regulatory agencies in applying a new balancing test weighing "sound banking practices" against the "protection of investors and the public interest," as contemplated by Section 15B(c)(1) of the bill is an unnecessary and inappropriate prerequisite to Commission regulatory action. Legislation intended to effect regulation of municipal securities activities should not cast doubt on the Commission's ultimate authority in the area of compliance with the federal securities laws any more than it should dilute the ultimate authority of the bank regulatory agencies to ensure bank conformance to federal and state banking laws.

As I have already indicated, bank regulatory authorities have a different enforcement orientation than that of the Commission, placing greater reliance on informality and confidentiality, or to be more blunt, secrecy in enforcement actions. This basic enforcement principle may be appropriate in the traditional area of bank regulation designed primarily to protect depositors, but we do not consider it to be appropriate in the area of protecting investors from misconduct on the part of dealers, including bank dealers, who have been found to have violated legal and ethical standards in their activities as securities professionals. The Commission should not be fettered by this basic bank regulatory enforcement principle where serious misconduct involving securities activities is involved, particularly since equality of enforcement cannot be attained if disciplinary action against one segment of a competitive industry is to remain secret while enforcement against another segment is subject to public disclosure.

I would now like to suggest for your consideration, an alternative to the enforcement structure which we suggested in our written comments, which could achieve the same uniformity and make much greater use of present bank and

securities industry regulatory structures. Under this alternative, enforcement authority over NASD members would be vested directly in the NASD, accompanied by direct inspection responsibility over its members, as distinguished from the concept of delegated inspection duties proposed in our written comments. Similarly, both inspection and enforcement authority over bank dealers would be vested directly in the bank regulatory agencies. While this alternative has obvious merits in that it would unite both inspection and enforcement functions, the Commission believes that this alternative should be adopted only if the Commission is 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 even-handed treatment of both bank and non-bank municipal securities professionals. It would also be essential to empower the Commission to initiate enforcement action with respect to any municipal securities professional at any time, regardless of any enforcement action by a bank regulatory agency or the NASD, if the Commission believes such action would be in the public interest.

In summary, the Commission believes that S. 2474 is a useful and timely measure. We believe that it can be further refined and improved as we have suggested and that it could thus provide a framework for regulation of professionals in the municipal securities markets which will advance the interests of fair competition, improved municipal securities markets for the benefit of issuers dependent on those markets and the protection of investors, which should command wide support.

We have also been asked to comment on S. 1933, which would extend to revenue bonds the present Glass-Steagall exemption permitting commercial banks to underwrite and deal in general obligation bonds. This extension is generally intended to reduce borrowing costs for municipal financing by allowing additional participants to compete for revenue bond underwritings. The principal issue raised by S. 1933 is whether it is in the public interest to extend this exemption to revenue bonds thus allowing banks to enter this field. This is a Congressional policy decision upon which the Commission expresses no opinion. Such an expansion of bank activity, however, could disrupt the nation's capital-raising mechanism, presently dependent in significant ways

on the existence of regional broker-dealers, and might eventually result in a less efficient market and higher costs to both municipal and corporate issuers. While we have no evidence today that these serious consequences will result from the entry of commercial banks into revenue bond underwriting, we believe that the Subcommittee should consider this possibility. It should also be noted that if S. 1933 were to be approved by the Congress without changing the regulatory structure to include SEC regulation over municipal securities activities, it would exacerbate the problems discussed in our testimony on S. 2474.