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CONSUMER PROTECTION AND FINANCE
HOUSE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE
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Mr. Chairman and members of this distinguished Subcommittee:

I am pleased to have the opportunity to present the Department of the Treasury's views on H.R. 15205, the Municipal Securities Full Disclosure Act of 1976. Treasury strongly supports the principles which underlie this legislation, and with qualifications I shall discuss later in my testimony, strongly supports this bill. Moreover, I would like to commend the committee for its willingness to take up this legislation so promptly. Since the implementation period for the procedures required by this legislation is rather lengthy, time is of the essence.

The Need for This Legislation

Perhaps the oldest cliche on Wall Street is that "uncertainty is a condition markets do not tolerate well." And today, as a consequence of the changes of the past two years, uncertainty remains altogether too prevalent in the market for the securities of state and local governments.

For many years the myth persisted that tax-exempt securities, and particularly those general obligations secured by the ad valorem taxing power of the issuing jurisdiction, were risk free. This myth was reflected not only in investors' attitudes toward new issues, but also in the behavior of the secondary market.

Rarely, if ever, did price changes in the secondary market for municipal securities reflect new information concerning the financial affairs of an issuer. Rather, price changes were normally marketwide, reflecting changing perceptions of interest rate prospects or economic conditions. In terms of its price behavior, the secondary market for municipal bonds was much more similar to the government securities market - - where, of course, there is no principal risk whatsoever - - than it was to the corporate markets, where changing risk characteristics were generally reflected in the prices of individual securities.

To be sure, the municipal market did go through the motions of distinguishing among issuers on the basis of risk. Many new issues, and virtually all of substantial size, were subject to the rating process and assigned a letter grade which attempted to define the relative risk characteristics of the security in question. But as we learned so forcefully during the New York City financial crisis, no one - - not even the rating agencies themselves - - believed that the levels of risk which were assigned relected the financial realities.

Notwithstanding the fact that the rating agencies had assigned New York City a lower rating than other issuers - - thus implying there was a greater risk of default by New York City than such other issuers - - and notwithstanding the fact that underwriters and investors in New York City securities demanded a higher return than they demanded from other, higher rated issuers - - thus reflecting allegedly different perceptions of risk - - both representatives of the rating agencies and the financial community insisted that the ultimate realization of the risk they had identified - - default - - was unthinkable and impermissible.

In short, until last year the municipal bond market in effect operated on two levels of awareness: the real and the superficial. On a superficial level, the participants behaved as if they were dealing with a real market, where prices reflected the financial condition of the issuer. But as a practical matter, the market operated on the assumption that no principal risk existed: that debt service obligations would be timely met by all issuers.

Today, there is only a single level of awareness. We know that default is a realistic possibility. Accordingly, we are forced to make real judgments as to the relative risk characteristics of particular securities. Yet there is no mechanism to insure that those judgments are made in a sound and responsible manner. It is to provide such a mechanism - - perhaps the most essential characteristic of a healthy, properly functioning, securities market - - that we need legislation such as that before the Subcommittee today.

As I shall discuss momentarily, I do not believe such legislation should mirror, or even be patterned upon, the form of regulation in the corporate securities market. I do believe, however, that we can look at the corporate market for guidance in addressing the threshold question of whether legislation at the federal level is required. Our corporate markets are the healthiest, most competitive, most efficient, and most attractive in the world. In my view, a principal factor in the strength of these markets has been the knowledge, shared by all investors, that the information they are relying upon is current, accurate, and comparable. We need to develop a system of municipal disclosure that meets these same criteria.

The Constitutional Parameters

Since the debate regarding municipal disclosure legislation began in earnest approximately a year ago, there have been those who have argued that any such legislation at the federal level would be an unconstitutional interference with the right of sovereign state and local jurisdictions to conduct their own affairs. When companion legislation was considered by this Subcommittee's counterpart subcommittee in the Senate, the Senate requested and received legal opinions to the effect that carefully drafted municipal disclosure legislation would not violate the Constitution.

Since then, however, new impetus has been given to the constitutional argument by the Supreme Court's decision last June in National League of Cities v. Usery. That case held that the Federal Government could not regulate the wages a state paid its employees on the theory that the Federal Government was probihited from interfering with a state's conduct of essential state functions.

I will leave the final legal appraisal of the impact of the Usery decision to the practicing lawyers, and in that respect the Committee may wish to ask those who opined on this issue to Senator Williams' subcommittee to reappraise their opinions in light of Usery. Let's take a moment, however, to look at the question from a practical standpoint, on the principle that our Constitution must be responsive to changing needs and changing conditions.

I can accept, indeed endorse, the principle that the Federal Government should not involve itself in the internal affairs of a state. I do believe, however, it is quite a different matter when a state or local government - - even in the exercise of a governmental function so essential as borrowing money - - chooses to deal with citizens of other states.

One of the key aspects of our Constitution is its guarantee to every citizen, to every jurisdiction, of the free and unfettered right to deal with citizens of other states: the right, largely free of state or local interference, to tap the financial resources of persons or entities located elsewhere. Looked at in this context, I would submit that it hardly befits a state to argue that the same Federal authority which guarantees it access to the financial resources of citizens of other states - - to the national financial markets - - does not permit the Federal Government to take action to insure that such assess is on fair and reasonable terms.

That is a practical man's view of the constitutional principles involved. Now let me turn to the practicalities themselves.

I believe that without a uniform nationwide system of disclosure, the municipal bond market will become increasingly fragmented and regionalized. Yet, if historical trends continue, such a process of balkanization will be accompanied by continuing growth in state and local government demands for credit: larger needs, but smaller markets. At some point - - indeed we may have reached that point in some areas today - - these smaller, fragmented regional markets will simply be unable to supply the credit demanded by issuers within those markets. Then, given the absence of a national market precipitated by unwillingness to adopt uniform rules of disclosure, obtaining credit in the traditional way - - by borrowing in the public market - - will become impossible.

That in turn will inevitably lead to demands for Federal assistance in state and local financing and, of course, far higher levels of Federal intrusion than those contemplated by the current proposal for municipal disclosure. It would indeed be a Pyrrhic victory for states rights and the principles of federalism, if a broad construction of Usery resulted in virtual denial of access by state and local governments to private sources of financing.

Basic Principles of Disclosure Legislation

I suggested earlier that we should not deal with the question of municipal disclosure simply by adopting the disclosure principles employed in the corporate markets. From relatively simple beginnings in the early 1930's, the issuance of corporate securities - - through judicial mandate and regulatory action - - has come to be governed by an extremely demanding and complex set of rules which create potential pitfalls for issuers and intermediaries at every turn.

The growth in these demands represents a value judgment that the investor is entitled to have the people with whom he deals take every conceivable step - - irrespective of how costly, how burdensome, or how inefficient - - to protect the investor from financial loss. In dealing in corporate securities, an issuer or an intermediary fails to dot every "I" and cross every "T" at its own peril. Unless the proper path is followed with absolute rigor and perfection, it is likely that the investor will be able to recoup his investment and more, irrespective of the investor's own contribution to the loss or of the existence of a causal relationship between the issuer or underwriter's conduct and the investor's loss.

While it may be satisfying or comfortable to think of such standards in moral terms, as a practical matter, their ramifications are purely financial. In the corporate arena, the need to dot "I's" and cross "T's" simply means that the entire process must be supervised by multiple teams of lawyers and accountants whose fees add considerably to the costs of the capital raising process.

While I have my doubts as to the utility of these standards in the corporate field, it is not our purpose today to reexamine them. I do, however, strongly believe that we must be acutely sensitive to the dangers inherent in transposing these practices to a system of municipal disclosure.

Simply stated, the extensive corporate disclosure requirements reflect a judgment that we should spare no expense to give the investor every last ounce of financial and legal protection. In the municipal area, where such expenses must be directly paid by taxpayers, I do not believe we can or should make a similar choice. Instead, in designing a system of municipal disclosure we should confine the burdens on issuers and underwriters to those required to produce healthy and efficient markets - - thereby reducing borrowing costs - - and resist the temptation to impose further costs for the purpose of providing extra "insurance" to investors, which will not be recouped out of lower borrowing costs, but instead must be paid by the taxpayers directly.

In the corporate field the phrase "protection of investors" has come to mean insurance for investors. In the municipal area I believe it incumbent upon us to confine the meaning of the term to what may well have been its original meaning: information.

The Desired Nature of Disclosure Legislation

The fundamental goal of disclosure legislation must be to assure that the maximum amount of relevant information is readily available, with a minimum amount of Federal intervention and a minimum of cost. Disclosure rules and regulations should enhance the market, not interfere with the market mechanism for municipal issues. Most importantly, in order to ensure that municipal investors are able to make a concise comparative analysis of the finances of different issuers, disclosure legislation must standardize the presentation of the information being disclosed.

It is the importance of standardization which requires that a disclosure program be administered at the Federal level. We have examined carefully the voluntary disclosure approach. As the Committee knows, it has been argued that since investors and underwriters are demanding more information, if the free market were left to its own devices, the information would be provided by those issuers which need market access. We concluded, however, that precisely to assure that the free market mechanism will function smoothly with respect to municipal issues, it is necessary to insist upon mandatory disclosure of financial information by issuers entering the market. It is only by mandatory disclosure that adequate, uniform, usable information can be assured, and that its flow to the investing public can be guaranteed.

Scope

There are many municipalities which do not enter the capital markets frequently or to a heavy degree, and thus present lesser concerns to the investing public or to the proper functioning of our nation's capital markets. There are many municipal issues which have a relatively limited market. So that mandatory disclosure does not result in overkill, we favor the setting of threshold limits below which disclosure would not be required.

Once the issuers which should be subject to disclosure standards have been identified, the information required of them should be carefully specified and relatively comprehensive. Some flexibility, of course, is advisable, but in general State and local governments are entitled to clear and explicit guidance from the Congress on the kind of information they are required to disclose.

Comments on Pending Disclosure Bills

Based on the above principles, we oppose H.R. 11044. By eliminating the 1933 and 1934 Act exemptions for municipal securities, this bill would require that municipal securities undergo the same disclosure, filing and clearance and registration procedures as corporate securities. Such an approach would impose burdens and costs which outweigh the benefits derived.

As I indicated at the outset, I concur with the essential substance of H.R. 15205. The bill provides for the preparation of annual reports, including audited financial statements, by issuers of municipal securities with more than $50 million outstanding. It provides also that distribution statements be prepared prior to public offer or sale of $5 million or more of securities. And it requires that such reports and statements be reliable and comparable, as well as readily available to underwriters, dealers and investors. Finally, it encourages State oversight by providing for exemptions from the distribution statement requirement where a State authority has approved the offer and sale of the issue.

From our standpoint, perhaps the most important feature of the legislation is the requirement of an annual independent audit. Not only does this requirement itself satisfy two of the three fundamental criteria of disclosure legislation - - insuring the accuracy and the comparability of the financial information provided - - but it also provides the issuer with an important management tool.

As we in the Treasury have become involved with the activities and the structure of particular local governments, we have come to recognize the relationship between sound supervisory mechanisms and the care with which employees handle the government’s finances. If the public employee knows that every action related to the fiscal affairs of his employer will be subject to review on an annual basis by an independent party, he is far more likely to act in a manner consistent with the employer’s best financial interests. Thus, in addition to meeting the fundamental need for insuring the accuracy and comparability of reported financial information, the independent audit can aid the issuer in its internal financial management as well.

In short, we believe the Chairman’s bill strikes an appropriate balance: requiring disclosure of as much information as is necessary to allow the market to function properly, without burdening our states and cities with requirements that impose unnecessary costs.

However, we would recommend several changes in the bill. First, I am concerned about the authority conferred upon the Commission by subsection (d) of Section 13A. To the extent this provision reflects the view that, in light of inflation, it may be appropriate at some future date to allow the Commission to adjust upward the minimum filing requirements, such intent could be more clearly expressed by substituting the word “increase” for the word “change” on line 5.

If, on the other hand, the provision contemplates a possible downward adjustment of the minimum limits, I believe the provision constitutes an inappropriate delegation of authority to the Commission. It is important to keep in mind that this legislation contemplates a degree of Federal involvement in the affairs of sovereign political units. Accordingly, it is our strong belief that any change which materially increases the scope of the legislation, or the burden on entities initially subject to the legislation, must receive the review and approval of the Congress in the form of new legislation.

This leads directly to a second area of concern. While we recognize the necessity for some rulemaking authority in the Commission to implement the statutory directives, we think the legislation, as currently drafted, goes much too far. As I indicated earlier, while the protection of investors is, and must be, a consideration, it is not in my view a consideration of such paramount importance as might be the case on the corporate side. The grant of discretion to the Commission to expand the type of information required must be carefully circumscribed and should recognize expressly the different competing considerations which exist in the municipal securities area.

Finally, there is the complex and troublesome question of liability. While the clamor over this issue has subsided somewhat in the wake of the Hochfelder decision and the return of relative calm to our municipal markets, I believe there remains a risk that the benefits of disclosure legislation - - healthier markets and net reduction in borrowing costs - - may be impaired by a failure to address the liability issue.

It is tempting to suggest deferring this question until a more general reappraisal of the private action under the securities laws is made. But given the emotional and financial interests inherent in any such general reappraisal, I believe it more desirable to take the opportunity presented by our consideration of comprehensive new legislation in the municipal field to develop principles applicable to this market alone.

In assessing the question of liability, it seems to me we are again placed in the posture of imposing a balancing test: do the benefits to the marketplace outweigh the costs incurred by imposing full liability on dealers and underwriters? Costs, it again must be stressed, which will be directly paid by the taxpayers of the issuing jurisdiction. To put it more bluntly, is requiring underwriters and dealers to be financially responsible for the accuracy and the completeness of an issuer's disclosures worth the price taxpayers will pay for imposing such a responsibility?

It is important to note that it is only this narrow question that we are considering. While the Committee may want to confirm my judgment with representatives of the dealer and the underwriter community, I assume that no one is suggesting that an underwriter or a dealer should not be liable for its own misconduct: for example, for concealing actual knowledge of false disclosures or material nondisclosures or for providing information to investors, other than that provided by the issuer, which is false or misleading.

What we must ask is whether an underwriter should be responsible for conducting an independent inquiry into the fiscal and financial affairs of an issuer to confirm that the issuer's disclosures are accurate.

My own judgment is in the negative. I believe the costs of such an independent inquiry far outweigh whatever benefits, if any, can be derived. And while there may be some superficial appeal to issuers in the prospect of sharing their exposure with other parties, in the final analysis no real sharing takes place. The issuers pay, and pay dearly, for conferring upon investors the right to seek recourse against the financial intermediaries they have retained.

Mr. Chairman, let me briefly summarize the principles - - many of which are already embodied in legislation before us - - which I believe must guide us as we move toward enactment:

- - First, the legislation itself must set forth with detail and clarity the specific items and methods of disclosure required. As little as possible must be left to subsequent regulatory interpretation.

- - Second, causes of action against an issuer must be strictly based on violations of the above requirements and an issuer's exposure limited to actual, out-of-pocket losses.

- - Third, the legislation should recognize the principle that potential underwriters' liability will be directly reflected in the issuer's borrowing costs. I personally believe that an underwriter should be relieved by statute of any liability with respect to disclosures by an issuer unless (1) the underwriter conceals actual knowledge of false disclosures or material non-disclosures or (2) it provides information to investors other than that provided by the issuer which is false or materially misleading.

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I am sure I need not emphasize for the Committee that a decision to support legislation involving a greater Federal role in the activities of a market is not one that is taken lightly by a representative of this Department and this Administration. But as strong advocates of free markets, we recognize that markets function best when the best information is available. And in our view, achieving that objective requires prompt enactment of the legislation before us today.

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