

TESTIMONY OF COMMISSIONER JOHN R. EVANS BEFORE THE  
SUBCOMMITTEE ON CONSUMER PROTECTION AND FINANCE OF THE  
HOUSE OF REPRESENTATIVES, COMMITTEE ON INTERSTATE AND FOREIGN  
COMMERCE, CONCERNING H.R. 4570 ON APRIL 18, 1975

I am grateful for the opportunity to appear before this Subcommittee today to express the views of the Securities and Exchange Commission urging the adoption of H.R. 4570, the Municipal Securities Act of 1975. With me this morning are Wallace L. Timmeny, Associate Director, Division of Enforcement, and Andrew M. Klein, Assistant Director, Division of Market Regulation.

Your invitation to appear here today to testify on H.R. 4570 specifically requested that, in view of the comprehensive record established in the Senate with respect to the most appropriate method of achieving federal regulation of the trading markets for municipal securities and of municipal securities professionals in connection with S. 2474, which passed the Senate last year, we focus our testimony on the question of whether there is any reason for the Federal Government to involve itself in such regulation at all. As we indicated to the Senate, the Commission believes that there are ample reasons for enactment of this legislation and that the time to do so is now.

In responding to the Subcommittee's concern for whether it is necessary to impose federal regulation on the trading markets for municipal securities and on municipal securities brokers and dealers, I believe it would be useful to review certain basic characteristics of municipal markets. The term

"municipal securities" refers, of course, to debt obligations of state and local government issuers. Municipal securities are unique in that interest on such securities is not subject to federal income taxes, and each issue of bonds varies according to the nature of the debt represented by the issue and the credit standing of the particular issuer.

Municipal bonds may be general obligations of the issuer, payment of which is backed by the "full faith and credit" of the issuing government to the extent of its powers of taxation. Municipal bonds also may be revenue obligations secured only by funds to be generated by use of the facility financed by the proceeds of the bond issue. Revenue bonds may be classified as "special tax" obligations, payable only from the proceeds of a special tax such as the tax on gasoline; "special assessment" bonds, payable only from assessments levied on users of the improvement financed by the issue; or "industrial revenue" bonds, where payment is secured only by, for example, lease payments to be made by the business entity operating a facility constructed with the proceeds of the bond issue. There are also so-called moral obligation bonds payable from revenues of the facility financed, which has a provisional state or local government commitment to use public funds if necessary to assure payment.

Upon payment of a fee, each issue of municipal securities is assigned a rating of investment quality selected from one of the seven to nine categories of ratings established by

Moody's Investors' Services, Inc. or Standard & Poor's Corporation, or both. Quite apart from differences in the identity of the issuer, one bond is not necessarily like another bond in the same sense that one share of common stock is identical to any other share of common stock of the same company. Instead, each issue of state and local debt has its own distinct investment characteristics, even when issued by the same issuer. These characteristics are not always reflected in the particular investment rating assigned by a rating agency because each "rating band" describes a broad range of variable debt characteristics.

Municipal bonds of investment quality are valued by balancing the prospects for ultimate payment of the debt against the yield which it must offer to attract purchasers. The yield is a function of the interest payable on the bond and of the price, in relation to the bond's par value, at which it may be bought or sold. The market tends to treat certain issues of bonds as if they were fungible because market professionals, by spreading their risks over numerous debt issues, are able to consider them as offering similar yields, presenting similar risks and likely to be traded at prices that, over a period of time, will bear a fairly fixed relationship to each other.

The professional municipal securities community may be separated into three categories: securities firms which buy and sell bonds for their own accounts as dealers; banks which

act as dealers and also buy and sell bonds for their own investment accounts; and brokers which act only as agents for buyers and sellers and do not buy or sell for their own accounts.

About 900 firms, including banks, are engaged in the business of buying and selling municipal securities. Of this total, approximately 125 firms dominate both the underwriting of new municipal bond issues and the maintenance of secondary markets in those securities. Although there are about four times as many non-banks engaged in municipal securities business as there are banks, it is estimated that banks do about fifty percent of the business. Securities firms engaged in both a corporate and municipal securities business, for the most part, are registered with the Commission as brokers or dealers, but their municipal activities are subject only to the fraud provisions of the Federal securities laws.

During 1974, a total of about \$22.8 billion of municipal bonds were issued, compared to registered public offerings of corporate equity and debt securities, aggregating approximately \$26.4 billion. For numerous reasons, including relatively "tight" money markets which have forced interest rates on municipal bonds to new highs and the significant rise in personal income over the last fifteen years resulting in higher tax brackets for many taxpayers, municipal bonds have become an increasingly attractive investment for individual investors. Although banks and insurance companies have accounted for an even larger percentage of the total holdings of municipal

bonds in recent years, unincorporated businesses, personal trusts and individuals have increased the dollar amount of their municipal bond holdings from \$30.8 billion in 1960 to \$62.3 billion in 1974, a 103 percent increase. It is quite evident that small investors with little or no sophistication are entrusting increasing amounts of their funds to this unregulated and relatively unfamiliar investment vehicle. It is this fact that has spurred the Commission, as well as the municipal bond professional community, to support legislation establishing a comprehensive regulatory scheme to ensure the integrity of the trading market for these securities and the ethical conduct of those serving municipal bond investors.

The trading markets for municipal securities are almost exclusively "dealer" markets. With certain exceptions, the market for a particular bond issue is usually relatively thin and is characterized by a significant spread between the bid and asked prices for bonds of that issue. These characteristics, coupled with the fact that many institutional holders of municipal bonds trade in large blocks, have given rise to "dealers' brokers," who perform the function of bringing together willing buyers and sellers of particular bond issues. While municipal bonds are customarily issued in units of no less than \$1,000 or \$5,000, the trading market for municipal securities involves transactions of relatively large dollar size so that a trade of less than \$10,000 is considered an odd lot.

In terms of numbers of bonds traded, the volume of secondary market trades is small compared to corporate securities volume.

Investors hold bonds primarily to ensure a continuing stream of tax-free income, and, thus, efficient trading markets for municipal securities are essential to the movement of bonds in and out of investment portfolios in response to changing money market conditions.

No one disagrees with the proposition that the nature of the trading markets for municipal securities has changed radically since the 1930's, when the Congress determined to exempt municipal securities and those professionals who confined their securities dealings to government issues from the provisions of the Securities Exchange Act. At that time, this question appears to have been a close one, however, and its ultimate disposition was based in large part on the finding that only wealthy and sophisticated persons invested in this market, and that such investors were able to fend for themselves and did not need the protections afforded by the Securities Exchange Act.

Today, a new class of investors, primarily consisting of small unsophisticated individuals, has developed for municipal securities and these investors need protection from sharp and abusive practices that have begun to appear in retailing municipal bonds. It is unclear whether the individual investor,

who is the target of so much intensive retailing effort in municipal securities today, has any real perception of the differences between trading markets for corporate securities and trading markets for municipal bonds. He often discovers that the market in a particular bond issue is illiquid only when he tries to sell, at which time he also discovers that the spread between the asked prices for many bonds is several times wider than the differential between bid and asked prices for common stocks. There is nothing intrinsically wrong with this kind of market, but there is something wrong with the investor's misconception of that market--a misconception which securities professionals should clear up at the very start of relationships with "first-time" investors in municipal obligations.

Unfortunately, however, while there is no reason to conclude that deceptive or unethical practices are rampant in this industry, there have been some recent conspicuous exceptions to the high professional standards which have prevailed in the bond industry for many years. Since the beginning of 1973, the Commission has brought seven enforcement actions against some 72 defendants for violations of the anti-fraud provisions of the 1933 and 1934 Acts in connection with municipal securities trading practices. The violations uncovered do not involve complex or sophisticated misconduct, but instead involve the very kind of "garden variety"

violations that the Federal securities laws are designed to prevent. Such violations include, among others, the most blatant kinds of deception and unethical behavior; high pressure "boiler room" sales techniques applied by unsupervised and unqualified sales personnel to unwary individual investors; calculatedly misleading sales pitches, sometimes coordinated among several firms or individuals, aimed at potential customers with whom the market professional has had no prior contact at all, designed to induce rapid, uninformed investment decisions; low quality high-risk securities peddled as investment grade bonds; mark-ups ranging up to 75 percent above prevailing market prices; and misrepresentation of the financial condition of issuers and of the nature of the bonds sold (e.g., defaulted revenue bonds sold as general obligation bonds).

The potential for this kind of deceptive and fraudulent conduct in the complex market for municipal securities is unacceptably high. The absence of federal regulation acts as an invitation to such misbehavior, and the bond industry is acquiring a reputation as a haven for shady securities professionals who would be barred from participation in the markets for corporate securities. The fact that the market for municipal securities traditionally has been considered a reputable and honest market should not be a source of comfort. Although our enforcement cases are fairly recent, the cases



that we have brought so far are alarming because they demonstrate, to both the Commission and the industry, that certain new investor protections under the Federal securities laws are necessary and appropriate for municipal investors.

Presently, municipal securities brokers and dealers are not required to register with the Commission, so we are not able even to identify such firms or undertake to prevent violations. Often it is only in instances where the misconduct is flagrant and continuous that cases in this area have come to our attention. Under existing law, neither the Commission nor any self-regulatory organization presently maintains or has any power to maintain surveillance of professional municipal securities activities. Aside from the general antifraud provisions of the federal securities laws, there are no federal or self-regulatory standards regarding the conduct of municipal securities professionals which would curb conduct violative of just and equitable principles of trade. There are no standards for professional qualifications or required supervision of retail salesmen having dealings with customers. Thus, there is no regulatory mechanism to detect in advance, or to prevent, unethical and improper conduct in this complex marketplace, and, while the Commission has power to enjoin fraudulent conduct, unfortunately, there is considerable damage both to investors and the securities industry that is not remedied by such action.

Moreover, the capital raising efforts of state and local governments are dependent on the continued enthusiastic support and participation by public investors. That support, in turn, must be based on public belief that the trading markets for state and local debt securities are fair and honest, and that the professional corps of municipal securities dealers serving those markets is qualified to do so and will perform its function honestly and ethically. The threat to public confidence in the municipal securities market is clear to the Commission and, apparently, to the municipal securities industry itself. Indeed, the industry has cooperated fully in the formulation of the regulatory structure contained in H.R. 4570 which is intended to preserve public confidence in these markets. The consequences of a loss of public confidence would be catastrophic. A preview of these possible consequences is available today in New York. On Tuesday, April 15, 1975, the New York Times reported that because of the financial difficulties experienced by Urban Development Corp., an agency of the State of New York, more than one billion dollars of municipal projects in that state, involving hospitals, nursing homes, and facilities for the handicapped, have been deferred indefinitely, pending resolution of the status of so-called "moral obligation" bonds.

As I have indicated, the Commission's antifraud powers alone have been insufficient to meet the problems developing in the municipal area. H.R. 4570 would provide mechanisms for the promulgation of uniform standards for fair dealing, for professional qualifications, and other matters essential to the health of the municipal securities markets. The traditional regulatory pattern of the Securities Exchange Act, including its reliance on self-regulation, would be applied for the first time to all municipal securities professionals. This system has worked well to foster high professional standards in the trading markets for corporate securities, and both the Commission and the industry believe it will work equally well in the market for municipal bonds. Surely, when investors trade in state and local debt issues, they are entitled to the same protections from professional misbehavior they receive when they trade in corporate securities.

H.R. 4570 would vest the power to bring about these salutary changes in the municipal securities industry primarily in a new self-regulatory organization, the Municipal Securities Rulemaking Board, which would be subject to Commission oversight. Initially, members of the Board would be appointed by the Commission under proposed Section 15B of the Securities Exchange Act and would at all times be representative of the securities and banking segments of the industry and issuers of and investors in municipal bonds. The

Commission, of course, would retain its direct rulemaking authority in the area of fraud and manipulation under Sections 10(b) and 15(c) of the Securities Exchange Act.

The intimate knowledge of the municipal securities trading markets shared by the members of the Board should enable the Board expeditiously to fashion rules binding on all municipal securities professionals to fulfill the broad remedial purposes of proposed Section 15B: to prevent fraudulent and manipulative acts and practices; to promote just and equitable principles of trade; to remove impediments to and perfect the mechanism of a free and open market in municipal securities; to prevent unfair discrimination, to provide for the form and content of and the dissemination of information concerning quotations relating to municipal securities; and to require the maintenance of records, among other purposes.

This legislation is the product of close cooperation between Congress, the Commission, bank regulatory authorities, representatives of state and local governments, and various industry trade associations. The Commission believes that it is a sound legislative proposal, and we support its prompt enactment.