

Securities and Exchange Commission Historical Society
Interview with Christopher Taylor
Conducted on April 2, 2014 by William Thomas

WT: This is an interview with Christopher Taylor for the SEC Historical Society's virtual museum and archive of the history of financial regulation. I am William Thomas and the date is April 2nd, 2014.

I take it you go by Kit Taylor usually?

CT: Most people know me in the industry as Kit Taylor, yes.

WT: Okay. Well, why don't you tell me a little bit about your personal background before we move into the bulk of your career?

CT: Okay. I have a PhD in economics. I left graduate school, went to work at the Federal Reserve Board, and for a year and a half worked on the savings and loan crisis at the time, in 1974, '75.

WT: Can we go back and talk a little bit – I guess you're from Pennsylvania?

CT: Oh, yes. I grew up 40 miles west of Philadelphia, went to a boarding school north of Philly, went to college at Swarthmore College south of Philly.

WT: Did you major in economics?

CT: Economics and mathematics, and then when I went to Princeton to get my graduate degree in economics, got specialized in – I think the three specialties were econometrics, mathematical economics, and centrally-planned economies, which was quite mathematical at the time. And then from there I got a job in the Capital Markets section of the Federal Reserve Board in Washington, D.C.

WT: May I ask who you did your PhD under?

CT: I did my PhD under Dwight Jaffee, Richard Quandt, and William Branson.

WT: I've had some contacts in the history of economics community, so they always try to work out the genealogies.

CT: Well, there were some people very much involved with it at the time.

WT: Oh, yes?

CT: Yes, very interested in it.

WT: Well, we won't get too distracted by that, so let's talk about then going into your career.

CT: Well, in getting into munis – as I think a lot of people, particularly reporters and other people who get involved in the municipal bond market, find themselves sort of doing it by the back door and ending up there for the rest of their lives. In my case, when I was at the Fed I was working in the savings and loan area. I hadn't had time to write any articles off my dissertation. My boss wanted to see that kind of thing. The Fed was encouraging it. And I became aware that they had a position in the Capital Markets section that hadn't been filled for three years. That position was state and local finance, which was supposed to be covering the municipal bond market. They hadn't filled it for three years. There was a good chance they were going to lose it in the next budget cycle, because the bosses sit there and say, "We haven't filled it for three years. We're going to take it away."

So I made a deal with my boss. I said, "Listen, I'll take that job and I'll spend 50 percent of my time writing articles off my dissertation and the other 50 percent worrying about the state and local bond market." And the day that I got my papers that said you're no longer a savings and loan non-bank financial institutions – it covered a lot of stuff besides savings and loan – when I moved over to that area formally was the day the last bond deal done by the City of New York broke syndicate, which meant that it was no longer subject to price restrictions, and it dropped 10 percent, which began, if you will, the whole New York City financial crisis.

WT: Okay. So you got your PhD in '74.

CT: Right, a year after I had joined the Fed, I finished up the doctorate and submitted the dissertation.

WT: Okay. So please continue.

CT: Okay. So, anyway, I was suddenly thrust into the New York City financial crisis. And I didn't know much about the municipal bond market, I didn't know much about municipal finance at the time, and the next two years were a lot of fun, very exciting, a real learning experience about state and local finance internally. In other words, how do cities and towns and everything – budgeting, pensions, the whole shooting match of issues, which are still around today and you can read about them in the context of Puerto Rico or the Detroit bankruptcy or the bankruptcies in California – same issues, very similar issues related to state and local finance. By that I'm using a broader term, not only the internal finances of the state and local government, but also the bond markets which they access.

And so I was asked constantly to update the Board of Governors, at the time run by Arthur Burns, about what was going on in New York City. And my bosses very cleverly sent me to New York City in March 1975 with no sort of general brief, and just to meet people up there. And in the course of that, one of the guys who was sort of the dealer who was at Chase Manhattan Bank at the time – he was sort of godfather, sort of the main guy for muni finance in New York City – took me aside at one point and said, “Is the Fed going to bail out New York City?” And I said, “That's highly unlikely.” And so I then get back after this trip, I didn't think much of it at the time, I go back to D.C. after

the trip and the first question I got out of my boss, the head of the division, the head of my section, and coming from the board was, did anyone ask you about bailing out New York City?

So I was tasked with writing a memo, which was kept permanently in draft form – I guess so it couldn't be subpoenaed or whatever – about how we could bail out New York City if need be, and should we. And it was interesting, I became very involved in New York City's financial picture, trying to figure things out, and we could probably do a history lesson solely on New York City. A couple things are sort of interesting side notes.

One, in a subsequent trip, I went and visited with the rating agencies – S&P and Moody's, at the time – and at Moody's talked to the sort of godfather of that organization at the time in munis. And I asked him – because I was writing this paper for the Fed Board of Governors – asked him, “How much debt does New York City have outstanding, both long and short term?” And he turned to me and he said, “Kit, I'm going to show you this piece of paper and I will deny until my death that I ever showed it to you.”

And it was a piece of paper, two sides, and it asked the city to fill out those numbers. The numbers had been filled out so many times and erased so many times that there was a hole, a little stripe hole in the papers, and next to it written in pencil were some numbers with a question mark. So, here you have a major city in the United States, clearly with billions of dollars' worth of debt outstanding, and nobody had a clue. So I

actually had to go do some investigation, ask the New York Fed to get some documents from the City, which they did, shipped them down to D.C., and made the first calculation of how much short-term debt New York City had outstanding. And I'm proud to say that that estimate was very, very close to what they concluded at one point was the actual number, although I'm sure no one really knew for certain ever.

In the course of that, I ended up reporting to the Board of Governors. Slowly the various layers of management above me were pulled away and I ended up working directly with the then-chairman of the Fed, Arthur Burns, on the New York City financial crisis, and writing papers for him, preparing briefing documents. And, at one point, after President Nixon resigned, he was going over and visiting with Haldeman and Ehrlichman and Gerald Ford and the whole shooting match, and trying to convince them of the nature of the depth of this crisis. And so that involvement with Burns and the city financial crisis was literally being thrown from the pan into the fire for about a year and a half – a lot of fun, as I said, I wouldn't have traded it for anything.

Afterwards, I still was involved with the city, because it was still being worked out, the financings were going on. And then, in the fall of 1977 – by then legislation had been passed, New York City got loan guarantees for its short-term debt so it could keep its financing going and the like – then in the fall of 1977, the Treasury was looking around for someone to run that office, the Office of New York Finance. I had become acquainted with several of the people over in that office, the deputy assistant secretary and others, because they had been involved with the New York City financial crisis while

they were in New York. They came down and worked in the Treasury, and so they asked me to come over, and in effect I was loaned to the Treasury for six months to run the Office of New York Finance while the original legislation was going through the renewal process in Congress.

So, at the end of that, I had been out of graduate school for five years and thought, well, did I really want to go back to the Fed. It was going to be awfully boring after this, because it was going to be sort of very routine economics. And so I was wondering about what to do and the like, and then the job at the MSRB opened up. And a friend of mine said, "Why don't you apply?" And so I applied for the job as executive director and became executive director in August of 1978, technically September of 1978. I came on the staff as a supernumerary. There was a one-month overlap with my predecessor. So anyway, that's how I came to be at the MSRB in the fall of '78 and was there until June of 2007.

WT: I'm wondering if I can ask you a little bit more about the New York City crisis. One of the reasons that I'm interested in it is that we've actually done quite a bit of archival work in the Treasury Department papers. We've seen some of their memoranda and that sort of thing. And so I'm wondering if you could elaborate a little bit on the roles of the Treasury versus the Federal Reserve, and also the move from the Nixon and Ford administrations into the Carter administration, if there's anything to say about it.

CT: Well there's an amusing part to the story about the transition from Nixon to Ford, because I think by the time I really got involved Ford had already become president. If you read one of the Woodward/Bernstein books, it points out that Gerald Ford was often presented with policy options in the form of multiple choice questions. And people pooh-pooed that. Rumsfeld, I think, was deputy chief of staff. I mean, some of the same characters that we saw under George W. Bush were there at the time Ford came into the presidency.

One day, when I was preparing and updating a briefing book for Chairman Arthur Burns, I opened up the briefing book and there was a three-page multiple-choice outline document of what the federal government should do vis-à-vis New York City. The Fed probably could have stretched its authority to deal with New York City, but the problem really was, in the city's case, is that the city didn't want anybody overseeing them. And in our form of government, states really are the parents to the children, which is New York City in that case. New York City didn't believe it was a child. It believed it was an eighteen-year-old teenager, perfectly capable of making rational decisions, although they'd screwed it up for twenty-five years by promising excessive wage increases and very generous pensions – problems, as I've said earlier, that exist today.

So what the federal government wanted to have happen – and these were discussions that I had had with Burns – was, look, you've got to have the state get involved. You have to have the state be an actor and take responsibility for the city. And so the workout in all of this, and then basically what happened with Hugh Carey – which I give him great,

great credit for willingness to step up – and there are a number of city leaders, a number of chairmen and CEOs of banks, who stepped to the fore and said, “Look, what’s the right thing to do? How do we work this out?” And they did it. Even the head of the municipal unions did it.

Believe it or not, the city pension funds, tax-exempt organizations, didn’t have to pay tax or anything, and ended up buying tax-exempt muni bonds, which is sort of a no-no in some ways. But they were forced to eat the bonds as part of the argument because they were a good deal of the problem. Their pensions were excessive then – probably still are to some degree, and that kind of thing – you had to have the city really get its act together. And so municipal employment was knocked down by, I think, 50 percent. The unions and the banks bought a lot of the city debt. They had a responsibility to do it.

Then the federal government said, “Look, we’ll come in and we’ll help. We’ll guarantee some of the short-term debt, provided you meet certain benchmarks,” one of which was that you have adequate financial data, because no one could believe that a city this large had no clue of how much outstanding debt it had. And so whole financial management programs were put into the city. The Office of New York Finance at the Treasury really had the responsibility for making sure that that process took place. They hired Arthur Andersen to advise them, who was overseeing what was being done by another accounting – I mean, people jumped into this kind of thing, and the Feds were the ones that had the hammer with the loan guarantees.

The guarantees were only for three years, and the question was what happens at the end of three years: are you going to have sufficient progress to then go ahead and renew the guarantees for people? So, I don't know whether that's answered your question or I've gotten too far afield, but that's really where the Treasury and everybody else was involved with New York City finance. They were renewed in '78 and then they expired three years later, the whole legislation expired three years later.

WT: Okay. And how deep were the concerns at the time that that might not be an isolated case?

CT: Oh, there were pretty – I mean, the first memo I got, the first request, after things stabilized – there were relatively private meetings between the board of governors and/or the chairmen. We were all in the room together. It was very unusual for a staffer to be sort of that close to those guys without any intervening supervision. But those guys wanted to know exactly that question: who's next? And the memo I wrote was: Puerto Rico. And you can pick up the papers and read about Puerto Rico today.

WT: Okay, so then one somewhat related question, I think – and this again goes to our working in the Treasury archives – is that the Carter Treasury actually had – I don't think this went anywhere but you might have some insight – proposals for a taxable bond option, or otherwise a bondholder taxable option. Do you remember that?

CT: Oh, God. Look, the first paper, when I was involved in municipal finance, before the New York City financial crisis, actually, the boss came to me and said, “Yeah, you’re going to be made the state and local finance person, but we don’t have the papers yet. By the way, here’s the Treasury proposal to have a taxable bond option. Tell me what you think of that.” So that proposal has been outstanding since the mid-’60s, there were a couple of economic papers done. And Treasury, in 1969, had some guy running the Office of Tax Policy at the time who was a big-time lawyer, from I believe Harvard, where he sort of talked about a lot of the reforms that we’re still talking about today, and TBO was one of those.

WT: Okay. So now I guess we can go on to the MSRB. And I know very little about its earlier – so first of all, who was your predecessor as executive director?

CT: Frieda Wallison, who was an attorney who was actually the general counsel before she became the executive director. Let’s go back to 1973, ’74, somewhere around there, tail end of the Vietnam War. There were a series of scandals that developed in the municipal bond market where individuals were deprived of basically all their life savings by unscrupulous dealers. They were labeled as the Memphis Bond Daddies, and it was a series of sales techniques that the people in Memphis refined. Most of those techniques actually developed further up the river in Cincinnati and then eventually came to Memphis and into Little Rock, Arkansas. Those were sort of the two hotbed areas.

The story, maybe perhaps somewhat apocryphal, was that one of the dealers called up people who were Vietnam prisoners of war who were coming back with large amounts of accumulated monies. And the dealer wrote to them and said, “Listen, I was a prisoner of war in Korea. When I came back, an unscrupulous muni dealer ripped me off and I lost my whole life savings. Send me your life savings,” which unfortunately they did. Not the brightest thing to do, put all your money in a check to somebody you don’t really know. So they sent them to this guy and he promptly invested it in fly-by-night muni schemes, which included catfish farms and a whole bunch of – there was a thing called fireplugs, where you used to be able to go through parts of Tennessee and just see these fireplugs along the road which were supposedly going to provide fire services to communities. And so the bonds were to be paid off by the new communities where they – well, these things were out in the middle of frickin’ nowhere.

So there were congressional hearings. To the credit of the, then, some of the people that were in the industry – from some of the bigger firms and from some of the more regional firms – they said, “Look, we’re going to get legislation. How do we do this so that both banks and broker-dealers are regulated?” And they developed and took to the Congress the scheme for the MSRB, which was a board of directors of five dealers from banks, five dealers from securities firms – because there was a separation between banks and securities firms at the time – and five public members, one of which had to be an issuer and one of which had to be a buyer. And that board was instructed to write basically a rulebook, and that got embodied in legislation in 1975.

Again, my boss at the Fed, at the time I was at the Fed, walked in with this legislation and we were asked to comment on it, and I said, “This is never going to work because the parties are never going to get together to produce it.” To their credit, from 1975 to 1978, they basically started to put together the basic rulebook and deal with those issues to at least have a basis. When I came in, in 1978, I figured that a lot of my role was going to be refining this set of rules, because no one gets it right the first time in D.C., and so we would be sitting there doing it. I came in at a fortuitous time, in some sense, because bond volume at that time was about \$23 billion a year. Within five years it was doubled, and over the course of the time that I was at the MSRB it went from \$25 billion to \$450 billion in terms of muni finance, and the industry really, really grew. So that’s how the MSRB came into existence, and, as I said, I came in just about the time when the first basic set of rules was done.

At that time, from the period of like ’78 to ’81, there were two rules that we put in place that I am particularly proud of and I think were critically important to the growth of the industry, and almost all the subsequent developments in terms of rulemaking done by the MSRB. The first was a requirement that CUSIP numbers be put on the bond, that bonds trade on the basis of CUSIP number. And CUSIP numbers are supposed to identify separately tradable items. You and I are both human beings, but you’re Will Thomas and I’m Kit Taylor, you’re wearing a tie and I’m not, and so what there really should be is a numbering system that says, “Okay, Will, this is who you are, you’re number 123; and I’m number 456,” so that if anybody wanted to trade something they would be able to go to a central place to find a description of the bonds.

It was sort of stunning to me at the time to realize there was a vast amount of trading going on and people didn't know what the hell they were trading, and they had no basis for doing so, and so you go, "Oh, God." And I've always had a lifelong interest in computers. In fact, I built my own first computer in 1958 out of the back of *Boys' Life* magazine. Anyway, you find out very quickly that if you're dealing with computers, you really do need precision and you need numbers. And I thought – and the deputy executive director, who we were very fortunate to have on the staff at the time I arrived, and a couple of board members – understood the importance of computerization for this industry.

So the CUSIP numbering requirement was pushed through. There was a lot of opposition from the industry. It was not welcomed, if you will, because it required dealers, then, that if they bought a bond from a customer, or sold a bond, it had a CUSIP number on it. "Oh my God, I had to identify what the hell I was selling." I cannot begin to tell you how important that was, because people were trading various securities which had the basic same name, but the underlying characteristics were different. They were backed by a different revenue source, they had different call features, and people were not specifying these things on the confirmation, so the customer had no clue what they were getting.

In addition, our friends at the SEC had a filing system, it was called Filing of Securities by Issuer. All they said to the dealers is, "Listen, all these pieces of paper, here, just put them in the bin that says who the issuer is." Well, there might have been five, six, seven,

eight different kinds of securities issued by the same issuer. And, in fact, the best example of that was the bonds of the Washington Public Power Supply System. Three issues of those were guaranteed by the Feds, two issues were not. But, if you went into the vaults – and I did go into the vaults and see those of one of the largest dealers at the time, it was what looked like a laundry bin. And the stuff was together, and you could see series one, two, three here, guaranteed by the Feds, series four, five over here, not guaranteed by the Feds, all mixed together.

WT: Where is this vault?

CT: It was in the basement of a very large securities dealer in New York City, who will remain unnamed. And those dealers – once the CUSIP numbering requirement was there, and once the SEC got through its head that, oh my God, an issuer in bonds can have different types of securities outstanding – they said, okay, you have to break the box, meaning you have to break up that clothesbasket of Washington Public Power Supply System bonds into ones and twos and threes and fours and fives, and you had to assign to customers, okay, you own fours and fives, which are not guaranteed, I own one, two, threes, that were – what was sold to whom, and everything.

So it was a huge accounting, behind-the-scenes thing. To the credit of this dealer, they had sufficient records that they could say, “Will owned the fours and fives, and Kit owned the one, two, threes,” and they were able to successfully break the box without it causing someone to end up with something that was not nearly worth what they thought it

was. But that was the critical element to the whole thing, which brings me actually to sort of a thing that I became aware of at that time, that was driven home, which was that the SEC itself had very little experience, none basically, with fixed-income securities. None of their rules were regulating any of the fixed-income securities markets, including corporate bonds – I mean just no clue whatsoever.

And so the second rule that I really take a lot of pride in was placing a yield-to-maturity on the confirmation. Each confirmation to a customer had to have the yield-to-maturity. You know, economists can argue about whether yield-to-maturity is a proper measure, but the fact is markets traded on yield-to-maturity, people compared bonds based on yield-to-maturity. There's also yield-to-call and things like this, but it was basically putting a calculated yield, where everyone could agree to the calculation on the confirmation so people could compare what they were getting and what the yields were.

And let's face it, you go to CNBC today, you turn it on, the ticker at the top says three-year treasuries, five-year treasuries, ten-year, yield this way. That concept really wasn't there in 1980, and the SEC didn't understand it. We put the requirement in, and I had the SEC staffer who was responsible for dealing with us come over accusing me of perpetrating a fraud because the calculation of yield-to-maturity says you reinvest the bond interest rate at the same rate as the yield-to-maturity, and in that sense it's an artificial kind of calculation. And I had to explain as nicely as I could that that's the basis on which everyone traded, and that's the basis that economists used, everyone used, it was the basic language.

Those two developments, actually, from that point on through most of the '80s – what the MSRB was doing ended up getting copied over into the corporate market, getting copied over into the treasury market, because we had responsibility to do it. The SEC sort of passively followed along, and said, “Okay, if the MSRB is going to do this for munis, you’ve got to do this for corporate, you’ve got to do this for Treasuries,” kind of thing – to a much lesser extent with Treasuries because it was the federal government. But that also allowed, as I said, the computerization of the industry and the ability to compare products, and those two things are the fundamental backbones of any market structure, which is where I come from. As a doctorate in economics and a person who studied markets, that’s the basis for an efficient market, you have to be able to compare the products.

And I would say you can almost look at the great bulk of regular rules – other than those that deal with political contributions and the like, and corruption – and see that the basis of virtually everything I did during my tenure and beyond, even today, is providing sufficient information to the customer to be able to know what they’re buying, and being able to compare that product, which is the basic functioning of a market. People would say, “Well, why are you putting this rule into effect, or that rule into effect?” And I said, “Listen, dealing in munis, and what we’ve tried to do is go from walking into a supermarket and seeing a thousand brown bags with hardly any label on them. And in fact, think back. You used to go to the grocery store, you didn’t even get all the stuff about what’s in the product, so we moved to going from a brown bag that you could

barely tell what the name of the thing is you were buying, to a brown bag with a name on it, a barcode on it, and nutrition information on it.”

And that’s been the whole basis for much of the rulemaking that we’ve done. I sort of viewed it as my – people would come to me, and they’d say, “Look, Kit, you’ve got a doctorate in economics and you’re not practicing economics.” I said, “No, I am practicing economics every day, trying to make a market efficient.” And whether it’s providing for the collection of official statements – gee, basic nutrition information, what the hell’s in the bond? – pricing. Price reporting, that took place in the ‘90s. These were two developments that took place in the ‘90s. I said, “So, you walk in and you’ve got your brown bag. Now you know you can find out what the ingredients were in a product. You might not know about its freshness date, but at least you can get the basic ingredients. And, oh, wouldn’t you like to know the price that was paid for that yesterday or fifteen, twenty minutes ago? Yes you would. We all do.” So it allowed comparison shopping.

WT: It’s the basis of what makes economic behavior possible, basically, is what you’re saying.

CT: Well, markets presume – I mean, and it’s kind of funny, I have to laugh at a lot of people on the street who kept throwing Adam Smith at me and sort of like “free markets” and all this, that if you actually go and you look at the economics behind a free market, you have to have centralized information about what you’re buying and selling. You have to know. Adam Smith talks about it. He talks about knowing what the description of the

product is. He hated dealer markets. He wanted markets centralized so people could price compare, and those kinds of things. And then all the mathematical economics and stuff that I studied in graduate school and in undergraduate school – the whole basis of economics is the proving that the free market, the competitive market model, is the most efficient market – presumes those things as assumptions, that you know what you’re selling, and you know what the price is, and you can see those prices.

WT: Are we talking basically about general equilibrium here now?

CT: Yes, general equilibrium, and reaching a general equilibrium solution that’s efficient presumes that. And so I’m sitting there thinking, “Yes, I’m practicing it every day, because I started with something that was so far away from that.” There were those in the dealer community who were progressive enough to realize what this does is lead to an expansion of the market. There were those in the industry who loved their little temporal or informational monopolies. They were the only ones that knew about it, and so they didn’t need to share that or want to share that because it would reduce their profit. Adam Smith says, yes, if you have a monopoly of some of this information necessary for an efficient market, you’re going to make above-normal profits. And there are many people that argue that that’s precisely why Wall Street makes so much money today – it’s these temporal or informational monopolies that they enjoy.

WT: I want to ask you a little bit about the legislative basis for the MSRB, because of course that’s from the 1975 Securities Act Amendments, but I know that there was some fluidity

and some expectation of further legislation for at least a couple of years after that. I know that Senator Harrison Williams floated some proposals.

CT: Oh, they did their usual oversight hearings. You know, like, “Are you doing your job?” If you’re not going to do your job, I’m going to impose these things.” Harrison Williams’s stuff had really little to do directly with the MSRB. The MSRB wrote rules for dealers, but not for issuers. Harrison Williams’s legislation was really geared – and by the way, the ’75 legislation exempted and prohibited the MSRB from really getting at issuers and telling them what to do. Harrison Williams’s legislation was really designed to control issuers, to make them produce audited financial reports, to go again to that product description and nutrition information and freshness date. And those arguments, unfortunately, are still very vibrant even today. Progress has been made, but, boy, it is sure slow.

WT: And you’ve alluded to the Tower Amendment. What was the impression of that at the time? Was that considered to be a good solution?

CT: Oh, the dealers in effect hated it, because they knew that part of the problem was that it’s the issuer and the underwriter getting together to bring something to the market to sell. But the issuer is saying, “I don’t have to tell the market what the hell’s there.” In some sense, it was brought home in the New York City – there was finally a report on the New York City financial crisis issued, I think in 1987, by John Dingell. Well, that was actually the WPPSS report. The New York City report came earlier, in the early part of

the '80s. If you look at that, you see Abe Beame saying, "I'm not going to tell you what the city's finances are, your job is to go out and sell the securities." Which was basically saying, "I don't care what you have to tell the consumer. Get them to buy." And that's antithetical to so many things we know about fairness.

Well, there were a lot of people in the dealer community that said, "Hey, wait a minute. Don't lay the responsibility on us. Put some responsibility on the issuer to tell the world what their status is." And, again, some of those arguments are still extant today with what we've seen in the pressures and stresses in the state and local sector.

WT: And of course we'll get to 15c2-12 a little bit later. So, in the interim, maybe I can ask about some of the other players, some of whom were also quite new. There was the Public Securities Association, National Association of Bond Lawyers. What were your relations with those?

CT: Well, let's start with the Public Securities Association. Bear in mind, again, the MSRB had people regulated by the Fed. The MSRB was unique in a way, as a Washington institution, in that we were private in terms of salaries, budget, the whole shooting match – all that had to happen was we had to report to the SEC whatever rules we wrote, and the SEC put their stamp of approval on it, and made it in effect a federal law. So here we were, a private body, writing federal law that could be enforced against banks and securities firms. The securities firms wasn't as much a big deal, but in the banking case you already had three federal regulators, and they were charged with enforcing MSRB

rules. The NASD at the time, FINRA's predecessor, was required to enforce rules for the securities dealers around the country.

But, see, on the board you had both dealer banks and securities firms. They had always worked together in the muni sector. They worked together in the Treasury sector, because banks were allowed to be in Treasuries and munis even after Glass-Steagall. So the PSA was formed as a way of bringing banks and securities firms together to talk about the fixed-income markets. And, witness its name, Public Securities: munis, treasuries. You know, it included Fannie and Freddie at the same time, government-backed agencies. That became the PSA, because they wanted to expand into corporates, mortgage-backed, and other securities, which they did subsequently.

We had the usual tension with them, because here we are writing the rules. The fundamental reaction of anybody subject to rulemaking is, "No, I don't want any rules." So I fully expected to have, you know – they were constant opposition, if you will. I often felt that the MSRB board, certainly for the first twenty years or so, was at the center of a lot of competing tension between the dealers and the banks, between the board, the PSA, the bond lawyers, who were representing issuer interest to some extent, the issuer. There were lots of issuer organizations. They were pulling on us saying, "Don't do anything because of Tower," you know. The dealers were telling us not to do anything. You had the bank regulators saying, "We don't like these rules." The SEC, having to – so we were constantly being pulled and pushed, and, as an economist, that's what makes markets, so I sort of saw in some ways that this was a good rulemaking process.

WT: The push and the pull.

CT: The push and the pull. I think it broke down as we got into the new millennium, but that's another story.

WT: Could you tell me a little bit about what the role of the executive director, yourself, was, versus the board.

CT: I ran the staff. But here was a part-time board from the industry. It wasn't their job to sit down. Their day-to-day stuff was trading, buying, selling. And the legislation's pretty clear that they were to bring their expertise to the table. So, from the very earliest days, the staff basically was saying, "Here's where we think we ought to go. We think we see this. You guys have talked at the board table about this problem or that problem. How do we solve it? This is the staff's proposed solutions. Here are two or three solutions." My role was to sort of hear the board, if you will, and direct the staff accordingly. And vice versa, to hear what was coming out of the staff stuff and try to communicate it to the board.

I once said, "Well, you know, regulation and the self-regulation, which is what we were supposed to be, is like trying to sell refrigerators to Eskimos." You're trying to sell something to people who don't generally want it, and you have to convince them that it's

in their best long-run interest. And long-run interest is not something that is readily apparent to a lot of people.

WT: Now, the MSRB was the first SRO by many years to have public members.

CT: Yes.

WT: I don't know if you can comment.

CT: Well, we actually had the first female SRO member, even before the New York Stock Exchange. We had the first female chairman before any of the other SROs. In that sense it was very progressive. The muni sector has always been the most diverse part of the securities industry. And if you go into Goldman Sachs today, or J. P. Morgan, I will wager that the most diverse department is still the muni departments. It is. The public member involvement was, at least for a very, very long period of time, not much different from the dealer involvement. These were part-time people who were brought on board with the idea that their expertise would be brought to bear, and that the tension between the relative groups represented on the board would result in an appropriate rule.

Yield-to-maturity almost – I mean, literally, I had two board members standing across from each other at the table, yelling at each other and threatening physical violence. I learned very quickly that people's passions were there, as they should be. I don't think that the involvement of public members was – I think it was good in some ways. I think

it was overemphasized, and particularly later on, because as you get into the '90s and into the first decade of the millennium you really ended up with a situation where the issuers were getting close to driving the truck. And it was all an outcome of the 1986 legislation, tax reform then, because it changed where dealers made money within their own operations, and it changed it to a market where public finance and underwriting of bonds was a big deal.

Well, what that does, in effect, is make the dealer sort of suck up to the issuer, so then the question is, do you have a balance between the issuers and the dealers, do you have that tension there? And I saw that sort of diminish over time. But public members – and look, if you're going to do it, you need to hear and you need to keep your ears open to all of the different constituencies out there. So I didn't view it as – yes, it was special and we were different, we were an example that it can work, industry can work with government. It doesn't have to be either/or. It doesn't have to be violent antagonism throughout the whole thing. And we were touted as an example in numerous congressional hearings of, "Okay, yes, this can work. Why don't we try it here, why don't we try it there?" That sort of thing.

WT: I know in the late 1970s, going into the 1980s, industrial development bonds were becoming a contentious issue because there were a lot more of them, and eventually there was the '86 Act.

CT: Well, even before the creation of the MSRB, those bonds were sort of looked at as on the edge in terms of tax-exempt use, and whether or not it was an abuse of the tax code to do industrial development bonds, because you're conferring tax exemption – which is a cost to the federal government, you know, because if they were issued in taxable form, the government would make more revenue. Tax exemption was viewed as being a positive benefit, and why was the government allowing certain states, who were very liberal in how they wrote industrial development bond legislation, and certain dealers, to benefit from this? And some very egregious deals got done where there was very little public purpose.

And then, by the time of the '86 Tax Act, you had people doing deals where there was no expectation whatsoever that any facility would ever be built, that it was solely for issuing bonds that were tax exempt, and after three years they'd be called and they'd go away. But, meanwhile, investors would get the tax exemption and issuers might get a little bit of benefit. The dealers certainly got a hell of a lot of benefit. They were underwriting the bonds. And so it was a thing that was viewed as a rip-off of the government, which then led to the '86 Tax Act, which said, "Okay, here are some of the things you can and cannot do. First of all, banks will not be allowed, except in very limited circumstances, to buy munis" – because banks were able to buy munis and deduct the cost of buying the munis, essentially the financing cost of buying the munis. Then they were getting tax-exempt income, and they were paying 50-percent rate. It was a hell of a deal for banks. I mean, property/casualty insurance companies – there was a somewhat similar but not quite as pronounced benefit to them.

And so the '86 Tax Act also eliminated tax shelters, so suddenly the only tax-advantaged investment after '86 were munis. The dealer community got restructured because a lot of dealers had trading between small banks, large banks, property/casualty insurance companies, there was a lot of secondary-market trading amongst big professionals. That essentially got blown out of the water, because these guys couldn't buy it anymore. I mean, dealer shops went out of business because their whole thing was based on selling to small banks and regional banks – gone.

So what you were left with was selling to retail, and underwriting the bonds, and that was a fundamental change in the structure of the market. And, to the credit of the board at that time – and there were two chairmen, John Rowe and Jimmy Hearty, those two guys got it – and that's when we pushed, and we pushed the SEC to allow us to collect official statements, which was supposedly a public document, is a public document. Bond lawyers thought it wasn't, by the way. Some of them didn't. And there was violent opposition from the issuer community. It was as strong an opposition as anything in the MSRB's history, in my judgment, even over our limitations on political contributions.

WT: We're around 1990 now?

CT: Yes, right around 1990.

WT: The MISL system?

CT: Yes. And the idea was, we'll collect the OS's because that's going to give you the, again, the packaging. It's going to tell you what's in the product, and it's going to give you a snapshot of the financial condition. I mean, I was stunned. This is a public document, and we were proposing to collect it, and, at our cost, store it. And the issuer community thought this was like the world's worst thing. The world is coming to an end. And I said, "This is a public document. How can you argue against the collection of a public document?" Well, I guess I had an inkling when a bond lawyer came up to me at a meeting and said, "Kit, you know you're going to destroy things," and I said, "What do you mean?" And he said, "Look, if we distribute the bond document, if people have access to it, then we have to abide by the covenants in the documents. We have to abide by what's written in the document. We can't change it."

And I looked at him and I was almost in shock. I said, "So you change the covenants after the deal is done but without the bondholders' knowledge?" "Oh yeah, we do it all the time."

WT: (Laughter)

CT: And I went – yeah, you're laughing. You're laughing, but this is 1990. The size of the market was a million-and-a-half different securities and over two-and-a-half trillion dollars outstanding, and we're talking about this. And I'm going, this is crazy. It took us

three years and a lot of hard work from staff and others to put that in place, and we came out of that battle, and unfortunately went right into a political contributions battle.

WT: Right. Okay, I think I'll bring us back a little bit, way back to the report on pricing.

CT: Okay. The report on pricing was basically an idea of sitting there, saying, "Listen, you have to know" – again, it goes back to the fundamentals of markets – "you have to know what the price is." And we wanted to get out there that there was a wide range of the prices and the markups that people were attaching to bonds, and we were trying – this was, what, the pricing report was what, 1980, '81. Tell me if I've got it wrong. It's been a while.

WT: You had it on your timeline, I think.

CT: Yes. The report of pricing, in the grand scheme of things, it wasn't as big a deal. What it was, was saying, "Listen, the acceptable range of markups, or what the margins that dealers can make on bonds, should generally be here and here." And the reason that was written was because the SEC wanted us to write a rule that the confirmation that went to the customer would show the dealer's gross profit. And there are almost no industries that I know of, today even, where you get to know exactly what the dealer made on your purchase. But the SEC wanted us to do this because they thought there was abuse in the area.

So we wrote the report on pricing, and said, “Well, it shouldn’t be more than this or that,” you know, we gave a range. But, way down the road, the SEC came back to the idea of this gross profit, and we said, “Okay, the only way to really address this that’s fair is to do price reporting,” which is, again, go back to Adam Smith. You know, go to the market and see what the prices are that things were bought and sold. And, if you look at trading patterns in munis, you see that when a new issue comes to market, there’s a lot of trading in the new issue. Six months out, there’s almost no trading in it. You could go five years, and then all of a sudden the product comes up. Nobody’s traded it. How do you know what it’s worth? Well you have to hope you get nutrition information and product description. But the other thing you want to know is, well, that one was similar to this one – what did this one trade for? And maybe this one is trading today, so I get a better idea of what this one’s trading for. So that was the basis for price reporting, and we started the effort to produce more and more price information, which resulted finally in 2005 with fifteen-minute reporting of prices. So you go back all the way. Again, it goes back to those things that, very early in my tenure, where I looked at it and said, if you want to have a market, these are the factors you’ve got to have and one of them is pricing.

WT: Just picking up a few other pieces, so of course there was the Tax Equity and Fiscal Responsibility Act that finally –

CT: The ’86 Tax Act, essentially, TEFRA.

WT: Right, '82, no?

CT: Oh. Yes, '82 was TEFRA. That didn't really affect us at all. '86 did.

WT: Why don't we talk about '86 then. You've already mentioned it a little, so if you have more to say.

CT: No. It restructured the market. It did, a) it changed our internal focus, that if you're going to sell to retail, you better give them the same information they get in equities. But, on the flip side, it also said the only way underwriters can make money is underwriting bonds and doing them on a negotiated basis. So this means an issuer will go into Rockville and say, "Okay Rockville, you're going to issue \$50 million worth of bonds for new parkland and libraries, you should use us and we'll get the management fee and we'll underwrite the bonds and we'll work for you." As opposed to a competitive sale, where Rockville says, "Okay, we're going to sell 50 million on XYZ day. Everybody put in their bids on that day." So negotiated sale, the dealers are competing on who's their best friend with the issuer kind of thing, and supposedly on their expertise.

Well, some of the dealers figured out pretty early on that they had to ingratiate themselves with the issuer, and the best way to ingratiate yourself with an issuer at the time was to make political contributions, and by 1993 we were talking about big numbers. Big numbers where issuers would walk in – the treasurer of a state would walk in to a dealer floor and say, "I need to walk out of here with \$50,000 worth of

contributions. Tell your traders and public finance people to open up their checkbooks.” I mean, that makes it look like the issuer was encouraging graft or whatever you want to call it, but, by the same token, dealers were doing the same thing. It was a mutual ugliness where in certain cases one party was pushing and the other was not.

And it reached a point where it affected the 1993 municipal election, New York City, the city finance director election. I mean the woman was running, I forget what her name – Elizabeth, it wasn’t Holtzman? Anyway, she was running for treasurer, and she’d come out of Fleet Bank and they gave her like \$250,000. That gave her a big number in terms of political contributions. She turned around and gave them a deal. And she was running for reelection. Anyway, it was in the newspapers, and by – I mean, I could smell that – I mean it had been talked about at the board that political contributions are a problem. There were dealers sitting there saying, “This is getting out of hand, we ought to do something about it.”

And then this thing breaks in New York City, and if you’re in Washington long enough you know when it’s going to come home to bite you and when you’re going to get congressional hearings. And, by the end of the summer, we knew we were going to be in front of Congress. Dingell was talking about it, and we had gone out and hired Harvey Pitt to do a paper for us on what we could do. And to the board’s credit, in an August 1993 meeting they basically said, “We’re going to ban them, and we’ll take the hit and see what happens with it.” And Arthur Levitt, who was chairman of the SEC, didn’t

think that it would withstand constitutional scrutiny, court scrutiny, and thus far it has, and I think it will continue to hold.

WT: And part of the reason that there is – it’s a ceiling on contributions rather than a ban.

CT: It basically says, “If you give money, we’re not stopping you. But, if you’re a dealer, and when you have personnel involved and you give to an issuer, you may not do negotiated business with that issuer. You can do competitive bid business. You don’t have to do business with him. You want to give to the governor of California’s race, that’s fine, but you cannot then underwrite his bonds for the state of California on a negotiated basis. Okay? You can’t ingratiate yourself, dealer. You can vote – you can give up to \$200, and I think the limit’s \$250 for somebody who lives in your neck of the woods. You know, if you live in Westchester County, New York, you can give money to state senator, to the governor, because that’s your constitutional right to be able to give.”

Now, we did put a limit on it, so, again, it wasn’t going to be the real or announced perception of abuse. We got sued by a fellow named William Blount. Mr. Blount failed at the Court of Appeals for the District of Columbia, and the Supreme Court denied certiorari, which meant that the Appeals Court decision stood. Interestingly enough, Mr. Blount went to prison for twenty years for essentially bribing the mayor of Jefferson County, Alabama.

WT: This was much later, of course.

CT: Yes. This was in 2010, he goes to jail for a very long period of time for having bribed the guy. He was outraged that he couldn't give money to his local friends.

WT: And then there was some question about whether or not the rule would be enforceable. I remember we were looking through the response letters, and there was one – I think to you – saying you must believe in the Easter Bunny if you think that –

CT: Oh God, yeah. The odd part about it is there were two aspects to the rule that are still very unique. One, the penalty is built into the rule. It is amazing that the dealer community at the time – and some bright lawyers did figure it out. They said, “Look, this is a problem.” Because, up to now and even today, the larger securities firms and people love to hire this band of lawyers, go down to the SEC and say, “You shouldn't charge us. We will neither admit guilt nor deny that we did these things, but we'll enter into a consent decree. But we'll argue with you about what was in the thing and what the penalty should be. We should be able to argue with you.” This rule said, “If you do it, two years, you're out of the box for two years. No ifs, ands, or buts. You can appeal to the NASD, but you're out of the box for two years.” So in the rule itself was the penalty, which some lawyers were really upset with because they couldn't weasel around if one of their clients screwed up. So you end up with that as one aspect of the thing.

The other aspect, which is, as I pointed out to the guy who said I believed in the Easter Bunny, “You guys will rat each other out in a heartbeat.” And we had reporting, so the

heads of the department lived in fear that one of their underlings would stupidly violate the rule and then they would be banned from dealing with an issuer. There were a couple very high profile ones. William Weld, who was running for, I think, the U.S. Senate at that time, came down to New York City, hosted a dinner with some of his buddies there. The host of the dinner said, "Open up your checkbooks everybody." They wrote checks to this guy. And the idiot who wrote the check didn't think the rules applied to him, and yet they did. And so the gentleman from Morgan Stanley got Morgan Stanley banned for two years from doing negotiated deals, and they were one of the big underwriters in Massachusetts. It was very, very costly to the business.

WT: And I've heard from a couple of people that once the rule was finally actually in place it actually became fairly well accepted, that people in the broker-dealers were relieved that they no longer had to open up their checkbooks.

CT: Oh heck, I got a call at Christmastime from a dealer at bonus time. It was a friend of mine, and he said, "Kit, I just want to thank you for this Christmas present." He said, "I am tens of thousands of dollars richer because I don't have to make these contributions." Now, the flip side is that a lot of dealers figured out a way around it, which was to hire political consultants, an intermediary to do the same thing that they were prohibited from doing. And, to make a long story short, we ended up having to ban those in 2006. It was a very acrimonious debate, both within the board and without the board, and I daresay there were a lot of people pissed off with me at that point.

WT: That's G-38, of course.

CT: Yes, and G-38 in its current form. So, G-38 in its current form says you cannot hire consultants. There's actually a pretty good regulatory economic argument for that in the simple sense that, why should a dealer be able to hire someone who is not subject to the professional qualifications rules and knowledge that the industry requires. I mean, the MSRB has professional qualifications rules, where people have to pass tests in order to enter the industry. It was actually one of the requirements Congress put in in '75, because the argument was too many used car salesmen were going into the industry without a clue about what a bond was, but they could sell, they could really sell, so we had to put in professional qualification standards.

And dealers are subject to whole sets of rules other than MSRB rules. So, why should a dealer be able to hire somebody outside that regulatory environment to go out and do the same business that he's doing, which is to go solicit a deal from an issuer? And to me, as an economist anyway, that's a pretty strong argument. I mean, you sit there and say either you're in or you're out, but you can't get around the whole basis of rulemaking by hiring somebody else to do your job for you. And the problem was actually that political contributions were being made right and left by the people that were posing as consultants. I mean it was big, big business.

And, to be honest, both the Republican National Committee and the Democratic National Committee had people who knew how to get around these rules. And some of those

committeemen and women were involved as consultants on both sides doing this, getting contributions. The monies effectively were being washed through these national committees. They probably still are to some extent, if you can figure out how it's done.

WT: If I can go back and ask about the writing of G-37, how difficult was it to get the terms right?

CT: Once you come up with the basic idea that you are going to ban underwriting for negotiated deals, you're going to get into an argument about what's a negotiated deal. I mean, I didn't think it was that difficult to come up with the terms, quite frankly, and it was relatively short. Yes, we had to issue Q&As. What happens in this situation, what happens in that situation? It was like what we see now on websites, FAQs, frequently asked questions. We put those out as a way of saying, "People have called us up with these." A lot of those questions, we didn't think were that difficult. A simple reading of the rule would've told you what the answer was.

I don't think the terms were that confusing or that difficult to write in terms of rulemaking. There are other rules that we did over the years which I thought were far more difficult because of the structure of how the bonds were coming to market. A lot of it had to do with clearance and settlement, a lot of it had to do with training. Even some of the pricing stuff was far more technically difficult. G-37, I don't view what we did there as being particularly difficult. The industry, the bond lawyers and others outside from the external point of view, I can see them sitting there going, "Oh my God," you

know, because it was a death rule. I mean the sword of Damocles hung over somebody who screwed up for the first time for these guys. They couldn't go screaming to their in-house general counsel and say, "Go down to the SEC and convince them that we're not bad guys. Enter into an agreement." No, the sword came down if you screwed up.

And there was tension around a couple of things as to how high up you go and stuff like this, but I have to say the board was pretty resolute throughout this, even with a lot of change. And there were dealers on the board who wanted to get rid of the rule. My general counsel actually came in on a conversation amongst board members. It was a conference call and she got put on the phone, and they kept yakking. Like, you know, "When are you going to get rid of Taylor? You got to get rid of Taylor and the rule," you know? People were angry. So from an external point of view, I wouldn't be at all surprised that people would tell you, "Gee, it was a long time until they got it right." It wasn't that long.

WT: Okay. So, since we're now planning to do a second session, I think I'll probably save 15c2-12 and the run-up to that for the beginning of our next session, but if I can go back into the '80s for something that'll probably be a bit more succinct, how about the escrowed-to-maturity controversy?

CT: Well, that actually is the basis for 15c2-12, because if you go to escrowed-to-maturity, what it was, again, is that some very clever dealers had said "Oh, this ain't nailed down, let's go change things after the fact." And there were dealers that thought the stuff was

escrowed to maturity, and some dealers said “No, it’s only escrowed to call.” Again, it goes to the whole question of what’s trading in the market, what does the product look like, what’s the product’s description, and that just heightened the board’s interest. The board had already started dealing with the whole question of “we need an adequate description.” We had the CUSIP descriptions, and there was a lot of complaining within the board about the quality of what CUSIP was putting on their descriptions. There was a lot of questions in the industry, because, again, we put the rule in about CUSIP numbers around 1979, ’80, and within five years we’re trying to do automated clearance and settlement. It meant dealers had to be very precise about things.

So there were a lot of people in the dealer community going, “Wait a minute, we don’t have a good source of the description.” And we had bond lawyers on the board that said, “The only true description is in the official statement”. And the escrowed-to-maturity thing also said a subsequent event can change the nature of the securities, and that needs to be centrally located so everyone in the market knows that that characteristic of the security is gone, or it changed and it’s changed permanently.

No, I think the escrowed-to-maturity thing was a great driver, if you will, to the changes in 15c2-12. Do I think what the dealers did was right? No, I didn’t. The changing of the thing is not at all correct. And there were dealers on the board who thought – and we privately communicated to the SEC – that this is something that board members certainly thought was closely akin to fraud. So escrowed-to-maturity, just another one of those

events where we had already, because of what was coming out of the Washington Public Power Supply System in the fall.

WT: Yes, that was the angle that I thought we'd go into 15c2-12 from.

CT: You had sort of three things happening in the late '80s. One, you had the '86 Tax Act, okay, it changed the structure of the market, putting an emphasis on underwriting and retail sales. The board comes out of that and says, "We need good descriptions. " We had just gone through the automation of the sort of back offices. That was saying we need better descriptions. You have the escrowed-to-maturity thing coming in as another factor in that thing. "We need better descriptions of the security." And it was at that point where we could all agree, everyone, the only legal description is in the offering document, the official statement.

WT: Well, shall we break off there?

CT: Let's conclude there.

WT: All right, that sounds good to me. Thanks.

[End]