NEW YORK CITY CAMPAIGN FINANCE BOARD HEARING[1]
January 31, 2005

Introduction

Thank you for this opportunity to participate in the New York City Campaign Finance Board's hearing on "doing business" and contracting with the City. I am Martha Mahan Haines, Chief of the Office of Municipal Securities at the U.S. Securities and Exchange Commission in Washington, DC. Today, I'd like to discuss the history and current status of securities regulations banning "pay-to-play" practices in the municipal securities market and share some of my experiences regarding anti-pay-to-play rules. Before I begin I must advise you that the Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication or statement by any of its employees. My comments here today reflect my own views, which are not necessarily shared by my colleagues on the Securities and Exchange Commission's staff or by the Commission.

I'd like to begin by clarifying what I mean when I refer to "pay-to-play." When I use that term I am talking about the practice of municipal securities market participants making political contributions to state and local government officials in order to be considered for an award of underwriting, advisory, or related business from issuers of municipal securities. In most cases these practices do not amount to outright bribery, which is already prohibited under state and federal law. There is usually no express *quid pro quo* - just an understanding that if you don't give, you won't get business.

While it is difficult to quantify the cost of fraudulent, unethical, and manipulative selection practices, there's little doubt that "pay-to-play" damages the integrity of the municipal bond market. It creates the impression that contracts are awarded on the basis of political influence, not professional competence. The investing public can easily pay more, and citizens of the municipality receive less, when bond services are awarded due to political influence instead of merit.

The Municipal Securities Market

The municipal securities market is a very large and important one. State and local governments have been issuing municipal bonds in the United States for over two hundred years. The market for municipal securities is characterized by great diversity and high volume and comprises an estimated 50,000 issuers including state governments, cities, towns, counties and special subdivisions, such as special purpose districts and public authorities. The size of today's market may surprise you – approximately $2 trillion of municipal bonds are currently outstanding in the United States. Trading volume

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exceeded $3.6 trillion last year. Individual investors hold more than 70 % of outstanding municipal bonds, either directly or through mutual funds.

At the time the Exchange Act was enacted in 1934, competitive bidding, in one form or another, was the most accepted method of financing used by municipalities and other public entities.[2] In competitive offerings, the issuer decides who will underwrite its bonds based almost entirely on price in response to the issuer's "notice of sale." Competitive bidding offers the public a measure of protection against the exertion of inappropriate influence on public officials by municipal underwriters. When bidding is done competitively and publicly, there is less possibility of collusion and political patronage. Because the competitive process offers all potential bidders equal opportunity to be awarded the bond issue, bidders must compete with one another based on the pricing of the issue and the willingness to accept market risk.

In contrast to competitive underwritings, negotiated underwritings present greater risk of abuse in the underwriter selection process. Issuers may become involved not only in selecting the lead underwriter, but also in controlling other provisions of the distribution. Selection may be based on considerations other than merit, creating a genuine risk that underwriters will be selected on the basis of political influence rather than the quality of the underwriter's service in distributing the securities.

Today, negotiated underwritings have become the dominant method of underwriter selection. According to data compiled by Bloomberg News, less than 20 percent of municipal bonds are sold by competitive sale. Let me be clear. For some bond issues there may legitimately be compelling reasons for an issuer to prefer a negotiated rather than a competitive underwriting. However, it is possible for pay to play practices that are next to impossible in competitive sales to exist in negotiated underwritings.

History of Pay to Play Regulation

Congress recognized the importance of integrity in municipal securities financing when it directed the formation of the Municipal Securities Rulemaking Board, as part of the Securities Acts Amendments of 1975, and authorized the MSRB to regulate the conduct of brokers, dealers and municipal securities dealers to, among other things, prevent fraudulent and manipulative acts and practices, promote just and equitable principles of trade, remove impediments to free and open trade, and protect investors and the public interest.

The MSRB's rules G-37 and G-38 were adopted in response to numerous reports concerning about questionable practices that broker-dealers were sometimes employing to obtain municipal securities business. There were numerous reported instances in which registered municipal securities dealers, their employees and related parties allegedly made payments or political contributions or entered into business ventures with political figures apparently to obtain the underwriting business of

[2] L. Loss & J. Seligman, Securities Regulation 343 (1989).

municipal securities issuers. Specific abuses were alleged in several state and local governments, including New York City.[3] The widespread perception of such practices called into question the integrity of the municipal securities market and the business practices some municipal underwriters utilized in order to obtain underwriting contracts. Several reports suggested that the greatest cost of improper contributions is the cost to investors, taxpayers, and the public at large.[4]

As a result of reports alleging improper payments regarding the New Jersey Turnpike refunding, in May 1993, two members of Congress requested the Commission, the MSRB, and the National Association of Securities Dealers ("NASD") to review the adequacy of regulation and oversight of the municipal securities market.[5] This culminated in the Division of Market Regulation's Municipal Securities Report,[6] and Congressional hearings on the municipal securities market held on September 9, 1993. The Municipal Securities Report recommended that "pay to play" contributions be addressed promptly.

When Arthur Levitt became Chairman of the SEC in 1993, among his stated goals was the reform of the municipal securities market. Early in his tenure, former Chairman Arthur Levitt asked municipal market participants to take voluntary measures to end conflict of interest practices such as pay-to-play. Initially, broker-dealers and independent financial advisors acted voluntarily to end these practices by adopting a "Statement of Initiative" providing that the political contributions made, in any manner, for the purpose of influencing the awarding of municipal finance business should be prohibited. Subsequently, a formal ban applicable to broker-dealers – Rule G-37 - was adopted by the Municipal Securities Rulemaking Board and approved by the

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3 "Holtzman Dials Direct for Dollars, Asking Bankers to Help Pay Off Debt," The Bond Buyer (May 12, 1993), at 1; "Wall Street Executives Appear on List of Fund-Raiser for N.Y. Comptroller," The Bond Buyer (October 29, 1993), at 1; "Get Off McCall's Committee," The Bond Buyer (November 1, 1993), at 42; "NYC's Stein Urges Mayor, Comptroller to Copy New Jersey, Ban Negotiated Debt," The Bond Buyer (May 12, 1993), at 1; "N.Y.C. Report Slams Holtzman For Negligence in Fleet Affair," The Bond Buyer, (September 16, 1993), at 1; "The Trouble with Consultants, The Market May be Getting Serious About Campaign Contributions, But There's More Ways to Peddle Influence," The Bond Buyer, (November 16, 1993), at 1; "Holtzman Says Loan Didn't Sway Choice of Fleet to Handle New York City Debt," The Bond Buyer, (April 26, 1993), at 1.

4 "Bond Buyers' Gain, Taxpayers' Loss," New York Times, (September 5, 1993), at 11; "The Trouble with Munis, The Market is Sound, But Abuses Hurt Both Investors and Taxpayers," Business Week, (September 6, 1993), at 44.

5 Letter from The Honorable John D. Dingell, Chairman, Committee on Energy and Commerce, United States House of Representatives, and The Honorable Edward J. Markey, Chairman, Subcommittee on Energy and Commerce, United States House of Representatives, to Mary L. Schapiro, Acting Chairman, Commission, Christopher A. Taylor, Executive Director, MSRB, and Joseph R. Hardiman, President and Chief Executive Office, NASD (May 24, 1993).

6 Securities and Exchange Commission, Division of Market Regulation, Staff Report on the Municipal Securities Market, (September 1993).

Commission. [7] Rule G-37 prohibits brokers, dealers, municipal securities dealers, municipal finance professionals, and political action committees from engaging in any negotiated municipal finance business with an issuer for two years after making a political contribution to an official of that issuer. The prohibition applies equally to officials who are incumbents and those who are candidates. The rule contains a *de minimus* provision under which a municipal finance professional can contribute up to $250 per election to any issuer official for whom the person can vote. MSRB Rule G-38, adopted in January 1996, requires disclosure of consulting arrangements.

Some state and local officials and politicians have also advocated or introduced legislation aimed at abuses resulting from political contributions and made attempts to reform the municipal securities underwriter selection process.

Description of Current Rules

MSRB Rule G-37 is a comprehensive scheme composed of several separate requirements affecting municipal securities underwriters, including business disqualification provisions triggered by political contributions, limitations on solicitation and coordination of political contributions, recordkeeping and disclosure.

Business Disqualification Provisions

Rule G-37 prohibits brokers, dealers and municipal securities dealers from engaging in municipal securities business with an issuer within two years after proscribed contributions made by the broker-dealer, any municipal finance professional associated with the broker-dealer, or any political action committee controlled by the broker-dealer or any such associated municipal finance professional, to an official of the issuer who can, directly or indirectly, influence the awarding of municipal securities business.

"Municipal securities business" includes certain broker-dealer activities such as the purchase of a primary offering of municipal securities from the issuer on other than a competitive bid basis (i.e. acting as a managing underwriter or as a syndicate member in negotiated underwritings), and acting as a financial advisor, consultant, placement agent or negotiated remarketing agent.

The rule defines an "official of an issuer" as any incumbent, candidate or successful candidate for elective office of the issuer, which office is directly or indirectly responsible for, or can influence the outcome of, the hiring of a broker-dealer for municipal securities business. This includes any issuer official, incumbent or candidate (or successful candidate) who has influence over the awarding of municipal securities business.

"Contributions" include any gift, subscription, loan, advance or deposit of money or anything of value made: (1) for the purpose of influencing any election of any official of a municipal securities issuer for federal, state and local office, (2) for payment or

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7 Securities Exchange Act Release No. 33868 (April 7, 1994).

reduction of debt incurred in connection with an election, or (3) for transition or inaugural expenses incurred by the successful candidate for state or local office.

The rule's disqualification provision is also triggered by contributions from employees of broker-dealers, defined as "municipal finance professionals" primarily engaged in municipal securities business. The rule exempts contributions made by municipal finance professionals of $250 or less per election to each official for whom the individual is entitled to vote. It does not apply to contributions by broker-dealers and municipal finance professionals to charities favored by politicians or those made to support bond referenda.

Family members are not specifically included within the definition of municipal finance professional. However, the rule prohibits a broker-dealer and any municipal finance professional from doing any act indirectly which would result in a violation of the rule if done directly by the broker-dealer or municipal finance professional. This is intended to prevent broker-dealers from funneling funds or payments through other persons or entities to circumvent the rule's requirements. For example, a broker-dealer would violate the rule if it does business with an issuer after contributions were made to an issuer official from or by associated persons, family members of associated persons, consultants, lobbyists, attorneys, affiliates, their employees or PACs, or other persons or entities with the intention of circumventing the rule. A broker-dealer also would violate the rule by doing business with an issuer after providing money to any person or entity when the broker-dealer knows that the money will be given to an official of an issuer who could not receive the contribution directly from the broker-dealer without triggering the rule's prohibition on business.

Solicitation Restriction

The rule also prohibits broker-dealers from soliciting contributions on behalf of officials of issuers with which the broker-dealer is engaging or seeking to engage in municipal securities business. This prevents broker-dealers from engaging in municipal securities business with issuers if they engage in any kind of fund-raising activities for officials of the issuers that may influence the underwriter selection process.

Disclosure and Recordkeeping

The rule established disclosure and recordkeeping requirements to facilitate enforcement of Rule G-37's "pay to play" restrictions and, independently, to function as a public disclosure mechanism to enhance the integrity of and public confidence in municipal securities underwritings. The rule's business disqualification provisions, solicitation restrictions and disclosure and recordkeeping requirements reflect well-established methods for dealing with conflicts on interest and other instances where improper influence is used to secure an unmerited benefit.

Exemptions

Rule G-37's two-year ban on business is automatically triggered anytime someone makes a contribution covered by the rule, even if the contribution is inadvertent or small. Rule G-37 includes a provision allowing the NASD to grant exemptions to a broker, dealer or municipal securities dealer who is prohibited from engaging in municipal securities business with an issuer within two years after a contribution. The NASD has granted such exemptions only in very limited circumstances.

Rule G-38 became effective on March 18, 1996. Rule G-38 requires written agreements between broker-dealers and consultants – individuals who are used by a broker-dealer, directly or indirectly, to obtain or retain municipal securities business. It also mandates the disclosure of such arrangements to issuers and to the MSRB.

First Amendment Issues

Some commentators believe the rule's prohibitions on political contributions impermissibly infringe on the First Amendment guarantees of freedom of speech and association, and constitutional guarantees of equal protection. These commentators believe that although municipal bond business should not be a "pay back" for political contributions, the rule restricts the ability of municipal securities underwriters and their employees to demonstrate support for state and local officials.

The Commission was sensitive to and carefully considered these constitutional concerns in considering the adoption of the rule. The Commission acknowledged that the business disqualification provision may affect the propensity of municipal securities underwriters to make political contributions. Although political contributions involve both speech and associational rights protected by the First Amendment, a "limitation on the amount that any one person or group may contribute to a candidate or political committee entails only a marginal restriction upon the contributor's ability to engage in free communication."[8] Even a significant interference with rights protected by the First Amendment may be justified by a sufficiently compelling government interest so long as the interference is closely drawn to avoid unnecessary abridgement of those protected rights.[9]

Prevention of fraud and manipulation is a compelling government interest. Rule G-37 was adopted in the context of a closely regulated industry and is directly relevant to the concerns of the regulatory scheme. "Pay to play" arrangements can have detrimental effects on the municipal securities market. I believe that the widespread perception that these practices are commonplace undermines the integrity of the market and diminishes investor confidence. Moreover, the restrictions inherent in the rule are in the nature of

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8 Buckley v. Valeo, 424 U.S. 1, 20 (1976).

9 Id. at 25.

conflict of interest limitations which are particularly appropriate in cases of government contracting and highly regulated industries.

The Constitutionality of the rule was litigated in the case of Blount v. SEC and the rule was upheld as a constitutionally permissible restraint on free speech – because it serves a compelling governmental interest of rooting out corruption in the market for municipal securities.[10]

SEC Experience with Rule G-37

It has been over 10 years since Rule G-37 first became effective on April 25, 1994. The Commission has brought a number of enforcement cases for violations of Rule G-37, against FAIC Securities, Inc., Pryor, McClendon Counts & Co., Lazard Freres & Co., LLC, Fifth Third Securities and others. Individual actions have resulted in penalties and disgorgement in excess of $1,000,000.

The U.S. Attorney recently issued an indictment involving officials of the City of Philadelphia and some individuals who did business with the City. I continue to receive telephone calls reporting potential violations of the Rule G-37.. Nevertheless, as a lawyer in private practice when Rule G-37 became effective, I personally observed the beneficial change in dealer behavior it caused. While the rule may not have completely eradicated pay to play practices by broker-dealers, I believe that G-37 has done a lot of good.

Recent press reports suggest that some broker-dealers may be attempting to circumvent the rule by making contributions to support bond referenda and political parties or through consultants, lawyers and spouses. I expect that the MSRB will consider further rule changes, if necessary, to prevent such abuses.[11] For example, last October the MSRB issued for public comment a proposal to amend Rule G-38 to prohibit a broker-dealer from making payments for solicitation of municipal securities business to any person who is not an associated person of the broker-dealer. It has not yet completed an evaluation of the responses it received or determined whether or not to file a proposed rule amendment covering the use of consultants with the Commission.

New York City Initiative

MSRB rules apply only to the people and entities it regulates, i.e., brokers, dealers, municipal securities dealers and their registered representatives, and only to transactions in municipal securities. The integrity of the municipal market rests not only on the shoulders of broker-dealers, but on those of issuers and other market participants as well.

Finally, I have three personal observations of particular relevance to the steps you are considering:

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[10] Blount v. SEC, 61 F.3d 938 (1995), cert denied, 517 U.S. 1119 (1996).

[11] MSRB "Notice Concerning Indirect Rule Violations: Rules G-37 and G-38" August 6, 2003.

First, while G-37 has not eliminated all pay to play like activities, it has significantly improved the integrity of the municipal securities market. Rules can be useful even when imperfect. *Second*, rules need to be revisited and revised over time to address changing circumstances and practices. You should expect that any rule that the City adopts will need periodic review and revision. *Thirdly*, I know that your staff has expressed concerns about enforcement of the proposals before you. The automatic prohibition in Rule G-37 has caused broker-dealers to become vigilant in policing their own activities so as to avoid the potentially draconian loss of two years of underwriting compensation from an issuer.

Thank you for the opportunity to speak to you today. I would be happy to answer your questions.