STAFF REPORT ON

TRANSACTIONS IN SECURITIES OF THE CITY OF NEW YORK

INTRODUCTION AND SUMMARY

August 26, 1977

S E C U R I T I E S A N D E X C H A N G E C O M M I S S I O N

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OF THE CITY OF NEW YORK

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INTRODUCTION AND SUMMARY

The last offer of securities by the City of New York to the general public was made in March, 1975. Since that time, the public debt market has been closed to the City. On November 15, 1975, the New York State Legislature enacted the Moratorium Act, which suspended the enforcement of the City's short-term debt, because the City was unable to meet its maturing obligations. Thousands of small investors had purchased a substantial part of the approximately $4 billion of short-term securities sold during the six months preceding March 31, 1975. On November 5, 1975, ten days before the passage of the Moratorium Act, certain short-term notes actually traded at a 35 percent discount from their principal face amount. On December 31, 1975, after the Moratorium Act was passed, but before it was declared unconstitutional, prices of certain short-term notes had declined to a 45 percent discount from their principal face amount.

The Investigation

In January, 1976, the Commission commenced an investigation into transactions in securities of the City. The staff's inquiry principally focused on the period from October 1, 1974, to March 31, 1975 — the period during which the City's reliance on short-term borrowing increased dramatically over prior comparable periods, and the period during which the City issued substantial amounts of certain debt instruments to the investing public that remained outstanding at the time of the passage of the Moratorium Act.

During its 19-month investigation, the staff obtained over 250,000 documents and compiled over 12,000 pages of investigative testimony.

The staff's Report is a distillation, analysis and evaluation of the evidence that has been obtained to date. The investigation, which is a continuing one, is in no sense an adjudicatory proceeding. Nor is the investigation or this Report a determination of the rights or liabilities of any person.

Background

For a number of years, the City was incurring increasing deficits in its operations. In order to finance these deficits, and to appear to comply with the legal requirement that it balance its operating budget, the City, among other things, increasingly resorted to the sale of "short-term" debt securities. 1/

On March 31, 1975, the City had outstanding debt in excess of $14 billion, as follows:

$ 7,887,733,170	Funded Debt
1,102,000,000	TANs
1,767,655,000	BANs
3,185,000,000	RANs
107,610,000	Other short-term debt
$14,049,998,170	TOTAL 2/

1/ The "short-term" debt securities offered by the City, with stated maturities of one year or less, included: Tax Anticipation Notes ("TANs"), issued by the City in anticipation of the collection of real estate taxes; Revenue Anticipation Notes ("RANs"), issued in anticipation of the collection of estimated taxes (other than real estate taxes), monies that were estimated to be received from the New York State and federal governments and certain other kinds of revenue; and Bond Anticipation Notes ("BANs"), issued in the anticipation of revenues from subsequent sales of bonds.

2/ Office of the Comptroller, City of New York. "Annual Report of the Comptroller of the City of New York for the Fiscal Year 1974-1975," October 31, 1975, parts 6-A and 6-C.

The City employed budgetary, accounting and financing practices which it knew distorted its true financial condition. These practices enabled the City to issue about $4 billion of short-term securities during the six-month period preceding its preclusion from the Nation's securities markets. 1/ This record amount of securities was issued at the very time the City was on the brink of financial collapse.

In fact, the City dramatically increased its short-term debt six-fold — from $747 million to $4.5 billion — in the six years from 1969 to June 30, 1975. The New York State Charter Revision Commission primarily attributed this "enormous increase" in the City's debt to:

> . . .the City's refusal to soundly finance its expense budget. Since 1970-71, every expense budget has been balanced with an array of gimmicks—revenue accruals, capitalization of expenses, raiding reserves, appropriation of illusory fund balances, suspension of payments, carry-forward of deficits and questionable receivables, and finally, the creation of a public benefit corporation whose purpose is to borrow funds to bail out the expense budget. 2/

These practices, it was concluded, did not "produce any cash in themselves; they simply enable[d] the City to borrow to pay current expenses." 3/

The June 30, 1975 deficit, as later adjusted by the City, exceeded $5 billion. Reliable financial information was unavailable, and the adjusted deficit could only be estimated because, among other things, the City's internal accounting control system had been deficient in material respects.

1/ Id.

2/ Preliminary Recommendations of the State Charter Revision Commission for New York City, p. 33.

3/ Id.

The estimates of receivables, which formed the basis for the huge amount of RANs and TANs offered in the October, 1974 - March, 1975 period, were overstated by the accrual of revenues, including federal and New York State aid receivables and real estate and other local taxes which were unearned, uncollectible or non-existent. For example, on October 1, 1974, a consultant to City Comptroller Goldin prepared an internal memorandum, stating in part:

> To balance the expense budget, the City employs a series of unsound budgeting and accounting practices including carrying forward bogus receivables, levying taxes on City-owned property. . . [and] overestimation of revenues. . . . The total amount of bad receivables which may have been rolled over exceed $500 million. 1/

Subsequent reports of New York State and City officials disclosed yet additional, significant areas in which the City's actual financial condition during the October, 1974 - March, 1975 period was vastly different from that claimed by the City and its officials.

During this period, the City continued to issue debt securities to investors throughout the United States and in foreign countries.

1/ Graphic evidence of these practices was confirmed by two audit reports on New York City prepared by the New York State Comptroller in July and August 1975. Thus, for example, he estimated that "the $502 million of real estate taxes receivable on the City's books at June 30, 1975 [was] overstated by approximately $408 million. . . ." Similarly, the State Comptroller also found that receivables from New York State and the federal government, which formed a basis for the issuance of RANs, were "grossly overstated." In an examination of $373.3 million out of $434.2 million of such receivables, the Comptroller "found them to be overstated by $324.6 million." Audit Reports Nos. NYC-3-76 and NYC-26-76.

As the City's financial plight worsened, it reduced the minimum face amount of the instruments it issued from $25,000 to $10,000, in order to penetrate the individual investor market more effectively. City securities were also placed with the City's pension funds and with a bond sinking fund -- funds under the management of City officials, who were acting in fiduciary capacities on behalf of the beneficiaries of such funds.

The critical importance of adequate disclosure to public investors during this period is illustrated by a letter of April 1, 1975 written by counsel involved in the distribution of the City's securities:

> In view of the rapidity with which events are developing in connection with the City's finances, we feel it is appropriate to summarize for the Banks our views on what has come to be known as the question of "disclosure." You will recall that an attempt was made to address the problem in the form of the City's Report of Essential Facts dated March 13, 1975. While it may be possible by updating and supplementing that Report to satisfy the applicable legal requirements with respect to future underwritten offerings, we understand from our discussions with the banks that the adverse information which would be required in such a report, would in all likelihood render the City securities unsaleable. 1/

In a May 4, 1976, speech, 2/ the City's Comptroller, Harrison J. Goldin, sought "to describe some of the conditions which existed, with respect to accounting and budgeting at the start of the City's fiscal crisis" as follows:

1/ Letter of White & Case.

2/ Address of New York City Comptroller Harrison J. Goldin, at the Annual Conference of Municipal Finance Officers Association of the United States and Canada, San Francisco, California, May 4, 1976.

> The City could not be sure of the amount of valid State and Federal receivables because agencies conducted their own negotiations on Federal and State grants, provided their own budgetary input on the amounts expected, spent the money long before the grants were received (if, indeed, they were ever received) and clung to a touching faith in the validity of receivables long after they had proved as unreliable as a politician's promise.
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> * * * *
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> The City could never count on receiving the full amount of real estate taxes budgeted in any particular year, because it insisted on budgeting 100 percent of the tax levy even though it was the invariable experience in New York - even in better times - that collections would run less than 95 percent of the tax levy. The difference in the case of tax levy of over three billion would obviously be somewhere around $200 million.
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> * * * *
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> There was a broad feeling, I believe, that even though the City's accounting and budgeting had been revealed as a kind of Rube Goldberg conception - a system which defied understanding or control - it was better to leave it alone as long as it churned out enough money to meet the bills and pay the debts.

The functioning of the process by which City securities were brought to the market place depended not only upon the issuer, but also upon the principal underwriters, bond counsel and rating agencies. As is evident from the facts set forth in this Report, in varying degrees, they also failed to meet their responsibilities. Thus, public investors were denied the protections to which they were entitled.

The Report

This Report consists of seven chapters. Chapter One of the Report, the Chronology, describes the principal financial events during the critical period. It sets forth the meetings and other events participated in by

City officials, bond counsel, the underwriters of the City's securities, rating service officials and certain other persons. The Chronology, and the underlying evidence on which it was prepared, set forth, in large part, the factual basis for the succeeding Chapters which examine the roles of the various participants in the offer and sale of the City's securities to the investing public.

Chapter Two discusses certain of the City's unsound accounting and reporting practices, and the system of internal accounting control on which financial data of the City was based. These practices successfully obscured the City's real revenues, costs and financial position. Substantial weaknesses in the City's system of internal accounting control caused its financial information to be inherently unreliable. Many of the City's accounting practices were specifically designed to assist the City in its budget-balancing exercises by prematurely recognizing revenues and postponing expenses to unrelated future periods. The increase in revenue recognition was accomplished by the accrual of revenues, including federal and New York State aid receivables and real estate and other local taxes which were unearned, uncollectible or nonexistent. The essentially cash-basis accounting for City expenditures failed to recognize significant costs incurred but unpaid during the year, including millions of dollars annually in pension costs, which were calculated based on outdated actuarial assumptions and paid two years later. These were significant factors which contributed to the City's financial difficulties and enabled it to borrow funds from the public which could not be supported by its sources of revenue.

Chapter Three describes the role of the City and its officials in the events surrounding the City's fiscal crisis. It concludes that:

(1) City officials were aware that there was an ever-growing disparity between revenues and expenses;

(2) City officials employed certain unsound budgetary, accounting and financial reporting practices which created the appearance that revenues and expenses were in balance;

(3) City officials prepared and published various reports which did not, individually or in the aggregate, clearly and accurately describe such practices or reveal the City's true financial condition; and

(4) The Mayor and the Comptroller made numerous reassuring public statements concerning the City's financial condition and the safety of investments in the City's debt securities, which statements facilitated the sale of the City's securities, and which did not provide adequate disclosure of the facts.

In sum, the Mayor and the Comptroller misled public investors in the offer, sale and distribution of billions of dollars of the City's municipal securities from October, 1974, through at least March, 1975.

Chapter Four focuses upon the key role played by the underwriters in the distribution of the City's securities. It discusses the underwriters' knowledge of the financial crisis and the City's related problems, the inadequacies of their disclosure of materially adverse information regarding the budgetary and financial problems of the City, and their failure to fulfill their responsibilities to the investing public. It also discusses the realization of these underwriters, and their failure to disclose, that their capacity to distribute substantial additional quantities of securities successfully was significantly impaired because of the City's financial crisis and that the market had become saturated with City securities. As the City's fiscal crisis further deteriorated, the public was subjected to a confusing and contradictory financial picture, with the result that public investors were misled.

Chapter Five discusses the role of the rating agencies. These agencies rate the creditworthiness of municipal obligations. Their ratings have a significant impact upon investment decisions and access by municipalities to the capital markets. The agencies appear to have failed, in a number of respects, to make either diligent inquiry into data which called for further investigation, or to adjust their ratings of the City's securities based on known data in a manner consistent with standards upon which prior ratings had been based.

Chapter Six examines the role of bond counsel. During October, 1974, through March, 1975, four firms issued opinions on the validity of the issuance of New York City securities. The Report examines the engagement of the firms and the procedures they used in providing their opinions. The Report also explores bond counsel's awareness of circumstances relating to the City's fiscal problems that affected matters basic to bond counsel's opinions. In addition, the Report examines the knowledge of bond counsel of other matters that should have been, but were not, disclosed to investors. The Report concludes that bond counsel, when on notice of circumstances that called into question matters basic to their opinions, should have conducted additional investigation. It also concludes that bond counsel, who continued with their engagement having knowledge of information material to investors, should, in view of the particular circumstances, have taken reasonable steps to satisfy themselves that such material facts were disclosed to the public.

Chapter Seven contains analyses of the responses received from questionnaires sent to individual investors, syndicate members and managing underwriters. The individual investor responses indicate that the majority had never invested in municipal securities before, and 90 percent responded that a factor in their investment was their belief that an investment in City securities was "safe and secure." The survey also found that, at the time they made their investments:

— 78 percent of the investors believed the City's bookkeeping and accounting practices to be excellent or good; and

— 79 percent of the investors believed that the City was in good or excellent financial condition.

Additional comments volunteered by a number of these individual investors concerning their experiences with these investments were overwhelmingly negative, and indicated quite clearly that, in their purchase of City securities, they had been "misled."

Epilogue

The Commission's mandate is to assure that investors in securities, whether issued by municipalities or others, receive the protections afforded by the federal securities laws. This Report concludes that investors in the securities of New York City did not receive those protections.

On a number of occasions, the key participants had a clear opportunity to prevent further serious damage to public investors. However, they did not do so. As the City's financial condition deteriorated, additional steps were taken to sell its notes to individual investors, thus unfairly and improperly shifting the inherent risks. At a minimum, before such a shifting of risk was attempted, the key participants had the duty to assure adequate disclosure upon which investment decisions could be predicated.

Depriving investors of their clearly defined rights cannot be justified by the need to provide vital services to New York's citizens. Rather than serving the salutary goals the City sought to effect, the failure to make meaningful disclosure prolonged the agony of the City's fiscal crisis, and delayed major necessary corrective efforts. This failure caused undue risks and substantial injury to investors in the City's securities. It also impaired the liquidity of a number of the City's major banks, which are leading financial institutions in the United States, and cast a pall on the capacity of municipalities generally to utilize the Nation's securities markets to fund their essential operations.

It is imperative that persons with responsibilities in the marketing of municipal securities reassess their roles to assure that, when required, they will meet the demands of such occasions. It is hoped that this Report will be studied by the various participants in municipal financing, and that they will commence a critical review of the facts as the first step in the development of a program designed to place into effect at the earliest possible time the necessary remedial measures, not only to prevent a recurrence of what took place in New York City, but also to install a system that will assure municipalities vital access to the Nation's securities markets and the protection of those who invest in municipal securities.