GC-55-85

INFORMATION MEMORANDUM

March 13, 1985

TO: The Commission

FROM: Daniel Goelzer

SUBJECT: Response to Congressman Wirth's letter regarding the municipal and government securities markets.

For your information, I attach a copy of the Commission's report as it was transmitted to the Congress.

Attachment

cc: Rick Ketchum
Caite McGuire
Bob Colby
Sandy Shtofman

Clarence Sampson
Ed Coulson
Clarence Staubs

Gary Lynch
Bill Kuehnle

John Huber
Cathy McCoy
Bill Morley

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OFFICE OF
THE CHAIRMAN

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

March 12, 1985

The Honorable Timothy E. Wirth
Chairman
Subcommittee on Telecommunications,
Consumer Protection, and Finance
House of Representatives
Washington, D.C. 20515

Dear Chairman Wirth:

In response to your letter of January 23, 1985, the Commission's staff has re-reviewed your prior requests concerning the municipal and government securities markets, with a view toward providing additional relevant information, and four of the Commissioners have authorized release to the Subcommittee of the enclosed report. */

As indicated in the report, the Commission supports repeal of the provision in Section 3 of the Securities Act of 1933 which exempts industrial development bonds from registration, and suggests that the Congress consider the repeal of Section 15B(d)(2), which prohibits the Municipal Securities Rulemaking Board from directly or indirectly requiring municipal issuers to furnish information concerning the issuer to the Board or to purchasers or offerees of the issuer's securities. Accordingly, a copy of the enclosed report is being transmitted to the Chairman of the MSRB for the Board's comments.

Because jurisdiction over aspects of the government bond market is vested in the Federal Reserve Board and the Department of the Treasury, copies of the enclosed report and prior correspondence are also being transmitted to the heads of these agencies, with the request that they respond directly to you, with copies to the Commission, in the event that they have any additional or conflicting views concerning the matters discussed.

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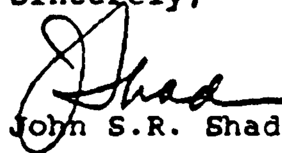
*/ One Commissioner has not formed a conclusion on the matters discussed.

As you may be aware, on March 4, 1985, ESM Government Securities, Inc., a government securities broker-dealer, ceased operations as a result of its inability to meet its financial obligations as they mature. On the same day, the Commission obtained a court order freezing the firm's assets and appointing a receiver. The Commission intends to continue its inquiry regarding this matter.

The Commission fully recognizes the Congress' need to be fully informed of all relevant data in order to adequately shape public policy. We are pleased to provide the Subcommittee with the enclosed report and stand ready to be of further assistance.

Sincerely,



John S.R. Shad

Enclosure

cc: Honorable John D. Dingell

Securities and Exchange Commission Report in Response to Congressional Inquiries Relating to Government and Municipal Securities Regulation

Question

Following the New York City crisis, voluntary guidelines for the disclosure of information in offering statements were adopted by the Municipal Finance Officers Association. Does the Commission know whether, in the case of WPPSS, these guidelines were complied with? Does the Commission believe they are sufficient?

Response

The MFOA */ Guidelines, in general, suggest that municipal issuers make disclosures which would be useful to offerees in making their investment decisions. The Guidelines cover a number of specific topics, outlining in general terms the types of disclosure which should be made within each category. Like Schedule A of the Securities Act of 1933, the Guidelines concern disclosure relating to the securities being offered, the issuer, the planned enterprise, the use of proceeds and related financial information. In addition, the Guidelines, like Schedule A, include specific subtopics of disclosure within the general categories.

We view the Guidelines as a beneficial effort to promote increased disclosure to investors. However, the Guidelines are voluntary; they

> "are suggestions of information which may be disclosed in offerings of municipal securities. They are not intended to be

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*/ The Municipal Finance Officers Association subsequently has changed its name to the Government Finance Officers Association.

> legally binding. They represent information that generally should be included in official statements because it would be relevant to investors on most occasions for most issues."

MFOA, Guidelines for Offerings of Securities 3 (1979).

Since the Guidelines are "not intended * * * to create disclosure requirements or a legal obligation to supply any or all items of information that are suggested," id. at 9, they cannot be viewed as an assurance that investors will receive all information material to their decision. Nor does any disclosure guideline, or even requirement, provide a guaranty against misrepresentations. Nonetheless, the MFOA guidelines are a useful reference tool and would provide a meaningful starting point for developing disclosure requirements.

The nature of the Guidelines also makes it impracticable to evaluate the extent of the WPPSS official statement's compliance. Since the Guidelines are not mandatory and the MFOA states that there may "be cases in which some of the suggested information is unnecessary or irrelevant," id., issuers need not treat the Guidelines as the sole route to an offering statement containing full and accurate disclosure. Nor can the Guidelines provide the preparers of such statements with comfort that they have produced an adequate statement.

Moreover, in general, the quality and content of disclosure in an official statement depend on the information

known to the issuer. Accordingly, a meaningful analysis of the Supply System's disclosures, in terms of either the "suggestions" of the MFOA Guidelines or the requirements of the antifraud provisions of the federal securities laws, can only be made after the Commission's staff forms a view as to the extent of the issuer's knowledge during the relevant time periods and the materiality of the information involved. Since the Commission's Enforcement Division has not yet concluded its investigation concerning WPPSS, the Commission does not yet have the comprehensive factual foundation necessary to perform such analysis.

Question

The American Institute of Certified Public Accountants undertook an effort to improve standards of accounting for municipal securities issues. Has the Commission assessed the adequacy of the voluntary program?

Response

As discussed in our earlier response, the State and Local Government Accounting Committee of the American Institute of Certified Public Accountants ("AICPA") undertook an experiment in government accounting and reporting during 1979 and 1980. The project involved twenty-seven state and local governmental units that volunteered to prepare experimental financial statements, for a single, recent period, on the basis of principles which differed from the principles specified in an AICPA audit and accounting guide. The project did not involve a continuing use of differing principles.

In addition to the twenty-seven governmental units that volunteered to participate, twenty-nine other state and local government officials and thirteen people who were not government officials agreed to complete a questionnaire regarding their views on the desirability of various alternatives to existing practices used in the preparation of financial statements for external use.

At the time of the experiment, the AICPA audit and accounting guide, "Audits of State Government Units" (the "Guide") and Statement 1 of the National Council on Governmental Accounting ("NCGA"), an organization supported by the Municipal Finance Officers Association, provided the principal guidance for the

preparation of financial statements by state and local governments. The purpose of the experiment was to evaluate the accounting principles described in the Guide, which some users contended were inadequate to meet the needs of external users of general purpose financial statements. The major differences between the principles used in the experiment and those in general use by governmental units were that the experimental principles involved the application of full accrual accounting (rather than part cash basis, part accrual basis) and consolidation of the financial statements of all funds and account groups (as opposed to a combination of separate statements and combining statements--separate columns for funds and account groups, with memorandum totals). The intended consequence of these differences in underlying principles was to provide information on cost of services, which would not otherwise be apparent, and to report financial position that included both current and non-current assets and liabilities, including all property accounts.

The 1981 report on the findings of the project revealed mixed results. With the notable exception of the information developed about cost of services, only about one-half of the sixty-nine participants viewed the experimental principles as superior to those specified in the AICPA audit and accounting guide in overall usefulness.

As indicated in our earlier response, neither the Commission nor its staff has made a formal assessment of the adequacy or effect of the AICPA experimental project on accounting and financial reporting by state and local governments. The project

had the potential to create a heightened interest in financial statements for state and local governments which were prepared on a basis closer to that used by private sector enterprises. Had that happened, the AICPA likely would have proposed changes in the Guide along the lines of the experimental principles. That was not the result, and the one-time nature of the experiment produced no significant changes in the AICPA guidance for the preparation of financial statements by state and local governments. However, progress made in another area holds promise for meaningful developments in this area of financial reporting.

A Governmental Accounting Standards Board ("GASB") was established in April, 1984, to succeed the NCGA. The GASB is headquartered in the same building, shares certain common facilities with the Financial Accounting Standards Board, and has a common sponsor, but the two organizations are independent and are funded separately--conditions insisted upon by representatives of state and local governments. Although the GASB replaces the NCGA and the AICPA as the primary source of guidance for the preparation of financial statements by state and local governments, the pronouncements of the AICPA and the NCGA will continue in effect until they are modified or superseded by GASB statements. In matters not covered by a pronouncement of the GASB or its predecessors, standards of the FASB will govern accounting for the activities and transactions of state and local governments.

The GASB expects to release a discussion memorandum in the very near future that will give background information on governmental accounting, discuss measurement focus/basis of accounting alternatives (primarily the consolidation question), address existing revenue and expenditure recognition problems and present issues to be addressed by respondents. It also has projects on its active technical agenda for deferred compensation and pension accounting.

The GASB has two full-time and three part-time board members. The board is supported by a full-time, paid staff devoted to consideration of the accounting and reporting issues involving state and local governments. Never before has an effort of this kind been dedicated to those issues. It is reasonable, therefore, to expect that meaningful progress will be made on identifying problems surrounding the financial accounting and reporting by state and local governments.

A recent Arthur Young & Company report entitled Government Accounting - Procedures and Practices 1985 cites substantial improvements in the governmental financial reporting process. However, our preliminary review of the report indicates that it may be overly optimistic. "Independent audit" as used in the report does not necessarily mean that an audit was performed by a non-governmental auditor. The "modified accrual basis" of accounting referred to in the report is in part a cash basis method. Thus, improvements in accounting and auditing practices may not be as significant as a first impression of the report might indicate.

We believe that voluntary improvements in the financial reporting process will obviously improve the quality of information received by offerees. We also believe that GASB solutions are necessary in order to ensure substantial and uniform disclosure. However, implementation of GASB pronouncements may be difficult as long as state and local governments generally are free to accept or reject external guidance in the preparation of financial statements.

The Municipal Finance Officers Association recognized this deficiency in its May, 1983, study entitled Surveying the States - A Nationwide Look at GAAP and GAAS for Local Government. The MFOA's recommendations called for: (1) state and local governments to prepare and publish comprehensive annual financial statements in accordance with GAAP; and (2) independent audits of these statements conducted in accordance with GAAS. We believe that these recommendations are laudable goals.

Although the absence of a requirement that municipalities comply with GAAP and GAAS militates against adequate financial reporting, we are not certain that direct federal regulation is the best means to improve financial disclosure. Less intrusive alternatives, such as efforts to bring industry pressure to bear on this problem, might achieve the same result. However, in considering any specific proposal, it would be essential to balance the costs involved against the benefits of comparability and additional assurances of accuracy to investors.

Question

When Congress determined in 1933 to exempt municipal securities from the registration requirements of the federal securities laws, one of the reasons for granting the exemption was the belief that the principal purchasers of such securities were institutions, which were able to protect themselves. However, the character of the municipals market has changed dramatically, with substantial changes in recent years. A September, 1983, report of the General Accounting Office noted that, while in 1972, households purchased 16% of all new municipal bonds sales, just a decade later, in 1982, household purchasers accounted for 87% of all new municipal bonds sales. Does this information indicate a need to reassess the policy underlying exemptions for municipal securities?

Response

As discussed in the staff report forwarded to Congress on April 27, 1984, the GAO report concludes that the nature of the municipal bond market has changed substantially since 1933. According to the report, ownership of municipal securities appears to have shifted from institutional investors to individuals. However, as we indicated earlier, it is important to note that the report's definition of "household" includes personal trust accounts that are managed by bank trustees, and that the figure for municipal bond purchases by households includes purchases of municipal bond mutual funds. The report also states that the number of issuers and issues outstanding has risen dramatically, an increase possibly attributable to the general growth of the nation's capital markets.

These factors were considered by Congress during its deliberations on the 1975 amendments to the Securities

Exchange Act of 1934. At that time the Congress chose to address problems in the municipal securities markets through the regulation of municipal securities professionals, rather than removing the registration exemptions.

As discussed in the answers to subsequent questions, we continue to believe that, as a general matter, issues related to the municipal markets should not be addressed by wholesale removal of the registration exemptions. Such an action would impose costs and burdens that we believe are not commensurate with the benefits that would be achieved.

However, we continue to support legislation imposing disclosure requirements for industrial development bonds ("IDB's"). IDB's are dependent for interest and principal repayment on the creditworthiness of the underlying corporate borrower, and thus are much closer to traditional corporate debt than general obligation and revenue bonds.

The Commission's earlier legislative proposals, and in particular the 1978 Industrial Development Bond Act ("IDB Act"), were intended to place commercial entities responsible for the debt obligation under an IDB financing agreement on an equal footing with other corporate entities obtaining financing in the securities markets by removing the registration exemption for IDBs. While the Commission's proposal of the IDB Act was partly in response to abuses in the issue and sale of IDBs by speculative or fraudulent entities, the theory behind removing

the registration exemption from IDBs was that investors ultimately must look to the corporate entity for repayment of interest and principal on the bonds. Consequently, investors need similar disclosure as for corporate bonds in order to assess the creditworthiness of the corporate entity behind the IDB.

The 1984 Tax Reform Act ("Deficit Reduction Act") places an upper limit on the amount of private activity IDBs (with exceptions) that will be accorded federal tax exemption each year and adds a number of other restrictions on IDBs, thus limiting the continued rapid growth in IDB financing. However, it is important to recognize that the Deficit Reduction Act still allows a substantial amount of IDBs to be issued each year. Based on a nationwide population of approximately 233 million, the Act allows the issuance of no more than 35 billion dollars worth of private activity bonds each year. In 1978, when the IDB Act was proposed, only 16.7 billion dollars of private activity bonds were issued. In 1982, only 37.7 billion dollars of private bonds which would be subject to the Deficit Reduction Act's volume restrictions were issued. Of these bonds issued in 1982, 7.3 billion dollars were student loan bonds and the remaining 30.4 billion dollars were IDBs. In contrast, non-tax exempt commercial bonds offerings in 1982 totalled only 44 billion dollars. */ In view of the large

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*/ Of course, some of the $37.7 billion dollars in private activity bonds would qualify for the Securities Act's private offering exemption from registration, while the 44 billion dollar corporate bond figure includes only public offerings.

amount of IDBs which still may be issued under the Deficit Reduction Act's provisions, we believe that the need for corporate disclosure expressed in the IDB Act remains in full force.

Question

In 1976, the Commission developed legislation to enhance disclosure and accounting with respect to municipal securities issuers. What is the Commission's current position on the legislation?

Response

We believe that the 1976 legislation no longer appears appropriate in its entirety. In particular, the 1976 legislation may have been excessive in requiring municipal issuers to prepare both annual reports and distribution documents. The increased costs entailed in continuous periodic disclosure would be substantial for large municipalities and states which are not frequent participants in the municipal bond market. Moreover, it is not clear that the costs of producing periodic reporting documents would be justified by the incremental increase in investor protection, because secondary market trading of municipal securities is confined primarily to the first year after issuance and to securities of issuers who go to market frequently. In light of these factors and the relatively low default rate on municipal bonds, the costs of imposing continuous disclosure requirements on all municipal issuers would appear to exceed the resulting benefits. */

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*/ One possible approach would be to require an issuer that distributes securities into the market to prepare a distribution document relating to those securities, but not to require annual reports from municipal issuers.

Nonetheless, we continue to believe that the flow of information to investors concerning municipal issuers should be strengthened. In this regard, we are concerned over both the quality and availability to public investors of municipal disclosure documents. The Commission believes that the least intrusive means to address these concerns would be the repeal of Exchange Act Section 15B(d)(2) which prohibits the Municipal Securities Rulemaking Board ("MSRB") from even indirectly requiring the preparation of offering statements. If Section 15B(d)(2) were repealed, the MSRB could, for example, condition participation in an underwriting on the exercise of due diligence in the review of the offering statement or on obtaining contractual assurance that the issuer will prepare an offering statement or include financial statements prepared in accordance with standards established by the GASB. */

Another possible use of this authority would be to require issuers to make available any offering statements that they prepare in sufficient amounts and on a timely enough basis so that broker-dealers could readily provide these documents to investors. Municipal issuers often prepare some form of the offering statement when new issues are sold, in order to avoid

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*/ The SEC, of course, has oversight responsibilities for the MSRB and is required to review and approve or disapprove, after public notice and comment, MSRB rule proposals.

liability for non-disclosure under the federal securities laws' antifraud provisions. Currently, if offering statements are prepared, the MSRB requires broker-dealers to send such statements to investors. Frequently, however, this requirement is frustrated by the issuer providing an inadequate number of copies or providing the offering statement too late to be sent with customer confirmations, as the MSRB rule requires. As a result, investors often do not receive any disclosure concerning the municipal issuer or the offering. These actions, of course, rely on the impetus of Rule 10b-5 liability to encourage the issuer to make available an offering document, and, in that sense, limit any additional federal disclosure requirements imposed upon municipal issuers.

Question

In a March 11, 1976 speech, former Commissioner A.A. Sommer, Jr. suggested that provisions similar to Section 11 of the Securities Act of 1933 might be useful in connection with offerings of municipal securities. What is the Commission's view on this suggestion?

Response

Under the federal securities laws, the potential liability for registration statement-related misrepresentations and omissions of material fact, coupled with the requirement to file such statements, acts as a deterrent to fraudulent activity. It is not clear, however, the extent to which the same result would be obtained if liability for offering statement-related misrepresentations and omissions were imposed on municipal securities issuers and professionals. Since there are no affirmative disclosure requirements related to such entities, imposing Section 11-type liability might act to deter the voluntary preparation of disclosure materials rather than serve as a protection against fraud, if issuers sought to protect themselves by reducing the information they disseminated. On the other hand, it is not clear whether market pressures would permit securities to be marketed with substantially reduced disclosure.

In any event, as discussed in the previous question, we believe that the least intrusive means of improving municipal disclosure would be repeal of Exchange Act Section 15B(d)(2).

This repeal would give the MSRB authority to condition municipal underwriting on additional factors it deemed important, including possibly the preparation of offering statements and the use of due diligence in the review of these statements. Although it is possible that additional information might indicate that other means of improving disclosure about municipal securities might be more appropriate, on the basis of our current information, this means would appear to be adequate.

Question

What are the Commission's recommendations for legislation to enhance the integrity of the government bond market?

Response

There are a number of problem areas in the government securities market which the Commission, bank regulators and industry representatives are currently addressing. In addition, we understand that the General Accounting Office is undertaking a survey of the Federal Reserve System's supervision of the Treasury securities market. We suggest that these efforts may produce substantial progress in addressing current problem areas and that they should be completed and evaluated before additional legislative efforts are considered.

The Federal Reserve Bank of New York has taken certain actions designed to improve the functioning of the markets, following the failures of certain unregulated dealers, which resulted in highly-publicized losses to participants in the market and raised temporary concerns about the integrity of the market. It strengthened its unit devoted to market surveillance and acted quickly to curtail certain practices with respect to repurchase agreements that contributed to the losses incurred. Furthermore, the New York Federal Reserve undertook to work more broadly with the dealer community to reform other practices in the government securities market. Specifically, the New York Federal Reserve expressed its intention to address the areas of capital adequacy, provision of timely audited financial information, credit exposure related to lengthy periods of "when-issued"

trading, extension of reporting on positions and transaction volume to a broadened group of dealers and securities clearance activities.

The Commission, of course, believes the adequate capitalization of market participants will have a positive impact on the integrity of the markets. Following close cooperation with the Commission and market participants, the Federal Reserve Bank of New York recently proposed for comment standards of a voluntary capital adequacy program which would apply to government securities dealers that are not subject to Federal supervisory oversight. */ Although the proposed standards are voluntary and traditional methods of governmental enforcement will not be available, the Commission notes that the New York Federal Reserve's informal methods in other areas have proven effective. **/ The market has a relatively small number of high volume participants and the resulting market forces provide significant impetus to implementation of market standards to all market participants.

We believe that the New York Federal Reserve's capital proposal addresses the most important of the areas the New York Federal Reserve has undertaken to explore. The Commission's financial responsibility program which includes rules establishing

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*/ Those participants who are registered with the Commission will continue to be subject to the Commission's net capital rule, Rule 15c3-1.

**/ We understand that the Federal Reserve Bank of New York will expect all primary dealers to request a certification letter from an unsupervised dealer counterparty with respect to compliance with a particular capital standard.

minimum net capital standards, limiting broker-dealer use of customer assets and requiring recordkeeping by broker-dealers has proven effective in providing safeguards to customers and in aiding market integrity. We stand ready to provide assistance to the New York Federal Reserve in exploring the propriety of utilizing these protective devices as was done in the area of capital adequacy. In addition, we are certain that the Federal Reserve's and industry's joint efforts in other areas will result in concrete proposals for improvement.

The Commission continues to be concerned that parties to repurchase agreements, many of whom are not sophisticated in money market activities, are not always adequately protected in their transactions. There is no regulatory or statutory substitute for exercising caution in engaging in repurchase transactions. Above all, parties to such agreements should be aware of the financial strength of counterparties to transactions in which they engage. Capital guidelines and the provision of timely audited financial information aid in making such informed credit judgments. In addition, parties lending funds should ensure that they receive securities of adequate value to collateralize those funds and that their interest in such collateral is sufficient in the event of insolvency of the counterparty. Continuous monitoring of the value of the collateral and requiring corresponding mark-to-the-

market payments have a direct impact on risk exposure. Parties borrowing funds should be aware that the margin given to collateralize funds received is subject to risk in the event of the insolvency of the counterparty. In particular transactions engaged in with any one party should be monitored to assure that the aggregate risk undertaken is appropriate in light of the circumstances.

The Commission staff is also concerned about certain clearance and settlement inefficiencies in government securities secondary markets, but expects considerable improvements during the next year. Recent and future improvements that focus on developing automated clearance, securities loan marking, and trade settlement systems should reduce the risk of dealer insolvencies due to operations failures and should increase secondary market integrity by increasing dealer financial responsibility. Among other things, automated clearance and securities loan marking systems help dealers track and meet their securities settlement obligations, help maintain the value of securities that collateralize dealer loans and repurchase agreements and help to prevent abuses that could lead to government dealer failures.

The Commission staff understands that, for example, securities dealers and custodian banks are developing a securities depository for government-guaranteed, mortgage-backed securities.

Because such a depository would reduce the movement of physical certificates in trade settlement, the potential for a "paperwork crisis" should be averted. Moreover, because a depository for such securities would act as agent for dealers in settling trades, effective depository rules could improve dealer financial responsibility. The Commission staff expects to meet with federal agency and industry representatives later this month to discuss industry progress, other clearance and settlement problems and possible solutions to those problems.

A related development was the decision by the Federal Reserve Board in April 1984 to examine ways to reduce risks on large dollar wire transfer systems, which are the primary money settlement mechanisms used by government securities dealers and the banking industry. The Board, we understand, is concerned about the risk that a dealer or bank using a private wire system may be unable to meet its payment obligations (particularly to users of wire transfer systems that net all intra-system payments during the day and settle those obligations at the end of the day through a different payment system, such as the Fedwire) and, as a result, cause a rapid deterioration in the financial position of other dealers or banks that anticipated final payment from that dealer or bank. Last year, the Federal Reserve Board solicited comment on ways to contain the effects of a settlement failure, reduce the volume of intra-day credit exposures, control remaining

credit risk and smooth operation of payment systems. We understand that the Board staff is currently reviewing the comment letters it received. Since government securities dealers rely on these systems to settle their securities payment obligations, any action to reduce payment system credit risks should improve the government securities market's financial integrity.

Of course, the Commission also has antifraud authority in the government securities market. Under that authority, fraudulent sales practices such as the recent allegations of excessive mark-ups in zero-coupon treasury receipts can be addressed.

Taken together, these efforts should address several of the problem areas in the government bond markets. Thus, it may be preferable for the Subcommittee to await the results of these efforts before taking further action.