

REMARKS BY  
THE HONORABLE HARRISON A. WILLIAMS, JR.

BEFORE  
THE GOVERNMENT SERVICES SEMINAR

ARTHUR ANDERSEN & COMPANY

MARRIOTT KEY BRIDGE HOTEL

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It is a pleasure to be with you tonight to discuss recent legislative developments affecting the municipal securities markets.

Although the Securities Subcommittee has been very active in recent years, our work has generally not involved accountants or the accounting profession.

As a result, our legislative contact with members of your profession has been minimal.

This is in marked contrast to the attention you have been receiving elsewhere.

The recent activism of the Securities and Exchange Commission, and the Supreme Court's landmark decision in the Hochfelder Case -- holding that negligence alone is not sufficient to establish liability for accountants for failure to conduct proper audits under SEC Rule 10b-5 -- are just two examples of current activities.

As interesting as these and other topical issues are, I will confine my remarks tonight to the area of municipal securities disclosure.

I can think of no more important area than Municipal Securities disclosure.

As taxpayers and as informed and concerned citizens, your interest in the governmental process is obvious; as certified public accountants, your professional interest in achieving improvements in financial management and reporting is of equal import.

In the latter area, I, for one, have found the work of Arthur Andersen & Co., its partners and managers, especially helpful.

Arthur Andersen's report for the Treasury Department on New York City's financial condition and its accounting system, and your pamphlet on "Sound Financial Reporting in the Public Sector: A Prerequisite to Fiscal Responsibility," document your leadership.

And they make clear your commitment to elevating the standards of government accounting.

I think you are to be recognized and commended for these excellent contributions.

Let me begin this evening with a brief review of developments in the primary and secondary municipal bond markets and the pending legislation concerning the regulation of tax-exempt bonds under the securities laws.

I would then like to discuss with you the importance of improved financial reporting in the municipal bond area.

I do not think we need dwell on the reasons for the heightened public interest in the municipal securities markets.

In less than a year, we have witnessed the temporary default of New York State's Urban Development Corporation, the near financial collapse of New York City, and the borrowing difficulties of two States and several large cities.

The result of these events, and the continuing drama in New York City, has been to fix Congressional and public attention on our municipal securities markets.

The responsibilities and liabilities of issuing governments, their officials and municipal securities professionals, such as lawyers, underwriters, and accountants, are now being viewed in a totally new light.

Congress, the Treasury Department, the Securities and Exchange Commission, and forward-looking state and local governmental officials have all begun to study the root causes of current problems and to attempt to formulate long-term solutions.

While my Subcommittee's immediate jurisdiction is over the Federal securities laws, the problems in municipal finance transcend the applicability of these laws and involve fundamental concerns over the ability of our securities markets to generate sufficient capital to meet state and local financing requirements.

In other words, fine tuning the efficiency of our capital markets is not only a necessity in providing investors with more information and protection; it is part of a broader search for

permanent solutions to an array of financial difficulties that now confront local governmental bodies.

It is axiomatic that implementation of long-term solutions to financial problems will cost money.

Maintaining programs in health care, welfare, education, mass transportation, employment, and essential public services will not become less expensive in the years ahead.

Where all of this money will come from, is a matter of pressing concern to all of us; as taxpayers and citizens.

There are several possible answers.

Revenue sharing is one.

Still another is restoring investor confidence in the sound condition of state and local issuers and in the integrity of the municipal market through improved disclosure and reporting requirements as well as through other investor safeguards.

During the years to come, individual investors will be asked and expected to invest to a greater extent than ever before in city and state securities issues.

We all know that at the present time, investor confidence has been damaged and it is, therefore, questionable whether or not these capital needs can be met.

Daily, in all the media, prospective investors are reminded that municipals may be tax-free, but that they can no longer be considered risk-free.

These are not abstract concerns.

Some state and local governments have not been able to market bonds at all; others only at extraordinarily high interest rates.

In some cases, underwriters have declined to bid on issues where they have been unable to satisfy their legal duties to prospective investors.

And banks and other institutional investors have greatly reduced their participation in both the primary and secondary markets.

Last year, the Congress considered and passed the 1975 Securities Act Amendments.

Under this legislation, the municipal securities industry -- bank and non-bank underwriters and dealers -- was for the first time brought under SEC jurisdiction, thus ending forty years of non-regulation of municipal securities at the Federal level.

Now, however, we must address the proper responsibilities of issuers under the Federal securities laws.

These needs were not identifiable, hardly perceptible a year ago.

But today, the situation is far different.

Current financial data, concerning state and local issuers is not always available.

This fact alone has undermined investor confidence in all but the most credit-worthy borrowers.

In addition, in overreaction to this situation, issuers are now faced with protracted and costly negotiations as a prerequisite to getting to market.

They are often forced by underwriters to supply voluminous information, part of which can hardly be considered “material” to, or even digestible by, investors.

And the pendency of several private fraud actions against issuers of municipal securities, as well as the ongoing SEC investigation into New York City’s financings, has underscored the applicability of SEC Rule 10b-5, to municipal securities.

Issuers and underwriters, like accountants, have become somewhat “gunshy” at the prospect of anti-fraud litigation.

Confusion over both the responsibilities and liabilities for straying from the ill-defined path of compliance with the anti-fraud provisions is also threatening to impair the efficiency and long-standing customs and practices of the offering process.

At a minimum, if state and local governments are to be able to raise funds at reasonable costs through the private sector, additional legislation is needed to define both investor needs and professional responsibilities.

Federal, state, and local officials seem to agree on the ultimate objectives, but the consensus breaks down over appropriate means to these ends -- whether voluntary issuer initiatives and market forces are adequate, or whether Federal guidelines are required.

Two bills, which would subject issuers of municipal securities to the Federal securities laws, have been introduced in the Senate.

One bill, S. 2574, would simply remove the exemption for municipal bonds from the Securities Act of 1933 and the Exchange Act of 1934 and thus eliminate any and all distinctions between municipal and corporate securities for the purposes of the securities laws.

The second bill, S. 2969, the Municipal Securities Full Disclosure Act, which I introduced, is predicated upon the same conclusions, reached by Arthur Andersen's "Fiscal Responsibility Report."

Specifically, it tracks your recommendation that "Cities, states, and other political subdivisions should be required to publish (. . . financial) statements annually and in connection with the sales of securities to the public."

My bill would require the preparation and distribution of disclosure documents by government borrowers.

Two types are envisioned in the bill; the annual report, and the distribution statement.

These documents would be "integrated" so that the more detailed information contained in the annual report could be incorporated by reference into the offering circular, which would then be updated by any additional information which might be material to the particular issue.

Beyond the specific provisions, I think it is essential to understand the underlying philosophy behind this legislative proposal.

Municipal Securities may be securities, but they are not corporate securities.

Regulatory commandments and prohibitions in the corporate sector may not be -- and in most cases, will not be -- applicable to units of local government.

Corporations and sovereign units of government are not alike, and in my view, should not be lumped under one regulatory roof.

This is the philosophy inherent in S. 2969.

The bill would, therefore, prescribe disclosure requirements for issuing governments far different and considerably more limited in scope than those contained in the Securities Act.

For example, prior registration and filing and review with the SEC is not required or even permitted.

Of particular interest and importance to your profession, is the provision in the bill which would require the preparation of financial statements, audited by an independent public or certified public accountant.

The SEC would be empowered to prescribe the accounting methods to be followed and the forms to be used in the preparation of such statements to ensure the competency, comparability, reliability, and sufficiency of the data.

It is expected, however, that in the first instance, the Commission will defer to the accounting profession and its established procedures before exercising this authority.

These provisions may well be the most important reforms in the bill.

The present state of Municipal financial reporting in general, and the lack of recognized accounting standards in particular, are anachronisms that can no longer be justified or afforded by taxpayers or investors.

The 1974 Report of the Twentieth Century Fund Task Force on Municipal Bond Credit Ratings identified the problem which is:

“. . . the lack of uniformity in accounting practices and timeliness in the reporting of state and local government statistics.

“Furthermore, not only do the reports differ in definitions, detail, and quality, but their veracity and accuracy are often neither examined nor guaranteed by an independent audit.”

The need for more definite accounting and reporting standards in the public sector is widely recognized.

Arthur Andersen confirmed this in its own study and forcefully reiterated its conclusions last month when Harvey Kapnick testified before my Subcommittee.

Further support for our position came from the Joint Economic Committee in its “1976 Joint Economic Report.”

As experts in governmental accounting, you will no doubt actively participate in designing and operating local accounting systems to conform to this legislation’s provisions.

For my part, I hope this is the case because these systems are not only a rudiment of investor confidence; but more importantly, they are also essential tools of good government and responsible stewardship of public funds.

I am, therefore, hopeful that before long, my Subcommittee can begin its deliberations on S. 2969.

The continued support of Arthur Andersen and the accounting professions will be important in achieving prompt enactment of this most important legislative proposal.

Through seminars of this kind, intra-industry communications, and cooperation with municipal finance officers, I hope that we will be able to achieve our common goal.

Thank you.