Office Memorandum • SECURITIES AND EXCHANGE COMMISSION

DATE: MAY 21, 1974

TO : Commissioner John R. Evans

FROM : Division of Enforcement

SUBJECT: Abusive Practices in Dealer Banks

The purpose of this memorandum will be to outline briefly the substantive background of your remarks before the Senate Banking Subcommittee on Monday, May 6, 1974, in response to a question from Senator Proxmire concerning the extent to which the Commission was aware of specific "abuses involving dealer banks with respect to underwriting or dealing [in general obligation bonds]."

The staff has for more than the past year been conducting an ongoing investigation into municipal bond sales and trading practices. As a result of this investigation the Commission has authorized the filing of four civil injunctive actions against approximately 50 defendants including 11 municipal bond dealers. While th Commission does not regulate banks, during the course of its municipal bond investigation certain abuses by banks in this area were noted. This memorandum details some of such abuses. The staff has currently focused its investigation on one particular dealer bank.

<u>Back Office Problems</u>

It appears to the staff from examination of certain bank records and procedures and testimony under oath of certain bank officers that at least a few banks have undergone some of the same back office problems which occurred in the securities industry as a whole in the late 1960s. Testimony is to the effect that while sales and trading volume grew substantially, there was no corresponding growth of back office controls. Testimony is to the effect that there were problems with late delivery and fails on both sides of transactions with dealer banks. It would appear that the banks' audit departments did not understand problems of the investment divisions and the result was a massive back log of paper work. In at least one bank these problems were compounded by the lack of trained personnel in both the investment divisions and the audit divisions and the virtual absence of supervisory procedures. Counsel for one bank has stated to the staff that one good thing which came out of the staff's investigation of the banks' investment divison was the realization by the bank that it had to tighten its supervision. The bank has now hired a compliance officer.

Adjusted Trading

At the very beginning of the staff's investigation into municipal bond trading it was discovered that banks engaged in the practice of adjusted trading. Under this procedure a bank owning bonds at cost and having a current market value below cost, sells such bonds at a price above the market, usually at a price equivalent to the book value of the bonds. The bank then simultaneously purchases from the same broker other bonds (often at a longer maturity and with a higher yield) at a price above market to reimburse the broker for the loss sustained on the bonds sold to him by the bank. Such transactions have the effect of deferring the realized loss on bonds sold by the bank and pricing the new bonds on the banks' books at a price above the true market value. The staff has observed that some banks, notably the smaller rural banks, but also some large dealer banks, frequently engage in this practice. Although our latest information as to specific "adjusted trading" activities by banks was in 1972, we have no reason to believe such activities have been discontinued.

Parking by Municipal Bond Dealers with Banks

During our various investigations leading to the civil actions already instituted, it was apparent that several banks were supporting various bond dealers by engaging in "parking" transactions. In parking the bond dealers, usually severely under capitalized, arrange to have part of his unsold or newly acquired inventory purchased by a bank with an agreement to repurchase at a mark-up of ½ to 1 point over the sales price. This, of course, adds to the dealer cost and ultimately the retail customer's cost. This practice has occurred in underwritings and in the after market.

The clear effect of parking as in interpositioning is in covering up the true nature of transactions and enabling excessive markups to occur.

Parking by Banks with Municipal Bond Dealers

It is common for banks to carry their trading account securities at the lower of cost or market and to quarterly reflect unrealized losses if the market price of such securities fall below cost. It has been discovered that at least one bank has parked securities with certain friendly dealers just prior to the end of a quarter with an unwritten agreement to purchase the securities back in the next quarter. These transactions usually take place near the bank's cost which results in a minimal loss appearing on the bank's books and records. This results in the bank misrepresenting operating income in reports to stockholders.

Transfers from a Bank's Portfolio Account to Trading Account

It is common for banks to value their investment portfolios at cost and treat income derived from such account as extraordinary income. The trading account as noted above is carried at lower of cost or market and the income derived from such is treated as operating income. It has been discovered that at least one bank after searching for unrealized gains in the portfolio account transferred such securities at cost to the trading account and then immediately sold the securities out of the trading account at the increased market value so as to show increased trading account profit. This has happened even when such securities could not be legally held by the trading account (under banking regulations) and after warnings by the bank's internal audit department that such practices were improper.

Transfers from the Trading Account to the Investment Portfolio

One government official with experience in a bank's investment division has stated that there is a great temptation to "unload losses" incurred by the bank's trading account into the investment portfolio, and that the ethics of management is the prime deterrent from such a practice. It has been discovered that at least one bank has persisted in this practice. The situation arises where a bank has an unrealized loss in certain securities and then transfers such securities at cost to the investment portfolio. The securities will then be held to maturity or sold at a later time when the market improves.

Retail Securities Transactions

Our information in this area is virtually nil, although it is clear that banks are increasing their sales efforts in this area.

Speculation in Federal Agency Issues

It has been discovered that over a several year period certain persons within a bank's investment department have engaged in various transactions in securities issued by agencies of the federal government for delayed delivery for their own benefit and to the detriment of the banks which employed them. This self-dealing was accomplished through the use of nominees and was facilitated by the close relationship which had developed between certain bank employees and certain dealers. Certain employees of the bank and broker-dealers would participate in the purchase of government securities on a when-issued basis from the bank and would later sell to the bank the same securities before or on settlement date. No money was ever put up by the purchasers to pay for such securities before they are sold back to the bank, nor did the bank employees have the financial ability to make such payments. The gravity of such practice by this bank's employees is compounded by evidence of such employees accepting weekend visits to a dealer's condominimum at a resort area, free plane rides and trips to race tracks and football games in various parts of the country.

Conclusion

It should be noted that the above constitutes preliminary observations by the staff. These matters are still under analysis by the staff and have not yet been presented to the Commission.

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