

96th Congress }  
1st Session }

COMMITTEE PRINT

SECURITIES AND EXCHANGE COMMISSION

FINAL REPORT

IN THE MATTER OF  
TRANSACTIONS IN THE  
SECURITIES OF THE CITY  
OF NEW YORK

---

COMMITTEE ON BANKING, HOUSING, AND  
URBAN AFFAIRS  
UNITED STATES SENATE



FEBRUARY 5, 1979

Printed for the use of the Committee on Banking, Housing, and  
Urban Affairs

---

U.S. GOVERNMENT PRINTING OFFICE

40-396 O

WASHINGTON : 1979

**COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS**

**WILLIAM PROXMIRE, Wisconsin, *Chairman***

**HARRISON A. WILLIAMS, Jr., New Jersey**

**ALAN CRANSTON, California**

**ADLAI E. STEVENSON, Illinois**

**ROBERT MORGAN, North Carolina**

**DONALD W. RIEGLE, Jr., Michigan**

**PAUL S. SARBANES, Maryland**

**DONALD STEWART, Alabama**

**PAUL E. TSONGAS, Massachusetts**

**JAKE GARN, Utah**

**JOHN TOWER, Texas**

**JOHN HEINZ, Pennsylvania**

**WILLIAM L. ARMSTRONG, Colorado**

**NANCY LANDON KASSEBAUM, Kansas**

**RICHARD G. LUGAR, Indiana**

**KENNETH A. MCLEAN, *Staff Director***

**M. DANNY WALL, *Minority Staff Director***

**ELINOR B. BACHRACH, *Professional Staff Member***

TABLE OF CONTENTS

	<u>Page</u>
I. SUMMARY .....	1
II. THE COMMISSION'S INVESTIGATION .....	1
A. Background .....	1
B. The Staff Report .....	3
C. Subsequent Developments .....	4
D. Termination .....	5
III. THE NEED FOR LEGISLATION .....	6
IV. EXISTING AND RECENTLY PROPOSED SYSTEMS OF REGULATION .....	9
A. The Municipal Securities Rulemaking Board .....	9
B. Municipal Finance Officers Association Guidelines .....	11
C. State Regulatory Efforts .....	13
D. Recent Federal Efforts .....	15
V. CONCLUSION .....	24
APPENDIX: Supplemental Staff Report	



OFFICE OF  
THE CHAIRMAN

SECURITIES AND EXCHANGE COMMISSION

WASHINGTON, D.C. 20549

February 5, 1979

The Honorable William Proxmire  
Chairman  
Committee on Banking, Housing  
and Urban Affairs  
United States Senate  
Washington, D. C. 20510

Dear Mr. Chairman:

I am pleased to transmit herewith the Commission's Final Report In the Matter of Transactions in the Securities of the City of New York.

This Report is submitted pursuant to your requests made in connection with the Committee's oversight responsibilities relative to the New York Seasonal Financing Act of 1975 and the New York City Loan Guarantee Act of 1978. With this Report, the Commission has determined to conclude its investigation In the Matter of Transactions in the Securities of the City of New York.

With best wishes.

Sincerely,

A handwritten signature in black ink, appearing to read "Harold M. Williams", written over a horizontal line.

Harold M. Williams  
Chairman

SECURITIES AND EXCHANGE COMMISSION

FINAL REPORT IN THE MATTER OF TRANSACTIONS  
IN THE SECURITIES OF THE CITY OF NEW YORK\*

I. SUMMARY

With the issuance of this release, the Commission announces the termination of its investigation in In the Matter of Transactions in Securities of the City of New York and calls for legislation to deal with problems, of national concern, which exist in the municipal securities markets.

II. THE COMMISSION'S INVESTIGATION

A. BACKGROUND

During the period from October 1974 through March 1975, New York City's increasing fiscal problems forced it to issue approximately \$4 billion of short-term debt securities. The City's excessive use of short-term borrowing eventually caused the market for its securities to become saturated. After March 1975 the public capital markets closed to the City and by November 1975 it was unable to meet its maturing obligations as they became due. At that time New York State passed legislation which attempted to impose a moratorium on the City's short-term debt obligations. Subsequently, the moratorium legislation was invalidated by court decision and the City redeemed its short-term debt securities through a financing arrangement between the City and New York State's newly-created Municipal Assistance Corporation ("MAC"). In the interim, however, these securities traded at substantial

---

\* Commissioner Karmel did not participate in the consideration of this matter.

discounts from their principal amounts and losses were incurred by public investors who sold their securities.

Because of New York City's major position in the municipal securities markets, its financial crisis posed a grave threat to those markets. The information concerning the crisis, its causes and implications was fragmentary and incomplete. The lack of any organized regulatory mechanism in this area prevented the assembling of the necessary information in an organized fashion. Members of Congress and others interested in the health of the municipal securities markets called for a comprehensive inquiry into New York's City's financial crisis. The Commission, although its primary responsibilities are not in the area of municipal securities disclosure, nevertheless undertook the comprehensive investigation that was required.

The Commission took the unusual step of publicly announcing commencement of the investigation in order to make its objective clear. 1/ The purpose of the Commission's investigation into the activities and practices of those who engaged in the offer and sale of New York City securities was to determine whether violations of the federal securities laws had occurred, and to determine whether to publish a report of the investigation, prescribe needed regulations and/or to recommend legislation.

To achieve the ends of its investigation as promptly as possible, the Commission expended substantial amounts of

---

1/ Commission Press Release, January 8, 1976.

its staff resources. The investigation was one of the largest and most complex in the Commission's history, involving the collection of more than 250,000 documents and the taking of over 12,000 pages of sworn testimony.

B. THE STAFF REPORT

Following the staff's investigation, a comprehensive staff report describing the conduct of those persons participating in the events leading to the City's crisis was released. 2/ The Staff Report was primarily factual in nature and focused on events in the City's fiscal crisis which occurred during the period from October 1974 to April 1975.

The Staff Report concluded that the City had employed budgetary, accounting and financing practices which distorted its true financial condition and that investors in its securities did not receive the protections of the federal securities laws. The Staff Report also concluded that, in varying degrees, the participants in the underwriting process, including the principal underwriters, bond counsel and the rating agencies, failed to meet their responsibilities to the investing public.

Through the issuance of the Staff Report, a major purpose underlying the Commission's investigation was fulfilled. Making public a comprehensive report of the facts developed by the Commission's investigation brought to light the facts regarding

---

2/ Securities and Exchange Commission, "Securities and Exchange Commission Staff Report on Transactions in Securities of the City of New York," (Washington: U.S. Government Printing Office, August 1977) ["Staff Report"].

the New York City situation and helped to focus attention on the need for further action directed toward investor protection in the municipal securities area.

C. SUBSEQUENT DEVELOPMENTS

Following release of the Staff Report, the staff proceeded to determine what corrective measures had been taken to ameliorate the problems uncovered in the staff investigation. Meetings were held with representatives of the City, and each of the underwriters, rating agencies and bond counsel mentioned in the Staff Report. Thereafter, the participants in the meetings submitted further comments. The appendix hereto is a supplemental staff report containing a summary of significant actions by the City, the underwriters, the rating agencies and bond counsel taken since the issuance of the Staff Report; as well as steps taken at the federal and state levels to improve the City's fiscal condition.

The federal government initiated seasonal loans to the City and the Emergency Financial Control Board was formed by New York State to oversee the City's efforts to respond to the fiscal crisis and implement fiscal reforms. In 1978, the oversight duties of the Control Board were extended on a long-term basis. In August 1978, the New York City Loan Guarantee Act of 1978 was enacted. That Act authorizes the Secretary of the Treasury to guarantee City indebtedness, provided the City complies with certain fiscal and financial requirements.

The City has made efforts to install improved accounting and fiscal controls and restraints. As indicated in the



appendix, however, further improvements are necessary. Moreover, the effectiveness of any system of controls and restraints is dependent upon the dedication and will of those whose responsibility it is to implement and maintain that system. It should also be noted that steps taken to date or taken in the future to improve the City's accounting practices and disclosure standards cannot directly increase its income, reduce its debts and expenses or change its underlying economic condition.

D. TERMINATION.

After thorough consideration of various alternatives which might be taken, including the possibility of enforcement actions, the staff recommended and the Commission has concluded that the public interest will best be served by Commission efforts in support of legislative solutions to the complex problems existing in the municipal securities field. The Commission has brought, and will continue to bring, enforcement action against those who violate the federal securities laws in connection with municipal securities. In the present circumstances, however, the Commission believes that enforcement proceedings should not be instituted.

The Commission's decision was based on a number of factors. Among the factors considered were the issuance of the comprehensive Staff Report; the change in the City's administration since the issuance of the Staff Report; various remedial actions taken by those who were mentioned in the Staff Report, most particularly by the City itself; Congressional and State actions with respect to New York City's financial difficulties, including the federal legislation enacted in August 1978 which imposes certain financial

controls over the City and requires, among other things, that the City's financial statements be audited; and, finally, the Commission's determination that enforcement action, which could well be protracted, would have limited additional remedial value and would require the commitment of substantial additional resources which, in light of the above, can be otherwise utilized more efficiently in discharging the Commission's responsibilities. Accordingly, with this report, the Commission has determined to conclude its investigation into In the Matter of Transactions in the Securities of the City of New York.

### III. THE NEED FOR LEGISLATION

New York City's experience exemplified the problems which may be encountered when a financially troubled municipality offers and sells its securities to the public. Due to the scope and severity of the City's problems, the Commission, its staff and all those interested in the municipal securities area obtained new and significant insights. The remedial actions taken by those mentioned in the Staff Report are instructive lessons for those currently engaged in municipal finance concerning improvements which serve both their own interests and those of the investing public.

The municipal securities markets were once almost the exclusive province of institutional investors located in or near the issuing municipality. Today, these markets are nationwide in scope and rival the corporate securities markets in both number of issues and their dollar value. The markets

now include many middle income public investors attracted by the tax advantages provided by federal tax laws to holders of municipal securities. 3/ As a result, securities issued by municipalities throughout the United States increasingly are competing with each other and with other types of investments for the available supply of investor dollars.

No regulatory system comparable to the system established for corporate securities by the federal securities laws exists with respect to municipal securities. Municipal securities are subject to the anti-fraud provisions of the federal securities laws, but are specifically exempted from their registration and reporting provisions. No independent checks are required in the municipal securities area that would reasonably assure that what is publicly disclosed by municipalities is reliable and accurate. There is no requirement that financial statements prepared for investors be audited, or that the audit be conducted by independent accountants. There appears to be no clear understanding that the underwriter should make a reasonable investigation to assure the accuracy of the information disclosed. There also is no clear

---

3/ This trend is evidenced by the proliferation of publicly-owned investment companies which invest in municipal bonds. Statistics for the period indicate that approximately \$10 billion worth of "unit-trust" funds were sold to the public from 1961 through 1977. The Tax Reform Act of 1976 allowed tax exempt status to be passed through to shareholders in "open-end" municipal bond funds as well. In the years 1976 and 1977, shares in thirty-three such funds were offered to the public and the total net assets of these funds reached \$2.3 billion. Wiesenberger Investment Company Services 41-42 (38th ed. 1978).

separation or statement of the functions of issuers' and underwriters' counsel.

Municipalities must have access to the public capital markets to raise the substantial amounts of money they need. Such access can only exist in an environment of investor confidence. Unlike the markets for securities of other types of issuers, however, the municipal securities markets have only limited investor protection mechanisms, and these mechanisms exist largely as a result of voluntary practices.

In the Commission's view, the conduct described in the Staff Report vividly illustrates the problems which can develop in the absence of an adequate system of regulation. The distortion of the City's true financial position, the inadequacies of the disclosures provided to the investing public and the failure of market participants to provide adequate protections to investors are abuses symptomatic of the inadequacies of the existing statutory framework -- a framework that leaves municipal securities disclosure largely unregulated. Thus, while the problems associated with New York's financial crisis may be indicative of individual wrongdoing, in a broader sense they demonstrate the compelling need for a statutory framework which would provide the basis for a clearer understanding by issuers and other participants in the municipal securities markets of their responsibilities and which would seek to

assure that public disclosures by municipalities are reliable and accurate. The lack of such a system, and the concomitant implications for the maintenance of investor confidence, are matters of national concern.

#### IV. EXISTING AND RECENTLY PROPOSED SYSTEMS OF REGULATION

Notwithstanding its call for a legislative program, the Commission believes that it is important to note that a number of efforts have been made to remedy abuses in the municipal securities markets and increase investor protection. Legislation was enacted, which the Commission strongly supported, to establish a system of regulation for certain municipal securities professionals. Certain states have proposed or adopted requirements with respect to disclosure by municipal issuers and certain issuers voluntarily have followed guidelines established by the Municipal Finance Officers Association. In addition, there have been a number of legislative proposals with respect to municipal securities disclosure.

##### A. THE MUNICIPAL SECURITIES RULEMAKING BOARD

Prior to the adoption of the Securities Acts Amendments of 1975 (the "1975 Amendments") <sup>4/</sup>, the market activities of municipal securities firms and dealers were substantially

---

<sup>4/</sup> Securities Acts Amendments of 1975, Pub. L. No. 94-29, 89 Stat. 97 (codified in scattered subsections of 15 U.S.C. 77-80).

unregulated. In the early 1970's the Commission initiated several actions against municipal securities professionals based on fraudulent trading and selling practices. 5/ In response to the abuses found in this area, Congress, with the support of industry representatives and the Commission, enacted a system of regulation and registration for dealers engaged in underwriting and trading municipal securities.

The 1975 Amendments also created the Municipal Securities Rulemaking Board (the "MSRB"), with primary responsibility for developing rules governing professional qualifications, recordkeeping, quotations and advertising. To date, the MSRB has adopted sixty rules. 6/ These include various "fair practice" rules dealing with suitability, fair pricing and commissions, and the supervision of employees. 7/

- 
- 5/ The Commission has on numerous occasions brought actions against various participants in municipal securities offerings under the anti-fraud provisions of the federal securities laws. See, e.g., Securities and Exchange Commission v. The Senex Corporation, 399 F. Supp. 497 (E.D. Ky. 1975); Securities and Exchange Commission v. R.J. Allen & Associates, Inc., 386 F. Supp. 866 (S.D. Fla. 1974); Securities and Exchange Commission v. Chas. A. Morris & Associates, Inc., 386 F. Supp. 1327 (W.D. Tenn. 1973); In the Matter of Jo M. Ferguson, Securities Act Release No. 5523 (August 21, 1974); and In the Matters of Walston & Co. Inc. and Harrington, 43 SEC 508 (1967).
- 6/ The 1975 Amendments expressly preserved the Commission's rulemaking authority. "Nothing in this paragraph shall be construed to impair or limit the power of this Commission under any provision of this title." Section 15B(d)(2) of the Securities Exchange Act of 1934, 15 U.S.C. §§ 78a-78kk (1976).
- 7/ Securities Exchange Act Release No. 15247, 43 Fed. Reg. 50525 (October 19, 1978); Securities Exchange Act Release No. 15248 (October 19, 1978), 43 Fed. Reg. 50526 (October 30, 1978).

These rules also require that, at the time a confirmation is sent, a broker or dealer furnish the investor with a copy of any official statement prepared by the issuer and disclose certain pricing and fee information. The creation of a regulatory system for certain municipal securities professionals was an important step in addressing problems which had developed in the municipal securities market. Nevertheless, that system was not designed to impose any requirements on issuers or directly to promote disclosure concerning municipal securities. 8/

B. MUNICIPAL FINANCE OFFICERS ASSOCIATION GUIDELINES

In December 1976, the Municipal Finance Officers Association (the "MFOA") approved a set of guidelines designed to "provide greater protection to investors through increased disclosure and through standardization of disclosure practices." 9/

---

8/ The disclosure standards which can be promulgated by the MSRB are necessarily limited, since Section 15B(d)(2) of the Securities Exchange Act prohibits the MSRB from requiring issuers, either directly or indirectly, to furnish investors or the MSRB with any "report, document, or information" not generally available. The legislative history of the 1975 Amendments indicates that the amendments "were designed to make it clear that [they] will not be a means of subjecting states, cities, counties or villages to any unnecessary disclosure requirements which could be promulgated by the [MSRB]." 121 Cong. Rec. 10727, 94th Cong., 1st Sess. (1975) (Remarks of Senator Tower).

9/ MFOA, Disclosure Guidelines for Offerings of Securities by State and Local Governments (1976). See also MFOA, Guidelines for Use by State and Local Governments in the Preparation of Yearly Information Statements and Other Current Information (1978); and MFOA, Procedural Statements in Connection With Disclosure Guidelines (1978).

In municipal securities offerings, the MFOA's guidelines provide for, among other things, a detailed description of the issuer's operations and debt structure and an evaluation of the legality of the issuance of the offered securities. The guidelines also suggest that an issuer's financial statements be prepared and presented in accordance with generally accepted accounting principles pursuant to the standards set forth in Government Accounting, Auditing and Financial Reporting ("GAAFR"). 10/ The guidelines are not mandatory; however, compliance with the guidelines would improve disclosure practices in the municipal financing area. 11/

Sufficient data is not yet available to determine whether the guidelines have had meaningful impact on the quality of disclosure available in the municipal marketplace. A 1976 study by a major accounting firm noted a "substantial lack" of conformity with generally accepted accounting principles applicable to governmental bodies and concluded that "this points up the hopelessness of voluntary compliance." 12/

---

10/ National Committee [now Council] on Government Accounting (1968).

11/ See generally, Peterson, Searching for Standards: Disclosure in the Municipal Securities Market, 1976 Duke L. J. 1177.

12/ Coopers & Lybrand, Financial Disclosure Practices of American Cities: A Public Report (1976). It has been estimated that approximately 50% of state accounting systems are prepared on a basis which is inconsistent with generally accepted accounting principles. Anthony, Fiscal Accounting in Non/Business Organizations (1978). Few issuers have taken advantage of a long-standing MFOA policy of issuing so-called Certificates of Conformance to municipalities which comply with GAAFR. Id. at 37.



### C. STATE REGULATORY EFFORTS

Only a few states require that prospective purchasers be furnished with the type of information essential to an informed investment decision. General obligation offerings by Oregon municipalities must be accompanied by a disclosure statement which conforms with the MFOA guidelines. 13/ North Carolina has adopted one of the most comprehensive regulatory frameworks. 14/ All municipal and public authority debt is issued by the State Treasurer's Office. Municipal official statements must include financial data which is independently audited and prepared in accordance with uniform principles. Disclosure standards similar to the MFOA guidelines are also required.

In the past few years several regulatory programs have been proposed by various other states. While certain of these programs are directed at needed reforms, there does not appear to be any nationwide movement among the states to adopt a strong uniform regulatory system. Even in those states where there have been tentative responses to the problems in the municipal securities financing area, difficulties have been encountered. The recent experience of Massachusetts is instructive in this regard. In early 1977, the Massachusetts State Legislature passed a bill which would have subjected

---

13/ Or. Rev. Stat. ch. 59, §135 (1967); Or. Rev. Stat. ch. 287, §018 (1977).

14/ N.C. Gen. Stat., ch. 159, §3, 45, 51 (1971).

municipal and public authority issuers to the registration and reporting provisions of the state securities law. The Massachusetts State Securities Commission would have been empowered to adopt specific disclosure requirements. The bill was criticized widely by the municipal securities industry and was recalled and defeated prior to its approval by the Governor. A more limited measure was subsequently adopted.

The New York State Legislature has also failed to adopt any meaningful disclosure legislation to date. As part of his legislative program, in each of the last three years the Governor has proposed a bill which would require local government units to prepare and file offering circulars in connection with public offerings of bonds and notes. The circulars would contain information prescribed by disclosure regulations adopted by the State Comptroller. A version of the bill was passed by the State Assembly in 1978. In the State Senate, however, it was referred to the Rules Committee, and no further action was taken on the bill during the legislative session. A committee of the Association of the Bar of the City of New York has proposed a similar measure which requires the filing of both an offering circular and annual reports containing information specified by the State Comptroller. <sup>15/</sup> The proposal would direct the Comptroller to

---

<sup>15/</sup> The Association of the Bar of the City of New York, "Proposals to Strengthen Local Finance Laws in New York State" (November 1978).

consider the MFOA guidelines in developing appropriate regulations. Issuers would be obligated to present financial statements which are prepared in accordance with generally accepted accounting principles or disclose the nature of any deviation from those principles.

Other than a few efforts, exemplified by Oregon and North Carolina, state municipal finance regulation has traditionally not emphasized disclosure. Most state statutes impose debt limitations and advertising requirements, and in some instances agencies have been established to review the fiscal capability of issuers and assure conformance with certain accounting standards. But the various regulatory patterns lack uniformity, and their jurisdictional reach has been limited to in-state localities and public authorities. Enforcement efforts have suffered accordingly. Further, states have not adopted qualification or registration requirements for municipal underwriters and dealers.

D. RECENT FEDERAL EFFORTS

Although the concept has had substantial support, 16/ there are no comprehensive federal registration and reporting requirements for municipalities going to market. The Federal

---

16/ See, e.g., Coopers & Lybrand, supra note 12.

Revenue Sharing Act, 17/ however, requires an independent audit every three years of the financial statements of those municipalities subject to that act. The audit is to be performed in accordance with generally accepted auditing standards although financial statements need not be prepared in accordance with generally accepted accounting principles. Regulations promulgated by the Department of the Treasury permit the audit to be conducted by state employees. 18/

Several federal legislative proposals have been suggested which take various approaches to the resolution of the problems highlighted by the Staff Report. Three proposals introduced in the 95th Congress would significantly alter the federal statutory scheme affecting municipal securities: S. 2339, the "Municipal Securities Full Disclosure Act of 1977" (the "MSFDA"); 19/ and, S. 3323 and H.R. 14090, which would amend certain provisions of the federal securities laws dealing with industrial development bonds. 20/

---

17/ 31 U.S.C. §1221 et seq. (Supp. 1976).

18/ 31 CFR §51.101 (1977).

19/ 95th Cong., 1st Sess., 123 Cong. Rec. 19272 (December 1, 1977).

20/ 95th Cong., 2d Sess., 124 Cong. Rec. S. 11193 (July 20, 1978) and H. 9861 (September 14, 1978).

1. The Municipal Securities Full Disclosure Act

The results of the New York City investigation highlighted the need for active consideration of the proposals outlined in the MSFDA. The MSFDA was introduced by Senators Williams, Proxmire and Javits in the fall of 1977 to provide a system of disclosure and periodic reporting with respect to municipal securities. The MSFDA is a revised and expanded version of the previously-proposed "Municipal Securities Full Disclosure Act of 1976," 21/ which the Commission endorsed at hearings held before the Senate Subcommittee on Securities. 22/

Proposed Section 13A of the MSFDA would require issuers that have more than \$50 million principal amount in municipal securities outstanding to prepare an annual report as well as reports of events of default. Further, under proposed Section 13A(c), all issuers, regardless of the size of the offering, would be required to prepare an offering document to be used in the public sale of securities. The bill would grant the Commission authority to promulgate disclosure rules within the parameters of disclosure schedules modeled on the

---

21/ S. 2969, 122 Cong. Rec. 3319, 94th Cong., 2d Sess. (February 17, 1976). The corresponding bill in the House was H.R. 15205, 122 Cong. Rec. E 4562, 94th Cong., 2d Sess. (August 23, 1976).

22/ Hearings on S. 2969 and S. 2574 before the Subcommittee on Securities of the Senate Committee on Banking, Housing and Urban Affairs, 94th Cong., 2d Sess. 18 (1976) (Statement of Roderick M. Hills, Chairman, Securities and Exchange Commission).

MFOA guidelines and to adopt differential requirements for various sizes and types of issuers and offerings. The Commission would also have broad authority to specify the form and manner in which financial statements required by the MSFDA are to be prepared and audited.

In contrast to corporate issuers, municipal issuers would not be required to file their reports with the Commission. These documents would not be reviewed or declared effective by the Commission or its staff. However, annual reports would be required to be made available to requesting security holders at the issuer's expense and to others at their own expense, and the offering document to be used for sales of securities would have to be furnished to municipal securities brokers and dealers and banks acting as agents for distribution to prospective purchasers.

Issuers would be exempt from the reporting provisions of the MSFDA if the state in which the issuer is organized adopts substantially similar laws or regulations. Issuers would also have the benefit of the existing exemptions of the Securities Act, such as the intrastate offering exemption.

The liability provisions of the MSFDA are modeled, in part, on Sections 11 and 12 of the Securities Act as well as Section 18 of the Securities Exchange Act. Proposed Section 13A(h) provides for an express cause of action against "any person" who offers or sells a municipal security in violation of the requirement that an offering document to be

used for sales of securities be prepared. Subsection (h)(2) imposes liability on anyone offering or selling a municipal security by means of a misleading oral or written communication. 23/ A private remedy for materially misleading statements in annual reports and default notices is provided in proposed Section 13A(j). Proposed Section 13A(g) would provide civil liability for municipal securities issuers and underwriters for materially misleading statements in distribution documents and for professional experts with respect to misleading portions of the documents which they prepared or certified. 24/

Various defenses are available to the offering participants. In contrast to the absolute liability imposed on corporate issuers by Section 11 of the Securities Act, a municipal issuer could avoid liability by proving that it "had, after reasonable investigation, reasonable grounds to believe and did believe" that the portions of the report which were not prepared by professional experts were accurate. 25/

---

23/ The proposed remedy is limited, however, since it would require purchasers to be in privity with the issuer or underwriter.

24/ Proposed Section 13A(g) affords a remedy only for investors who purchased the security in the primary offering.

25/ With respect to portions of the report prepared by an expert, issuers and underwriters could avoid liability by proving that they "had no reasonable grounds to believe and did not believe" that material misstatements or omissions were made.

A similar defense exists for experts and for underwriters in the context of a negotiated offering. The defense afforded underwriters in a competitive bid offering is even broader. 26/ In that instance, the underwriter need only demonstrate that he "had no reasonable ground to believe and did not believe ... that the statements therein were untrue." An additional defense under proposed Section 13A(g) afforded offering participants is the necessity for a plaintiff to show that the security was purchased in reliance upon the material misstatement or omission in the distribution document.

Proposed Section 13A(i) of the MSFDA would preclude any private action against issuers, underwriters, or professional experts for misleading distribution documents, except as authorized in the MSFDA. The effect of proposed Section 13A(i) is to supplant currently existing implied private rights of action under the anti-fraud provisions of the Securities Act and the Securities Exchange Act. Defrauded purchasers in the primary offering would be limited to the remedies in proposed Sections 13A(g) and (h), which impose stricter procedural and substantive burdens than would apply, for example, in an action under Commission Rule 10b-5. 27/

---

26/ Approximately 75 percent of the outstanding municipal offerings and 60 percent of the issues which went to market from the beginning of 1975 through August 1977 were sold pursuant to a competitive bid. Sorenson, Negotiated vs. Competitive Issues, The Weekly Bond Buyer, October 5, 1977, Col. 1 (Supplement No. 1).

27/ 17 CFR 240.10b-5 (1977).



## 2. The Proposed Industrial Development Bond Legislation

In May 1978, the Commission proposed a bill to deal with industrial development bonds (the "IDB Bill"). In most instances, industrial development bonds ("IDB's") are payable solely from the revenues received by a governmental entity under the terms of a contractual agreement, typically a lease, with a private enterprise. The bonds are not backed by the general credit and taxing power of the governmental issuer. As such, IDB's are virtually indistinguishable in economic and legal substance from corporate debt securities. Nevertheless, most IDB's have been expressly exempt from the registration and reporting provisions of the federal securities laws. 28/

There is increasing evidence of defaults and abusive practices in connection with IDB offerings. Further, a number of Commission enforcement actions have been brought in which the Commission has alleged that, for example, the

---

28/ In 1968, the Commission adopted rules classifying the contractual obligation of a private enterprise in certain IDB arrangements as a "separate security" which did not come within the municipal securities exemptions of the various securities acts. In 1970, Congress reinstated the registration exemption for industrial revenue bonds which qualified, under §103(b)(4) and (b)(6) of the Internal Revenue Code of 1954, for tax-exempt status. See, §3(a)(2) of the Securities Act of 1933, 15 U.S.C. §77c(a)(2) (1970).

use of proceeds and the financial condition of the corporate lessee have been misrepresented. 29/ In some cases, the issuing authorities are controlled by the corporate lessee and exercise no independent supervision or investigation responsibility. 30/ Neither state laws nor the 1975 Amendments (which created a regulatory structure for certain municipal securities professionals) have served as a sufficient safeguard.

Thus, as noted above, the Commission proposed the IDB Bill, which would eliminate most of the registration and reporting exemptions of the Securities Act and the Securities Exchange Act which are currently applicable to IDB's. 31/

---

29/ See, e.g., Securities and Exchange Commission v. Donald F. Roberts, Civ. No. 78-0809 (W.D. Mo., filed October 16, 1978); Securities and Exchange Commission v. Western States Plastic, Inc., Civ. No. 77-0408 (W.D. Okla., filed April 10, 1977); Securities and Exchange Commission v. Adventure Line Manufacturing Co. Ltd., Civ. No. 77-1013 (D. Kan., filed January 18, 1977); Securities and Exchange Commission v. Astro Products of Kansas, Inc., Civ. No. 76-359 (D. Kan., filed October 26, 1976); Securities and Exchange Commission v. The Senex Corporation, 399 F. Supp. 497 (E.D. Ky. 1975); Securities and Exchange Commission v. R.J. Allen & Associates, Inc., 386 F. Supp. 866 (S.D. Fla. 1974); and Bache, Halsey, Stuart, Inc., Securities Exchange Act Release No. 12847 (October 1, 1976).

30/ See, e.g., Securities and Exchange Commission v. Donald F. Roberts, Civ. No. 78-0809 (W.D. Mo., filed October 16, 1978).

31/ The IDB Bill was introduced in the 95th Congress by Senator Harrison Williams and Congressman Harley Staggers. S. 3323, 95th Cong., 2d Sess., 124 Cong. Rec. S.11187 and 11193-94 (July 19-20, 1978); H.R. 14090, 95th Cong., 2d Sess., 124 Cong. Rec. H.9861 (September 14, 1978).

The IDB Bill would, however, preserve the existing exemptions in the federal securities laws for IDB's issued for essentially governmental projects. These issues are defined as those in which:

"(1) the obligation is payable from the general revenues of a governmental unit ... having other resources which may be used for payment of the obligation, or (2) the obligation relates to a public project or facility owned and operated by, or on behalf of and under the control of the governmental unit ... or (3) the obligation relates to a facility which ... is part of a public project which ... is owned by and under the general control of a governmental unit...." 32/

Under the amendments to the Securities Exchange Act proposed by the IDB Bill, issuers of IDB's would be required to comply with the reporting provisions of Section 15(d) of that Act for the years in which a Securities Act registration statement is filed and thereafter until the number of bondholders falls below three hundred. 33/ In addition, the Securities Exchange Act would be amended to grant the Commission authority to suspend trading in IDB's. Finally, the exemption of IDB's from the Trust Indenture Act of 1939 34/ would be removed.

---

32/ Section 2 of the IDB Bill.

33/ In effect, that provision of the Securities Exchange Act requires, among other things, certain issuers of securities to file with the Commission current, quarterly and annual reports containing information of material interest to investors.

34/ 15 U.S.C. §§77aaa et seq.

## V. CONCLUSION

Recent voluntary efforts by certain issuers and underwriters to provide increased disclosure to investors have been significant, and a number of municipalities now provide investors with an official disclosure statement. To the extent that issuers comply with the MFOA guidelines, substantial improvements in the quality of municipal disclosure have been achieved. Unfortunately, the extent and quality of the disclosures contained in official statements vary widely; their length has ranged from a one-page announcement of the offering to a highly complex document of more than two hundred pages. In some municipalities, public officials certify the accuracy of disclosures; in other municipalities this is not done.

Even more troublesome is the fact that financial statements, when included in official statements, range from a collection of basically unrelated data to statements which give a clear presentation of the financial condition and results of operations of the municipality. As a result, it is difficult if not impossible for an investor to make meaningful comparisons or to decide the relative merits of new municipal and corporate securities offerings and outstanding issues already trading in the markets.

The Commission believes that many of the voluntary measures adopted by issuers are salutary and encourages the continuation and extension of these measures. They

have not been uniformly adopted, however, and experience has shown that voluntary measures may deteriorate in periods of stress.

In view of the abuses that have occurred in the past, the magnitude and importance of the municipal securities markets, and the number and variety of issues and issuers involved, the Commission believes that reliance upon purely voluntary efforts at improvement is not an adequate response to the need for increased investor protection which has been demonstrated.

In the Commission's view, the most critical deficiency in existing municipal securities practices is in the area of municipal accounting and financial reporting. The financial and disclosure problems experienced by a number of municipalities and highlighted by New York City's crisis suggest that there is a critical need to assure greater accuracy and uniformity in municipal accounting and financial reporting. The Commission believes that legislation designed to standardize the methods used in the preparation of municipal accounts and the form and content of municipalities' financial statements should be accorded the highest legislative priority.

Attempting to establish a comprehensive system for the municipal securities markets raises a number of issues which require careful consideration. These include the relationship between the federal government and state and local governments,

as well as the relationship between the public and private sectors of our economy.

There are a number of approaches that could be utilized to establish a fair and uniform system of regulation for the municipal securities markets. The disclosure system established by the federal securities laws with respect to corporate securities would provide a useful analogy. The philosophy of that system is based on the tenet that, if there is full and accurate disclosure, the individual investor is the best judge of how to invest his money.

A satisfactory municipal securities regulatory system should provide key roles for private sector participants. The issuer should prepare its financial statements in accordance with uniformly applied accounting principles and should present information in an understandable manner. Similarly, underwriters should have provided to them adequate disclosure documents. Rating agencies should have adequate and accurate information on which to act and should insure disclosure of the reasons for their ratings to the investing public. Each of the parties involved in the underwriting process should satisfy itself that all legal requirements have been complied with and that the public is provided with accurate and understandable information.

In addition, the municipal securities financing process must not be subject to undue burdens or delays, either of which could add to the costs associated with

municipal securities financing. The regulatory system adopted also must have sufficient inherent flexibility so that its requirements can appropriately be applied to the differing sizes and types of issuers and financing packages which may exist.

This discussion of the disclosure problems in the municipal securities markets has concentrated upon the underwriting process. Nevertheless, the Commission is also concerned about the quantity and quality of information available to participants in the secondary trading markets. Currently, investors must rely on the knowledge and care taken by individual dealer representatives, the municipal annual reports (if available), ratings (if current), and their own ability to follow municipal, fiscal, and financial developments in the press. The disclosure system should provide for disclosure of material information in the secondary, as well as the primary, market.

The Commission stands ready to make its knowledge and experience available to the Congress to achieve an appropriate legislative solution to the deficiencies in the issuance and marketing of municipal securities, of which the New York City matter was a unique but instructive example.





APPENDIX:

SUPPLEMENTAL STAFF REPORT

I. INTRODUCTION

This Supplemental Staff Report details certain significant actions which have taken place since the issuance of the Staff Report. It is divided into two parts and discusses first, actions taken by the City and the underwriters, counsel and rating agencies mentioned in the Staff Report; and second, New York State and Federal legislative responses to the City's fiscal crisis.

II. CERTAIN ACTIONS TAKEN BY THOSE DISCUSSED IN THE  
STAFF REPORT

A. THE CITY

1. Accounting Practices

The investigation of the City's accounting practices illustrated the basic premise that an adequate system of internal accounting controls is necessary to provide integrity to published financial data. The investigation also illustrated that proper accounting principles must be consistently applied in order to have reliable financial data.

The Staff Report criticized the accounting practices employed by the City prior to June 1975 as unsound and not fairly presenting the City's financial condition. The City's accounting deficiencies, however, were far more significant than a simple failure to adhere to accepted accounting standards. The staff reported that "New York City's accounting and reporting practices effectively served to obfuscate the City's real revenues, costs and financial position and

that substantial weaknesses in the City's system of internal accounting control caused published financial information to be inherently unreliable." 1/ The City's "use of budgetary, accounting and financing practices ... enabled it to borrow funds from the public which could not be supported by its sources of revenue." 2/ The City issued debt securities supposedly supported by substantial receivables; however, significant amounts of these receivables were, in fact, uncollectible. Moreover, the information presented in the City's "Notices of Sale" and "Reports of Essential Fact" "was essentially a product of [the City's] defective system of internal accounting control." 3/ In a 1977 preliminary official statement, the City stated that "[b]ecause [receipts and disbursements through the 1975 fiscal year] are unaudited and the City's records during these years were not fully reliable, the data are subject to substantial possible error." 4/

The City's accounting practices enabled the City's officials to present annual budgets which were speciously balanced.

---

1/ Staff Report, Chapter Two at 1.

2/ Id.

3/ Id. "Notices of Sale" and "Reports of Essential Fact" were documents used in the offer and sale of many of the City's debt securities prior to June 1975. These documents were inadequate for making informed investment decisions.

4/ Preliminary Official Statement of the City, dated November 10, 1977 at 46. That statement was issued in connection with an attempted offering of \$200 million of notes which was canceled.

Revenue estimates were overstated and budgeted expenditures understated due in part to the City's basis of accounting which permitted premature recognition of revenues and deferred recognition of expenses. The increase in revenue recognition was further accomplished "by the accrual of revenues ... which were unearned, uncollectible or nonexistent."5/

The City's accounting practices exacerbated a precarious financial situation by their failure to reflect the City's true financial condition. "The City's accounting methods recorded cash due in later years as a receivable (and as revenue) in a current fiscal year, but did not record liabilities of the same current year until a later year, when the cash was actually disbursed."6/ This accounting practice "permitted the City to distort its financial position by overstating its assets and understating its liabilities and further failed to disclose a material cumulative operating deficit."7/ The City's past accounting practices further failed to reflect its financial condition by concealing the magnitude of cumulative deficits. On August 29, 1975, MAC issued a detailed press release, which estimated the City's deficit at June 30, 1975, at approximately \$2.6 billion. In the City's Annual Report for the fiscal year 1975-76, the estimated deficit as of June 30, 1975 was revised to \$5.078 billion.8/

---

5/ Staff Report, Introduction at 7.

6/ Id., Chapter Two at 7.

7/ Id.

8/ Office of the Comptroller, City of New York, Annual Report of the Comptroller of the City of New York for the Fiscal Year 1975-1976, October 20, 1976, at 25.

2. Revisions in Accounting Practices

(a) Audited Financial Statements

The City's 1978 Annual Report 9/ included financial statements for the General, Capital Projects and Debt Service Funds and a Statement of Long-Term Obligations. As discussed in both the notes to financial statements and the accompanying auditors' report, the City does not maintain complete records of its general fixed assets. Accordingly, a Statement of General Fixed Assets was not presented. Generally accepted accounting principles applicable to municipalities require such a statement. The financial statements of the City otherwise are represented to be in conformity with generally accepted accounting principles and were audited by a consortium of accounting firms led by Peat, Marwick, Mitchell & Co. The opinion of the independent public accountants was rendered subject to the effects, if any, of the ultimate resolution of numerous real estate tax certiorari proceedings alleging inequality of assessment by the City.

(b) Federal and State Aid Revenue

Prior to June 1975, the City accrued its Federal and State aid revenues in a manner which did not permit a fair presentation of the City's financial condition. 10/ The City

---

9/ Office of the Comptroller, City of New York, Annual Report of the Comptroller of the City of New York for the Fiscal Year 1978 ["1978 Annual Report"], October 31, 1978.

10/ Staff Report, Chapter Two at 19. Recent state and federal legislation requires that the City comply with generally accepted accounting principles by 1982. See Part III infra.

recognized a receivable (and, therefore, revenue) when the initial budget revenue estimates for Federal and State aid revenue were recorded on the Comptroller's books. The City's accounting method did not provide for the establishment of an allowance for estimated Federal and State aid revenues which would not be collected. Accounting methods which permit fair presentation of financial condition would require receivables for Federal and State aid to be offset by an estimated allowance for amounts which will not be collected. 11/

The City often issued revenue anticipation notes ("RANS") in anticipation of the receipt of Federal and State aid revenues. The City's balance of RANS outstanding, ostensibly supported by Federal and State aid receivables, increased from \$420 million at June 30, 1970 to \$2.56 billion at June 30, 1975. 12/ Through its RANS the City borrowed against the budgeted estimate of Federal and State aid, which was itself overstated. 13/

On July 1, 1975, the New York State Comptroller's Office stated that "the City had included as accounts receivable sub-

---

11/ National Committee (now Council) on Governmental Accounting, Governmental Accounting, Auditing and Financial Reporting (Chicago: Municipal Finance Officers Association 1968) ["GAAPR"] at 12. The allowance account should be established for the same reason as in commercial accounting: "to present an accurate picture of resources which will actually be realized in the course of operations and to prevent an overstatement of assets and equity accounts...."

12/ Staff Report, Chapter Two at 22.

13/ Office of the New York State Comptroller, Report No. NYC-3-76 Prior Year Accounts Receivable, at 4.

stantial amounts that were not collectible or where the likelihood of collection was extremely remote...." 14/ In August 1975, MAC attributed \$778 million of a then estimated \$2.6 billion cumulative City operating deficit to uncollectible Federal and State aid and other receivables. In October 1976, the City revised this estimate to \$963 million. 15/

For the fiscal year 1976, the City changed its basis for recognizing Federal and State aid receivables, claiming that "[t]he amount reported as receivable from the Federal and State governments represents the amount the City expects to receive subsequent to the end of the fiscal year, as reimbursement for expenditures made and services rendered." 16/ In addition, "the City accrues revenues prior to cash receipts only when they are 'known and measurable'.... State and Federal revenues are recognized based upon a bill or claim submitted to the sponsor. Year-end adjustments are made for aid revenues earned (by virtue of expenditures incurred) but not yet billed...." 17/

---

14/ Id. at 3.

15/ Staff Report, Chapter Two at 19. Of the \$963 million, the City Comptroller attributed \$678 million to a revaluation of receivables and \$285 million to the establishment of a reserve for federal and state aid disallowances.

16/ Corporation Counsel of the City of New York, and Special Counsel to the City of New York, A Review of the Accounting and Budgetary Reforms Instituted by the City of New York, (New York: New York City, April 1978)["City Submission"] at 9.

17/ Id. at 50.

The City has also established a reserve for disallowances, in order that the City's yearly financial statements reflect the loss of revenues due to such disallowances. The reserve as of June 30, 1978 totaled \$369 million, including \$125 million added during fiscal 1978. 18/

(c) Real Estate Taxes

As stated in the Staff Report, the City recorded real estate tax revenues on an accrual basis without offsetting the taxes receivable with an estimated allowance for uncollectible tax revenue. 19/ Furthermore, the City balanced its yearly expense budgets with anticipated real estate tax revenue estimated at 100 percent of levy, without providing for uncollectible real estate taxes. These practices were inconsistent with acceptable accounting practices. 20/ Similar to the standards applicable to Federal and State aid receivables explained above, accounting principles which permit a fair presentation of financial condition require that when an accrual basis of accounting is used, an "Allowance for Uncollectible Taxes" be established to provide for taxes that will not be collectible. 21/

The real estate tax revenue estimates did not represent amounts which would be available during the fiscal year to

---

18/ 1978 Annual Report at 3-4.

19/ Staff Report, Chapter Two at 28.

20/ Id. at 27-33.

21/ GAAFR at 12.

meet budgeted expenditures. Nevertheless, the City sold to the public tax anticipation notes ("TANS") in anticipation of receipt of the "accrued" real estate tax revenue. The Office of the State Comptroller issued an audit report in August 1975, which estimated that over 80 percent of the total uncollected real estate taxes reflected in the City's annual report for fiscal 1974-75 as receivable, were neither readily available nor collectible. 22/ Therefore, as of June 30, 1975, \$380 million of City TANS outstanding were ostensibly supported by \$502.2 million of uncollected real estate taxes, of which only \$94 million was estimated by the State Comptroller to be collectible. 23/

The New York State Comptroller found the City tax rolls were inflated and, therefore, estimated tax levies were overstated. 24/ In the 1977 fiscal year, the City removed \$761 million of publicly-assisted housing and \$217 million of City-owned properties from the tax rolls. An additional \$213 million of properties, \$160 million owned by the Urban Development Corporation and \$53 million owned by the City, were removed in fiscal year 1978.

---

22/ Office of the New York State Comptroller, Audit Report No. NYC-26-76, Uncollected Real Estate Taxes, at 4.

23/ Id. Two major causes for the City's inflated real estate tax receivables were: (1) properties were carried on the City's tax rolls which were not subject to tax or for which taxes could not be collected (City-owned and diplomatic property); and (2) there was failure to provide for the increasing number of defaulting taxpayers and cancellations and abatements.

24/ Id.



However, additional publicly-owned properties (mostly City-owned) with an estimated assessment value of \$250 million remain on the 1979 tax roll. 25/

The effects of the inflated tax levies were to allow borrowing against inflated receivables, to erroneously portray a balanced budget, to understate the real estate tax rate, and to artificially increase the City's debt limit.

The City, having experimented with a cash basis of accounting for real estate tax receivables since 1976, introduced a modified accrual basis for the 1978 fiscal year. According to the City, under this accounting method, recognized revenue represents payments received against the current year levy and certain estimated payments to be received in the following year, reduced by estimated tax refunds to be made in the same period. The City states that real estate taxes are being reported on this basis to conform to generally accepted accounting principles. 26/ Further, the City has adopted new budgeting procedures, "which...require that the amount of the current real estate tax levy available for Expense Budget appropriations be reduced by a reserve for uncollected taxes." 27/

---

25/ The City-owned properties included in this category are acquired, in part, in in rem proceedings. Since they are not held for "public use," they are not tax exempt; but the City cannot collect taxes from itself. Official Statement for the sale of \$200,000,000 General Obligation Serial Bonds dated November 17, 1978, [the "November 1978 Official Statement"] at 65.

26/ November 1978 Official Statement at 30.

27/ City Submission at 10.

While the staff is not in a position to assure itself of either the accuracy of the City's tax rolls or the adequacy of its internal controls, it believes that where meaningful controls are maintained and there is assurance of such accuracy, an accrual basis of revenue recognition for real estate taxes may be acceptable. 28/ With the proper monitoring of these accounts and of the tax rolls, an accrual basis could produce accurate and reliable financial data.

(d) Capitalization of Expenses

The City's Capital Budget represents a financial plan of expenditures for capital items and capital projects such as streets, parks, bridges, tunnels and schools. The Capital Budget is financed, in part, by the City's long-term debt. The City's Expense Budget provides a plan for City operations of a current nature. It is financed largely by recurring revenue obtained from State and Federal aid, the real estate tax levy, and a variety of other taxes. These revenues are used to fund the departmental operations of the City, to provide current services in areas such as police and fire protection, education, health and social services, and service debt.

As indicated in the Staff Report, the City issued long-term debt instruments to finance expenses reflected in the Expense Budget. For fiscal 1975, operating expenses financed

---

28/ 1978 Annual Report at 13. The National Committee on Governmental Accounting recommends the accrual basis (GAAPR at 12). The American Institute of Public Accountants ("AICPA") does not make a specific recommendation but sets forth criteria for selecting a basis in its industry audit guide; Audits of State and Local Governmental Units, (New York, AICPA 1974), at 15.

this way totaled \$722 million. For the eleven-year period, 1965 through 1975, a total of \$2.434 billion of operating expenses were financed in this manner. 29/ This financing practice is unsound for various reasons: it diminishes the City's ability to borrow for other purposes; it increases the original expense by the interest expense of the long-term debt; and, it allows the current presentation of a "balanced expense budget" when, in fact, some of the planned Expense Budget items will be funded through the Capital budget.

The City is still financing operating expenses through the Capital Budget and, therefore, through long-term debt. 30/ This practice is now disclosed in current City reports. By New York State and federal statutes, however, the City is mandated to discontinue this financing practice by fiscal year 1982. 31/ This means that, for a period of approximately four years, certain items which should be financed through the Expense Budget will be financed through the Capital Budget.

In the past, the City did not record these operating expenses in its General Fund and, therefore, excluded them from both the City's current operating expenses in the General Fund and the City's current operating deficit or surplus accounts. The City currently reports these operating expenses in the General Fund.

---

29/ Staff Report, Chapter Two at 66-70.

30/ City Submission at 14; 1978 Annual Report at 4.

31/ See Part III, infra.

(e) Fund Accounting

Prior to the June 1975, the City utilized a "needlessly complex" fund structure. <sup>32/</sup> The City's financial statements were based on and reflected the City's fund structure and were incomprehensible when read in the light of traditional accounting standards, in part because the funds which made up the City's fund structure utilized accounting methods which were inappropriate.

As reflected in its most recent Annual Report, the City's fund structure is now presented in a clearer fashion. Most significantly, the City now presents a "fund balance account" in its General Fund which shows the City's cumulative deficit. However the City has not established a "General Fixed Asset Group of Accounts," which would provide information about the City's investment in fixed assets. Nor, at the present time, does the City have central recordkeeping for its fixed assets "whether purchased through the capital budget (such as a new school building) or through the expense budget (such

---

<sup>32/</sup> Staff Report, Chapter Two at 70. For an overview of fund accounting refer to Appendix A of Chapter Two of the Staff Report. "Fund structure," in the context of a municipal accounting system, refers to the various funds established to meet legal requirements and provide sound financial administration. A "fund" is an independent fiscal and accounting unit within a municipality's accounting system and is used to account for the transactions of a specific activity or provide accountability to demonstrate compliance with legal or other requirements.

as a police car)." 33/ The City must, however, establish a "General Fixed Asset Group of Accounts" by July 1, 1980. 34/

In several instances cited in the Staff Report the City was criticized for its failure to establish "Enterprise Funds" which are designed to account for activities of a municipality which are "... financed primarily by charges to consumers ...." 35/ In addition, the July 1978 Accounting Systems Directives of the State Comptroller's Office included a recommendation that the City's water and sewer operations be accounted for by an enterprise fund or funds. 36/

1. Housing Enterprise Fund. In its unaudited "estimated financial statements" for the year ended June 30, 1977, the City included a separate financial presentation of a Housing

---

33/ City Submission at 15. See also 1978 Annual Report at 2 (auditor's opinion) and at 12, Note A. On January 29, 1979, the Commission was informed by the City that it has engaged a major accounting firm and a firm of systems consultants to assist in the development of a "centralized fixed asset system." A report completed by the accounting firm on September 15, 1978, based on a sample of ten city agencies, concluded, among other things, that nine of those agencies do not maintain centralized records or ledgers for fixed assets or conduct any periodic review of physical inventory. Only one sampled agency could report the number of fixed assets on hand.

34/ This deadline to implement a General Fixed Asset Group of Accounts was established by MAC in 1976 pursuant to the 1975 MAC legislation, Public Authorities Law, Section 3038(a) (McKinney), and is unaffected by the 1978 Financial Emergency Amendments, discussed at Part III A, infra, See, New York State Comptroller's Office Manual: Accounting System Directives for New York City ("Accounting System Directives") (June 1977) at 1-14 to 1-15; 1978 Annual Report at 12, Note A.

35/ GAAFR at 50.

36/ Accounting Systems Directives at 1-12.

Enterprise Fund which accounted for certain housing-related activities, principally the Mitchell-Lama and multiple-dwelling housing programs. 37/ The audited financial statements contained in the City's 1978 Annual Report, however, did not include a separate Housing Enterprise Fund financial presentation. Instead, the housing-related activities, which are principally financial in nature, are reflected in the General Debt Service Fund and Statement of Long-Term Obligations. It appears that City believes that these operations no longer meet the definition of "enterprise" activities for purposes of financial reporting. 38/

2. Water and Sewer Enterprise Fund. The City has one of the largest water and sewer operations in the country, operated by its Department of Environmental Protection. 39/ Fiscal 1978 expenditures of the Department of Environmental Protection were estimated by the City to be approximately \$135 million, 40/ some of which is apparently related to Department activities other than water and sewer operations. The City reported revenues for water and sewer charges of \$231 million for 1978. 41/

---

37/ See, e.g., Official Statement for the sale of \$105,995,000 General Obligation Serial Bonds dated August 25, 1978, at 154-56.

38/ Note B to the City's 1978 financial statements. Reportedly, the City's involvement in this area has been substantially reduced since fiscal year 1975 when expenditures amounted to \$261.4 million. In fiscal 1978, expenditures were only \$21.5 million. (November 1978 Official Statement at 90.)

39/ November 1978 Official Statement at 78-79.

40/ Id. at 79.

41/ 1978 Annual Report, Part II, at 28.

In many municipalities, "utility" operations -- such as water, gas or electric services -- are separately accounted for within one or more enterprise funds. Representatives of the City, however, have indicated to the staff that the City does not believe that its water and sewer operations meet the definition of "enterprise" activities for financial reporting purposes since it is not the intent of the City administration to have water and sewer operations be self-sustaining -- that is, to have revenues cover at least a substantial portion of operating expenses. It appears that the City's lack of necessary fixed asset records would, at present, prevent the City from presenting a Water and Sewer Enterprise Fund in accordance with generally accepted accounting principles.

The City's failure to separately present a Water and Sewer Enterprise Fund is important since one of the peculiarities of municipal accounting practices -- as distinguished from those practices followed by commercial enterprises -- is the fact that depreciation is recorded for financial statement purposes only for those assets which are accounted for as part of an enterprise fund. No depreciation is recorded with respect to assets devoted to activities which are accounted for within the General Fund or other non-enterprise funds. The City accounts for its water and sewer operations within the General Fund. While precise data is not currently available, the City has estimated -- based on related debt service costs -- that fiscal 1978 depreciation on assets devoted to water and sewer operations would have been about \$90 million.

(f) Accounting for Pension Costs

While the Staff Report raised a number of questions regarding the City's accounting for pension costs, the City has taken corrective action with respect to most of the matters criticized.

In the Staff Report, a question was raised as to whether a portion of the additional unrecorded pension cost liability resulting from the use of outdated actuarial assumptions and other errors should be accounted for as a "correction of an error" and treated as an adjustment of the City's cumulative deficit. 42/ In a note to its 1978 financial statements, the City did disclose the fact that vested benefits of plan participants exceed the assets of the pension plans and the recorded City liability by approximately \$4.3 billion. 43/ However, the City has taken the position that it need not adjust its cumulative deficit to reflect its failure to properly record pension costs during the years 1968 through 1974.

The impact of the City's position regarding this matter will be to spread the additional costs which should have been recorded for fiscal years 1968 through 1974 (as well as prior years) into future accounting periods. Current expenses are

---

42/ Staff Report, Chapter Two, at 53-61 and Appendix C.

43/ 1978 Annual Report, Notes to Financial Statements, at 17, Note I.



thus increased -- and will be increased for many years to come -- by a portion of those costs which would otherwise have been charged to the City's cumulative deficit.

Additionally, it appears that the City is using amortization periods for past service costs which bear no rational relationship to the average remaining service life of participants in each of the City's pension plans. 44/ The City has informed the staff that it is presently using a forty-year amortization period for past service costs but that the average remaining service lives of employees covered by the plan range from twelve to eighteen years.

In effect, by using excessively long amortization periods, the City will be charging lower costs to years related to the active service periods of its employees than would otherwise be required and will continue to charge costs to the later years of the amortization period which are applicable to prior years.

(g) Internal Accounting Control . . . . .

An effective system of internal accounting control is essential in order to provide reasonable assurance that financial records produce reliable information and that assets are safeguarded. The inadequacies of New York City's system of internal control, as described in Chapter Five of the Staff Report, independent of other accounting problems, significantly hindered the City's capability to generate financial data that was reliable and accurate.

---

44/ See Staff Report, Chapter Two, at 58-60.

The City's publication of audited financial statements for the year ended June 30, 1978 was a significant accomplishment and one which is indicative of substantial progress on the City's part in being able to meet its financial disclosure obligations to security holders. In addition, the City has represented that numerous changes and reforms have been instituted with respect to internal accounting control and related matters since the issuance of the Staff Report.

In their report on the City's financial statements for the fiscal year 1978, the City's independent public accountants did not report on the City's system of internal controls. The staff has been informed, however, that the City's independent public accountants will be making a substantial number of comments and suggestions regarding the City's system of internal accounting control as a result of matters which came to their attention during the 1978 audit.

The City has indicated that a letter from the independent accountants dealing with these matters will be forthcoming in 1979 and that the City contemplates making public both the letter and the City's responses thereto. The City has also manifested its intent to attempt to produce unaudited interim financial statements as of December 31, 1978. This exercise should be of significant benefit to the City in

evaluating its ability to produce reasonably accurate and complete financial information on an interim basis.

However, the continued existence of any "material weaknesses", 45/ if uncorrected by the City, would raise questions about its ability to produce reliable and accurate unaudited financial information. 46/ This is especially so if such weaknesses are accompanied by other infirmities in the City's systems of internal accounting control. To the extent that publicly disseminated information, in the form of financial statements or otherwise, is subject to unusual imprecisions or other risks of unreliability, the City, of course, has an obligation to assure that the information is accompanied by appropriate disclosure of such risks.

---

45/ A "material weakness" is defined in the authoritative auditing literature as "a condition in which the auditor believes the prescribed procedures or the degree of compliance with them does not provide reasonable assurance that errors or irregularities in amounts that would be material in the financial statements being audited would be prevented or detected within a timely period by employees in the normal course of performing their assigned functions."

46/ For example, the City's November 1978 Official Statement, while containing audited financial statements for fiscal 1978, also contains extensive financial data regarding plans for future years which are unaudited and presumably based on the City's system of internal accounting controls.

(h) Audit Committee

As discussed in Part III below, the New York City Loan Guarantee Act of 1978 47/ requires that the City establish an audit committee as one of the conditions governing eligibility for federal guarantees of City debt. The audit committee's membership is to consist of the Mayor of the City, the City Comptroller, the President of the City Counsel, two individuals with expertise in municipal finance and one representative from each of two different independent public accounting firms that are neither engaged by the City or the Comptroller of the City. 48/ Its duties are to assist in the determination of the areas of inquiry, review the progress, and evaluate the results of the annual audits required by the Act to be conducted by independent public accountants. 49/

In effect, a corporate audit committee acts as a watchdog for the company's shareholders. While audit committees are novel in the municipal field, New York City's audit committee could serve a similar function and assist in assuring the integrity of financial information provided to investors and the City's citizens. The audit committee can point out any areas in which it feels further inquiry should be made

---

47/ Pub. L. No. 95-339, 92 Stat. 460 (1978).

48/ Id., §103(7)(B). The latter four individuals are to be chosen by the New York City Financial Control Board. See Part III, infra. The staff has been informed by the City that one of these individuals will be appointed Chairman of the audit committee.

49/ Id.

and monitor the quality of interim financial information. The effectiveness of the audit committee will depend, however, on a number of factors. These include the resources put at its disposal; its ability to consult, with, and review the work of, the independent auditors; the cooperation given it by the City; and the qualifications and independence of the four members who are not elected officials of the City.. 50/

### 3. Disclosure.

The Staff Report characterized the information about the City's financial condition and the safety of its securities that was publicly available during the studied period as "confusing, contradictory, and fragmented." 51/ The staff attributed this situation largely to incomplete and misleading public statements and press releases by City officials and to the essential inadequacy of the City's published financial reports.

Since the financial crisis in 1975, when the City was foreclosed from the public capital markets, with the exception of a private placement of \$345 million in bonds to the City's pension funds in December 1975, each issue of

---

50/ Since, by virtue of its statutorily mandated membership, the City's audit committee cannot be deemed truly independent, it is extremely important that these four persons are chosen carefully. They should have the ability to review, outside the presence of the City officials if they so desire, matters such as scope of the audit, major accounting policy decisions and any qualifications to the independent auditors' opinion. In this manner the audit committee and the City will gain necessary public credibility.

51/ Staff Report, Chapter Three at 112-13.

securities by the City has been accompanied by an official statement (or preliminary official statement). 52/

The Official Statement used by the City in its public offering in January 1979 is a document in excess of 200 pages. 53/ It contains, among other information, the City's 1978 fiscal year audited financial statements and unaudited financial information descriptive of the City's financial plans, operations, cash sources and uses and expected results of operations. It also includes information relating to recent financial, litigation and legislative developments, as well as economic and social factors affecting the City's fiscal and financial position.

Although the staff has not examined the City's official statements in the way that corporate disclosure documents are frequently examined by the staff, they appear to afford the investing public markedly improved disclosure over that provided

---

52/ Placements with the pension funds were made pursuant to the Amended and Restated Agreement of November 26, 1975, which did not require the City to furnish official statements to accompany the placements effected on December 5, 10 and 17, 1975. The March 26, 1976 placement of \$185 million in bonds with the pension funds was accompanied by a draft official statement uncertified by the Mayor or Comptroller, but which was accompanied by a letter explaining why certification was not then feasible. MAC securities offerings have also been accompanied by official statements, but information contained therein relates primarily to MAC, not the City.

53/ This document was used in connection with the public sale by the City of \$125 million in RANS in late January 1979. This was the City's first sale of securities to the public since its financial crisis in 1975. Previously the City attempted in 1977 and 1978 to return to the public capital markets. These offerings were withdrawn, due in part to the low rating assigned by the rating agency. The successful January 1979 offering received a higher rating.

by the City's documents described in the Staff Report. 54/ Similarly, the 1978 Annual Report of the Comptroller, containing the audited financial statements noted above, appears to provide a more informative description of the City's finances as of June 30, 1978, than did the earlier Annual Reports that were criticized by the Staff Report. 55/

#### 4. Summary

The foregoing discussion highlights certain significant areas in which the City has made improvements. It is not all-inclusive. While the City has not affirmatively responded to all of the problems detailed in the Staff Report, it has nevertheless made improvements in its accounting and internal control systems and in its public disclosure to investors and has undergone its first audit by independent auditors. As indicated above, however, there remain a number of necessary steps which should be taken. The steps required by the New York City Loan Guarantee Act of 1978 should, if properly implemented in a timely manner, assist the City in establishing an acceptable accounting system.

---

54/ A survey conducted by the Council on Municipal Performance, however, found material departures from the Municipal Finance Officers Association's Disclosure Guidelines for Offerings of Securities by State and Local Governments in the City's preliminary official statement dated June 14, 1977. III. Council on Municipal Performance, Municipal Securities Regulation: A Public Perspective, Appendix G-13, "Survey Results: Core Sample" (December 19, 1977).

55/ See, e.g., Staff Report, Chapter Three at 128.

B. THE UNDERWRITERS

New York City's principal underwriters 56/ (the "Underwriters") were criticized by the Staff Report for their failure to disclose to the investing public certain material facts known to them concerning the City's financial condition and the market for the City's securities. As the City's fiscal and financial condition worsened, the Underwriters continued to distribute City securities to their customers notwithstanding the lack of adequate public information. 57/

As the Staff Report documented, the Underwriters and syndicate members unduly relied upon ratings of Moody's Investors Service, Inc. ("Moody's") 58/ which, in turn, were founded upon inadequate investigation. 59/

The Staff Report concluded that during the October 1974 through April 1975 period the Underwriters marketed \$4 billion in New York City notes as safe and secure investments despite

---

56/ The City's principal underwriters during the period covered by the investigation were:

The Chase Manhattan Bank;  
First National City Bank (Now Citibank);  
Morgan Guaranty Trust Company of New York;  
Manufacturers Hanover Trust Company;  
Bankers Trust Company;  
Chemical Bank; and,  
Merrill Lynch, Pierce, Fenner & Smith, Inc.

57/ For a discussion of the problems associated with the Underwriters, see generally, Staff Report, Chapter Four.

58/ Standard & Poor's Corporation ("S&P") maintained a rating of the City's bonds, but not its notes.

59/ Staff Report, Chapter Five at 31.



their knowledge of the City's financial crisis and its related problems. The Underwriters became increasingly aware that the City would soon be unable to continue to finance its ever increasing deficit and that the market for its securities might close. The Underwriters also became aware that the basic underpinning of the notes, the availability of revenues, was "in serious question." 60/

Note offerings were unaccompanied by disclosure documents until March 13, 1975, when a "Report of Essential Facts" -- which did not contain adequate disclosure -- was prepared for a RANS issue. 61/ Oral and written representations to investors omitted to disclose material information about "the financial condition of the City, the risks involved in investing, the nature of the purported first lien, the nature of the City's receivables supporting the ... securities, ... marketability, and the position taken by the underwriters for their investment and fiduciary accounts." 62/

A municipality's official statement is central to any system designed to facilitate full disclosure. That a high proportion of municipal issuers now provide such documents and that many leading underwriting firms require them in virtually all cases, are important developments.

---

60/ Staff Report, Chapter Four at 2.

61/ Id. at 52.

62/ Id. at 36.

The Underwriters, those discussed in the Staff Report as well as several other national and local underwriting firms interviewed by the staff, can and do perform independent credit analyses of municipalities whose securities offerings they underwrite. The Underwriters have generally stated, however, that circumstances severely restrict their ability to conduct any "due diligence" inquiry in any competitive bid offering 63/ and that, in these circumstances, the inquiry may consist of nothing more than a perusal of the official statement or other information provided in connection with the offering or contained in their files. In contrast, the Underwriters generally state that in any negotiated offering they do perform a "due diligence" inquiry in some ways similar to that conducted in underwriting corporate issues.

Several of the Underwriters have recently enlarged their municipal research divisions; others have more distinctly separated their research and underwriting functions; and a few have given their research divisions or others veto power over the underwriting or syndicate divisions if disclosure or creditworthiness is deemed below standard.

The Underwriters have generally stated that if they have any doubts concerning the accuracy of various disclosures

---

63/ A competitive bid underwriting is one in which the underwriter, usually by submission of sealed bids, is determined to be the highest bidder. By contrast, a negotiated offering is one in which the underwriter and the issuer arrive at the price to be paid to the issuer in a privately negotiated transaction.

by the issuer they will not participate in the offering. The staff has been informed of several instances in which syndicates have been disbanded or offerings delayed because underwriters have been dissatisfied with the quality of an issuer's disclosure. Many of the Underwriters have also indicated that if they have any doubts about the safety of an investment in a proposed offering they would not proceed with the offering, and that they make their own independent determination in this regard and do not rely on the rating services.

While, as indicated above, there have been some improvements in the procedures used by the Underwriters in the areas of greatest concern, generally the degree of improvement among individual Underwriters varies considerably.

Many of the Underwriters have indicated that some of the steps they have undertaken, or which might be reasonable additional steps to improve the underwriting process, extend beyond existing statutory requirements. Some Underwriters have stated that a few of the steps they have already taken voluntarily have placed them at a competitive disadvantage and that it would be difficult for them to go much further without legislation. These comments demonstrate both the weaknesses and limits of the voluntary approach, and the need for legislation which would create a single standard, universally applicable.

### C. THE RATING AGENCIES

The staff's investigation and report concerning rating agencies 64/ focused on the activities of Moody's and S&P, the dominant rating agencies in the municipal securities field. These two registered investment advisers 65/ rate the vast majority of the municipal issues which come to market each year. Moody's rates between 3,000 and 3,600 municipal issues per year representing, in dollar amount, approximately 76 percent of new issues by municipalities. S&P, which rates only bonds, 66/ rates approximately 900 municipal issues each year.

As noted in the Staff Report, ratings are extremely important in marketing municipal securities. 67/ It appears that it is virtually impossible to market large issues, such as those of New York City, without a rating by one or both agencies. The ratings are relied upon by underwriters in determining whether to underwrite a particular issue and are an important factor in determining the interest rate a municipality will pay, and investors will receive. The ratings also appear to be an important factor in the investment decisions of individual

---

64/ The role of the rating agencies during the New York City financial crisis is set forth in Chapter Five of the Staff Report.

65/ Both Moody's and S&P, or their predecessors, have been registered with the Commission as investment advisers since shortly after the enactment of the Investment Advisers Act of 1940.

66/ S&P rated notes in only a few instances and never rated New York City notes.

67/ See, e.g., Staff Report, Chapter Five at 1,5.

purchasers. 68/ Indeed, the ratings given to a particular issue may determine if institutions, such as savings banks, either due to legal or internal policy restrictions, may purchase a particular debt security or be required to divest themselves of obligations they already hold.

Chapter Five of the Staff Report questioned the adequacy of the steps taken by the rating agencies to preserve the continued accuracy of their ratings of New York City securities during its fiscal crisis. The Staff Report discussed certain adverse information concerning the City which was or should have been known to the rating agencies and detailed the actions taken by the agencies as that adverse information developed. 69/

Since the issuance of the Staff Report, the rating agencies have reported certain improvements in their operations. Both Moody's and S&P have augmented and attempted to upgrade their analytical staffs. Both agencies are computerizing their systems of information gathering, retention and analysis. The information which the agencies receive from municipalities is more extensive and of better quality. 70/ They often receive

---

68/ A sampling of individual investors in New York City securities indicated that, although few had read the written analyses prepared by the rating agencies, a significant number stated that they were aware of, or informed of, the rating and that the rating was a factor in their investment decision. Staff Report, Chapter Seven, Appendix B, questions 4(h) and 9(c), and Appendix C, questions 4(h) and 9(c).

69/ Staff Report, Chapter Five at 31.

70/ The additional information received by the rating agencies may not result primarily from any requirements imposed by the rating agencies upon municipalities, but rather from changes in the municipal securities market which occurred after the New York City financial crisis.

municipal disclosure documents. Information is received from various municipal and other sources and can be cross-checked. In many instances, audited financial information is received. Both rating agencies state that they have increased their contact with issuers, their field trips are more frequent and the procedures by which ratings are reviewed and revised have been changed with a view toward improvement. 71/

The information gathered after issuance of the Staff Report indicates that, although the rating is a significant factor to many public investors in municipal securities, 72/ the rating agencies do not take steps to ensure that an appropriate explanation of the rating process and the meaning of the rating will appear in the selling document for the rated securities. While S&P has advised the staff that it would amend its standard letter agreement with municipal issuers to "request" the issuer to include an explanation in the official statement, Moody's has expressed opposition to taking similar action.

The rating agencies follow a practice of not specifically identifying the key reason or reasons for a rating. The multi-page "analyses" sent to subscribers of Moody's and S&P set forth a great deal of information of varying degrees of importance that is obtained from the issuer's official statement

---

71/ The increased use of "bring down" certificates appears to have assisted this process by permitting the rating agencies to keep their information current. See discussion of the use of "bring down" certificates in the text, infra p. 32.

72/ See note 68, supra.

or other published reports. Some of the information may be discussed in detail, but nowhere is there an unequivocal statement of the factors considered to be most important in making the rating decision.

As noted above, since issuance of the Staff Report certain improvements have been made by the rating agencies; nevertheless, the adequacy of the procedures employed by such agencies in connection with the assignment and continuation of ratings, as well as their disclosure practices, remain a source of concern.

#### D. BOND COUNSEL

The important role bond counsel played in the City's fiscal crisis is set forth in Chapter Six of the Staff Report.

Bond counsel independent of a municipality is typically retained to pass upon two issues of paramount significance to investors: (1) the legal validity of the authorization and issuance of the municipal security; 73/ and (2) the tax exempt status of the security. The opinion of bond counsel is important because it gives investors a degree of assurance that, while market and credit risks may remain, legal risks as to validity and tax status are, unless otherwise disclosed, nonexistent.

The investing public relies on bond counsel, whose opinion often accompanies the sale of municipal securities. The extent of bond counsel's participation in the offering process, however,

---

73/ The municipal financing excesses of the 1870's led to the discovery that many bonds had been illegally authorized, resulting in the requirement that independent bond counsel pass upon the validity of proposed municipal issues. Securities Industry Association, Fundamentals of Municipal Bonds.

traditionally has not been made clear to the investing public. That bond counsel's opinion merely concerned the legality of an issue, and not the adequacy or accuracy of disclosures contained in the selling document, was often not made explicit.

The Staff Report noted several specific criticisms of certain practices in existence during 1974-75 with respect to securities of the City. 74/ The Staff Report found that in establishing a basis for its opinion concerning an offering, bond counsel gathered certain documentation from the issuer.75/ This documentation was specified in a "requisition letter" sent by bond counsel to the issuer. The amount and type of information requested appears to have been left to the discretion of bond counsel. Based on the limited survey reflected in the Staff Report, and the subsequent meetings and communications held with persons mentioned therein, it appears that more information is being sought now and, more important, that such information is more current and is generally certified by responsible municipal or state officials.

Another area of criticism noted in the Staff Report was the variation of practices by bond counsel in their use of "bring-down certificates." In the context of municipal securities offerings, bring-down certificates are documents which are delivered and executed at the date of closing and which reaffirm information previously certified by municipal officials and others.

---

74/ Staff Report, Chapter Six at 25-57. At least one bond counsel participating in the New York City offerings did not use a retainer letter to delineate the scope and nature of its responsibilities. It now appears that such a letter is used.

75/ Staff Report, Chapter Six at 28.



One firm failed to request bring-down certificates in its role as bond counsel for New York City securities. 76/ This deficiency has now been remedied.

One of the bond counsel cited in the Staff Report has reported that it has widened the scope of its inquiry and has requested broader and more current certifications of facts. That firm stated that, should a change of material fact come to its attention, even though the change does not relate directly to the question of legality but is, instead, one relevant to the creditworthiness of the issuer, the firm would consider it its duty to assure the disclosure of that change, or to withdraw. This recognizes, at least in part, the obligation of an attorney to take corrective action when he discovers material misstatements or omissions or other "red flags" indicating the potential of fraud. 77/

### III. NEW YORK STATE AND FEDERAL LEGISLATIVE RESPONSES TO THE CITY'S FISCAL CRISIS

The legislative responses detailed below had as their principal aim assurance of the continued liquidity of the City. Certain of the conditions attached in order to achieve that assurance, such as the requirement for independently audited financial statements prepared in accordance with generally accepted accounting principles and the creation

---

76/ Staff Report, Chapter Six at 48-62 passim.

77/ See, e.g., In the Matter of Jo M. Ferguson, Securities Act Release No. 5523 (Aug. 21, 1974); see also Securities and Exchange Commission v. Frank, 388 F.2d 486 (2d Cir. 1968). Cf., American Bar Association Code of Professional Responsibility, DR 1-102(A)(4), DR 7-102(A)(5) and DR 7-102 (A)(8).

of an audit committee, also may serve the interest of the investing public.

A. NEW YORK STATE RESPONSES

The Financial Control Board ("FCB") was established by the State of New York in 1975 to monitor and control the City's fiscal and financial management during a defined Emergency Period. The FCB is headed and controlled by the Governor. Other members are the Mayor, the City Comptroller, the State Comptroller and three members appointed by the Governor with the advice and consent of the State Senate. The Board has an Executive Director and fulltime staff member. 78/

The FCB controls virtually all City revenues and disburses them pursuant to a financial plan which it must approve. The FCB may audit compliance with the plan and must review collective bargaining agreements and construction contracts for more than \$1,000,000 and other contracts for more than \$100,000. The FCB also approves or disapproves the City's proposed long and short-term borrowing.

In June 1978 the Legislature enacted the Financial Emergency Amendments. 79/ That legislation supplemented and extended the Financial Emergency Act for the City of

---

78/ See generally, New York State Financial Emergency Act for the City of New York, Chapter 868 of the Laws of 1975, as amended by Chapters 869 and 870 of the Laws of 1975 and by Chapter 201 of the Laws of 1978 (unconsolidated) (McKinney's Session Laws, 1975).

79/ Chapter 201 of the Laws of 1978, as amended, (Assembly Bill 13025).

New York and the legislation creating the Municipal Assistance Corporation ("MAC"), 80/ in anticipation of enactment of the New York City Loan Guarantee Act of 1978 81/ and in order to meet the demands of the private capital market.

The provisions of the Financial Emergency Amendments with respect to the FCB, and the provisions imposing additional accounting, fiscal and financial controls on the City, became effective in August 1978 upon the enactment of the New York City Loan Guarantee Act of 1978. Under these Amendments, the defined Emergency Period, during which the FCB exercises its extraordinary powers, terminates when any federal guarantees are no longer in effect and the FCB has determined that the City's expense budget has been balanced according to generally accepted accounting principles for each of the three immediately preceding fiscal years. After the termination of the Emergency Period, the FCB will perform certain reviews and is empowered to reimpose an Emergency Period should enumerated events indicating financial irresponsibility occur. The FCB's residual powers last until the earlier of June 1, 2008, or the date on which there are no longer any outstanding

---

80/ Chapters 168 and 169 of the Laws of 1975, as amended. Public Authorities Law, Section 3001 et seq. (McKinney, 1970-1975, 1976, 1977 supp.). The MAC legislation, in addition to providing a financing mechanism (MAC) to assume and stretch out a portion of the City's unfunded debt, imposed fiscal and financial limitations on the City which were then supplemented, strengthened and subjected to affirmative FCB enforcement authority.

81/ The New York City Loan Guarantee Act of 1978 was signed into law on August 8, 1978.

City or MAC notes or bonds entitled to the benefits of a State bond covenant required by the Amendments.

The FCB's duties include assuring that the City's expense budget will be balanced in accordance with generally accepted accounting principles for the 1982 fiscal year and each year thereafter and assuring that there is substantial progress toward this goal in the interim. 82/ Similarly, the FCB must insure that the City's capital budget for 1982 and thereafter is free of expense items.

The FCB will be required to periodically examine the City's projected revenues and expenditures and other estimates contained in its financial plans and the City is required to submit such financial plan modifications as the FCB may require, or have them imposed by the FCB.

Other fiscal and financial controls that the FCB is empowered to enforce are:

(i) the City's establishment of a general debt service fund maintained and administered by the State Comptroller;

(ii) limitations on the City's authority to issue short-term debt;

(iii) requiring the City's annual financial statements to be audited by a nationally recognized independent certified public accounting firm (or a consortium of firms) in accordance with generally

---

82/ Prior to the Financial Emergency Amendments, the 1975 legislation required that the City use the State Comptroller's uniform system of accounts for municipalities, not generally accepted accounting principles.

accepted auditing standards, the auditor's report to state whether the financial statements comport with generally accepted accounting principles.

(iv) requiring monthly reports by the City to FCB concerning the results of operations which indicate any variance between actual and budgeted revenues, expenses and cash balances, and quarterly reports concerning debt service requirements; and,

(v) the City's establishment of a general reserve of not less than \$100 million at the beginning of each fiscal year to cover potential reductions in projected revenues or increases in projected expenditures during each fiscal year.

B. FEDERAL RESPONSE

Under the New York City Seasonal Financing Act of 1975, 83/ which expired on June 30, 1978, New York State, the United States and the FCB concluded a credit agreement for short-term loans to the City. Before committing the Federal Government to the short-term seasonal credit agreement, the Secretary of the Treasury received a borrowing and repayment schedule approved by the FCB and determined that there was a reasonable prospect for repayment.

---

83/ 31 U.S.C. 1501 et seq. (1975).

Pursuant to the Seasonal Financing Act and the credit agreement, the City made periodic reports to the Treasury Department and notified the Department of any changes in its financial plan. The United States General Accounting Office and a representative of the Secretary of the Treasury were authorized to audit and review the City's books and records and were to receive monthly statements of any material changes in the City's financial plan, monthly statements of results of the City's operations, annual statements of the City's financial position and semi-annual evaluations of the City's current economic conditions.

Although the credit agreement required the City to use its best efforts to obtain seasonal financing from private or state sources after July 1, 1977, the Governor, the Mayor, and the FCB concluded that further federal assistance, in the form of loan guarantees, would be necessary beyond June 30, 1978. In March 1978, the Administration proposed legislation that would have authorized the Secretary of the Treasury to guarantee up to \$2 billion of taxable bonds issued by New York City or on its behalf (e.g., by MAC). After extensive hearings, the Senate and House of Representatives each passed differing versions of Federal guarantee legislation. On July 25, 1978, the House of Representatives passed a compromise version of the legislation which emerged from a conference committee. The measure was passed by the Senate on July 27, 1978. The measure entitled The New York City Loan Guarantee Act of 1978, became law when signed by the President on August 8, 1978.

The New York City Loan Guarantee Act of 1978 authorizes the Secretary of the Treasury to guarantee City indebtedness for up to 15 years, the guarantees to be made during a four year period ending June 30, 1982. 84/ Only those City debt instruments sold to City or State pension funds would be eligible for the guarantee, which would not be transferable. The Secretary must first determine that the City is entirely unable to obtain credit through traditional sources in amounts and on terms sufficient to meet its financing needs. Moreover, during the period in which he is authorized to provide the guarantees, the Secretary must determine that the remainder of the City's long-term borrowing needs and all of its seasonal borrowing needs during that period would be met through commitments from the State, State agencies, private sources or through the public capital markets. Thus, the loan guarantees are to take effect only if the Secretary determines that they are the only missing element to the City's financing package for the next four years.

---

84/ Total guarantee authority of up to \$750 million is available for fiscal 1979; with a maximum of \$500 million for long-term indebtedness and with a maximum of \$325 million for seasonal financing, to the extent City pension funds are prevented from providing it under the Internal Revenue Code. Additional guarantee authority up to \$250 million, plus the unused portion of the 1979 authority, is available in fiscal 1980 for long-term debt only. Similarly, there is additional authority for \$325 million in both 1981 and 1982, (provided the City's 1982 budget is balanced under generally accepted accounting principles), subject to one-house Congressional veto.

The New York City Loan Guarantee Act of 1978 requires that the City remain in compliance with certain fiscal and financial requirements. These requirements include: the City's budget for fiscal year 1982 must be balanced in accordance with generally accepted accounting principles, and the budgets for fiscal years 1979, 1980, and 1981 must be balanced in accordance with the New York State Comptroller's uniform system of accounts for municipalities; operating expenses must be fully eliminated from the capital budget and reflected in the operating budget by 1982; an independent fiscal monitor (the FCB) must remain in place during the life of the authorized guarantees and must have authority to control the City's fiscal and financial affairs during this period; the City must agree to obtain annual independent audits and an independent audit committee with specified membership must be established; the City must assent to having its financial statements audited by the United States General Accounting Office; a reserve fund must be established independent of City control, equal to at least 5 percent of the principal and 5 percent of one year's interest on the then outstanding guaranteed City indebtedness (the State's 1978 amendments require a \$100 million reserve fund); and the FCB must review and report annually on the work of a City Productivity Council, which must be established to develop and implement methods to enhance the productivity of the City's labor force. In addition, after June 30, 1979, the State of New York must satisfy certain requirements regarding its aid and assistance to New York City.



The guarantee legislation also contains provisions designed to hasten the City's ability to enter into the public capital markets. The City is required to devote a portion of the proceeds from the sale of its future unguaranteed long-term debt to retirement of the guaranteed indebtedness, subject to provisions authorizing the Secretary of the Treasury to provide relief from these requirements where necessary in the interest of the City's capital needs.



