

“REFORM EFFORTS IN MUNICIPAL FINANCE, LITIGATION,  
AND BANKING: PROGRESS AND PROGNOSIS”

REMARKS BY CHAIRMAN ARTHUR LEVITT  
UNITED STATES SECURITIES AND EXCHANGE COMMISSION  
ASSOCIATION OF THE BAR, CITY OF NEW YORK  
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I want to talk to you about three important reform movements underway in Washington -- call them the three “R”s -- municipal finance reform, litigation reform, and reform of the Glass-Steagall Act. Each of these springs from a different source -- but ALL of them hold great implications for the securities industry, and they deserve to be examined in some detail. I’ll begin with municipal finance.

This is an issue that’s been close to my heart for as long as I can remember. You could even say that it runs in the family -- as many of you know, my father served for 24 years as New York State Comptroller; what is less well known is that the very first SEC inquiry into municipal finance was set in motion by a series of audits of New York City revenue-anticipation notes he performed in 1975.

My father viewed public debt as a sort of paradox -- as both “one of the most important of the fiscal mechanisms available to government -- and one of the most vulnerable to misuse.”

Today, the SEC is keeping a close eye on those vulnerabilities. We’ve been working to hold the municipal market to high standards, especially in light of its transformation from an institutional to an individual investor market.

That change has been dramatic. A decade ago, individual investors held about 45 percent of outstanding municipal securities; today, the figure is 70 percent. It is a huge market, now valued at about \$1.2 trillion, and of critical importance to our nation’s infrastructure. It represents the schools that teach our children, the water we drink, the power that enhances our lives and drives our economy, the roads that take us where we want to go.

The enormous power of the municipal market demands that it operate with complete honesty and integrity. And yet certain practices in the industry remain closer to the back-room deals and “honest graft” of George Washington Plunkitt and his ward captains in 1905, than to the full disclosure and unimpeachable integrity demanded by our markets in 1995.

I’m speaking, of course, of what’s come to be known as “pay-to-play” -- the practice of tying public financing business to political contributions. Left essentially unchecked, this particular form of corruption has grown brazenly, and in recent years has tarnished the reputation of bankers, lawyers and public officials alike.

Investment bankers were the first to confront the ethical implications of pay-to-play, by placing a voluntary ban on political contributions to officials with whom they did bond business; this was followed by a Municipal Securities Rulemaking Board (MSRB) rule restricting contributions and solicitation.

Several organizations of municipal bond issuers have adopted resolutions to address the problem, and some jurisdictions -- Florida, for example -- have made the ban on pay-to-play a matter of law. The City of New York has demonstrated leadership on this issue; in its recent request for services, the City asked potential counsel whether they disclosed their political contributions. The Government Finance Officers Association will consider recommending similar actions at its annual meeting, which begins this weekend.

I expected lawyers to be in the vanguard of the effort to wipe out pay-to-play. I am sad to say they are not. The National Association of Bond Lawyers (NABL) has adopted a modest statement of principles, which at its most severe calls for disclosure of political contributions. Two firms from Little Rock, one from Ohio, and one from San Francisco, have adopted this statement -- a less than overwhelming response. Perhaps more tellingly, as far as I know only a single member firm of the NABL Board of Directors has committed itself to these luke-warm measures. NABL also missed an opportunity to move forward with its response to the MSRB's proposed rule G-38, which would require underwriters to report arrangements with consultants. NABL asked that lawyers be excluded; I have to believe they can do better than this.

Indeed, the SEC looks to the profession to address the problem. That the bar has, for the most part, remained silent on the question is deeply disturbing. Private practitioners face a host of ethical perils when they interact with a public client, particularly when that client is represented by an elected official with the power to dispense legal work. Add to it an elected official vigorously seeking campaign contributions -- and viewing selection of counsel not as an exercise of the public trust, but as a personal plum -- and you have an ethical witches' brew, one that has bedeviled the municipal finance bar for some time.

This Association, however, is in a position to help change that -- indeed, there is hardly an organization better suited to fill the vacuum of leadership in the bar. For one hundred and twenty-five years, you've led the profession on matters of ethics, the public good, and the practice of law, and now your Committee on Ethics is considering the question of limiting "pay-to-play" in New York. I hope you'll act to help us end this insidious practice; public investors deserve a municipal market that is governed by the invisible hand, not the greased palm. I'm certain that if you lead, others will follow.

There is another aspect to this issue. As counsel participating in municipal bond offerings, you should be concerned about pay-to-play practices, not only from an ethical perspective, but as a disclosure issue as well.

In its March 1994 interpretive release regarding the disclosure obligations of municipal issuers and dealers under the antifraud provisions, the Commission expressed its view that "[i]nformation concerning financial and business relationships and arrangements among the

parties involved in the issuance of municipal securities may be critical to an evaluation of an offering.”

Disclosure of these material arrangements could indicate the existence of actual or potential conflicts of interest, and may reflect upon the qualifications, level of diligence, and disinterestedness of financial advisers, underwriters, experts and other participants in an offering. Pay-to-play corrupts the system, and investors are certainly entitled to know whether the securities they are purchasing benefited from the normal and expected arm’s-length checks and balances built into the offering process.

Investors expect participants in securities offerings to follow those standards and procedures -- especially in the case of municipal securities, where the local financing authorities often erect specific safeguards to preserve the integrity of the public financing process. Material deviations from those procedures warrant disclosure.

Members of the Bar need to be sensitive to these issues regardless of their role in the offering -- whether they are acting as issuer’s counsel, disclosure counsel, bond counsel, or underwriter’s counsel. Counsel for the various participants must ensure that all have access to facts regarding material financial and business relationships, including political contributions, that could influence municipal securities offerings. Whatever your role, you will be responsible for having reviewed the content of the official statement. As with any disclosure issue, if, based upon information available to you, it appears that the offering materials contain misleading statements -- or are materially incomplete because of the omission of information indicating a conflict -- you’ll be expected to raise those issues with all participants in the offering. The “I only looked at the tax issues” defense, or the “I relied on my lawyer” defense, will not be credited lightly by the SEC.

Speaking of defense, let me now shift over the litigation reform, which has received a great deal of attention lately, both at the SEC and here at the Association of the Bar of the City of New York. Although Congress has considered reform of the system of private litigation under the federal securities laws before, the Republican victory in November really got the issue rolling.

On the House side, securities litigation reform was wrapped into one of the ten points in the Republicans’ Contract with America and launched on a very fast track. A fairly extensive reform bill, sponsored by Representative Cox and others, was introduced on January 5th, the day the new Congress convened. This bill contained a number of provisions designed to eliminate abuses in securities class actions, and to curb frivolous lawsuits, that the Commission was prepared to support. But it also contained measures that we felt were ill-conceived, measures that would make it difficult or impossible for defrauded investors to bring meritorious cases. These included a strict “loser-pays” provision, overly stringent pleading requirements, and the elimination of liability for reckless conduct. The bill also would have effectively eliminated actions based on the fraud-on-the-market theory of liability.

Following hearings at which the Commission and this Association, among others, testified, the bill was revised to alleviate some of its harshest potential impacts on private rights

of action. Although it still contained provisions that we believe would adversely affect private actions by investors, the bill did move in a positive direction. One remaining area of particular concern is a safe harbor provision that would shield from liability false forward-looking statements that were made with the intention of misleading investors. On March 8th, the bill passed the House by a large margin.

Now the scene has shifted to the Senate, where the Committee on Banking, Housing, and Urban Affairs just eleven days ago approved and reported out of committee a compromise securities litigation reform bill put together by the Committee Chairman, your Senator Alfonse D'Amato. The Senate bill incorporates many of the provisions contained in legislation introduced last year by Senators Dodd and Domenici, and, in my judgment, represents an improvement over the House bill. The goal of striking the appropriate balance between curbing abusive practices and protecting investors has not quite been reached, however.

The Senate bill contains some troubling provisions, such as its safe harbor for forward-looking statements. Although it is clearly an improvement over the corresponding provision in the House version, the Senate bill would, in some cases, allow statements to receive the benefit of safe harbor protection even though they were known to be false. The bill also fails to extend the statute of limitations for securities fraud actions as recommended by the Commission, and does not restore a private cause of action for aiding and abetting.

It remains to be seen what will happen in the full Senate and, assuming a bill is passed, in the conference committee. Judging by the bipartisan support received by the bills in both the House and the Senate, it seems likely that some form of securities litigation reform will be enacted by Congress this year. Of course, the Commission will continue to work with Congress and other interested parties to develop legislation that protects investors while eliminating abuses.

The most popular word in Washington today, on BOTH sides of the aisle, is probably "change." In a 1936 speech, Franklin D. Roosevelt defended the New Deal by saying, "Wise and prudent men -- intelligent conservatives -- have long known that in a changing world, worthy institutions can be conserved only by adjusting them to the changing time." How surprised he would be today, when conservatives have seized the mantle of change, and quote FDR even as they try to undo the New Deal.

The Glass-Steagall Act was signed into law by President Roosevelt in 1933. Over the years, important aspects of this New Deal legislation have been trimmed back; today, however, a complete overhaul is being proposed.

On January 4th of this year, Chairman Leach of the House Banking Committee introduced "The Financial Services Competitiveness Act of 1995." The SEC supports the bill's principal purpose -- to modernize the financial services regulatory framework by reforming Glass-Steagall. Reform would provide banks with greater flexibility and new avenues for innovation. In so doing, it could improve bank competitiveness at home and abroad.

In weighing Glass-Steagall reform, however, Congress also needs to consider how financial services modernization will impact investors and the U.S. capital markets as a whole. The U.S. securities markets are the deepest, most liquid, and strongest in the world. In one recent year alone, 1993, those markets raised \$1 trillion in capital for companies. These funds were raised through the entrepreneurial and risk-taking efforts of securities firms, from private investors, and without the benefit of federal deposit insurance. The continuing success of our capital markets requires that we preserve the securities industry's ability to assume risks, and that we maintain a strong system of investor protection to support public confidence in the securities markets.

The Commission finds much that it can support in H.R. 1062. Chairman Leach's bill, by initiating the debate on Glass-Steagall reform this year, has already made an important contribution. In addition, the bill proposes a number of useful changes to the regulation of financial services -- for example, a flexible yet effective framework for addressing conflicts of interest that may arise when banks advise or sell mutual funds.

Looking at the bill as a whole, however, the Commission is concerned that H.R. 1062 could impair the operations of the highly competitive U.S. securities markets. The bill's proposed regulatory structure does not fully take into account some of the real differences between the securities and banking industries. Banks have traditionally operated subject to regulatory restrictions on risk-taking -- restrictions imposed in the interests of bank safety and soundness. But securities firms, and the securities markets generally, specialize in entrepreneurial and risk-taking activities.

For this reason, securities regulation does not, and should not, seek to insulate securities firms from the risks they incur in their business activities. H.R. 1062, however, proposes a complex, bank-oriented regulatory structure that would rigidly constrain the operations of securities firms that are affiliated with banks.

The Commission is also concerned that H.R. 1062 would allow banks to continue to conduct a wide range of securities activities outside the sales practice, capital, and other investor protection requirements of the federal securities laws. Over the past two decades, by virtue of expansive interpretations of the Glass-Steagall Act, banks have dramatically increased the scope and volume of their broker-dealer activities. Because of the 60 year-old bank exclusions to the federal securities laws, this expansion has occurred in significant part outside the legal framework governing all other broker-dealer activities. H.R. 1062, rather than taking a fresh look at the bank exclusions, would continue and even extend the range of securities activities that can be conducted in banks and outside the federal securities laws. This would compromise functional regulation and investor protection in favor of expanding bank powers.

I want to stress that the Commission does not oppose Glass-Steagall reform; quite the contrary -- we remain strong supporters of financial services modernization. We simply believe that the regulatory framework contemplated by H.R. 1062 is flawed and would not serve the best interests of investors and the capital markets.

We have the most successful capitalist system in history, and the market has reached unprecedented heights. Change can be disruptive under those circumstances. But we became pre-eminent as a nation not by RESISTING change, but by EMBRACING it.

All three areas I've discussed -- the municipal market, litigation practices, and financial services -- are ripe for reform. It is my fond hope that, as we proceed down that road, the Association of the Bar and SEC will continue to work together, to ensure that the changes we make are reasonable, that they are balanced, and -- most importantly -- that they serve our nation well by serving its people well.

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