STATEMENT OF RICHARD KEZER,
PRESIDENT OF THE DEALER BANK ASSOCIATION,
ON H.R. 15205, BEFORE THE SUBCOMMITTEE ON
CONSUMER PROTECTION AND FINANCE
OF THE
HOUSE COMMITTEE ON INTERSTATE AND FOREIGN COMMERCE
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Mr. Chairman and distinguished members of the Committee,

I am Richard Kezer, President of the Dealer Bank Association and Senior Vice President of Citibank, in New York City. I am pleased to appear before you today on behalf of the Dealer Bank Association, a group of approximately 140 commercial banks that actively underwrite and make markets in almost all forms of public securities.

The Dealer Bank Association ("DBA") strongly supports disclosure of material information by issuers of municipal securities. We believe that such disclosure will increase investor confidence in municipal securities. We also strongly support statutory clarification of the municipal securities underwriter's obligations. We believe that such clarification will permit issuers to sell their securities more quickly and at a lower cost.

The DBA also believes that appropriate federal legislation is likely to provide the quickest and surest means of reaching these goals. Accordingly, we applaud this Subcommittee's decision to hold hearings on H.R. 15205, "The Municipal Securities Full Disclosure Act of 1976," introduced last week by the Chairman.

After briefly reviewing the nature of the market with which we are dealing, I will describe the DBA's views on several of the major provisions of H.R. 15205, and then discuss more extensively what the role of the municipal securities underwriter ought to be under new federal legislation.

The municipal securities market is an extremely large one. According to statistics prepared by The Bond Buyer, a total of 8,107 issues were brought to market in 1975, and a total of $51.9 billion of municipal securities were sold that year. About $29.3 billion of the municipal securities sold in 1975 were long-term bonds, and about $29.0 billion were short-term (12 months or less) securities. There are perhaps 750 participants in the market, including bank dealers, non-bank dealers and brokers. And, of course, there are many thousands of issuers of municipal securities - - states, state agencies, cities, counties, school districts and many others.

Historically, municipal securities have been extremely safe investments. In the last forty years particularly, there have been very few municipal defaults. Investors have been able to invest billions of dollars in municipal securities with a high degree of confidence that they will receive the interest and principal they expect. The recent problems of New York City aside, municipal securities have been considered second only o federal government securities in safety. Moreover, issuers and underwriters of municipal securities have only rarely been charged with misleading investors about the nature of the issuer and its financial resources.

The municipal market is characterized by competitive bidding in which syndicates of underwriters bid against one another to buy an issuer’s securities for resale. Competitive bidding makes it impractical for a prospective underwriter to obtain access to the issuer’s files and personnel and to commit the staff needed to conduct an independent investigation into the accuracy and completeness of all the information provided by an issuer. An underwriter, in a normal market, would typically be a part of syndicates bidding on a large number of issues in any given time period, and be a part of

the successful syndicate only about a quarter of the time that he bids. For example, in 1975 my bank was a member of syndicates that bid on 434 issues of long-term bonds; these syndicates were successful 110 times. By way of comparison, we were the underwriters in just 22 negotiated transactions in 1975.

Although the municipal securities market seems to be functioning efficiently at the moment, uncertainties concerning the obligations of municipal securities underwriters disrupted the market during a substantial part of the last year. These uncertainties prevented some issues from coming to the market at all, and decreased the number of bidders and increased interest costs for other issuers.

One important way to prevent disruptions in the future is, in our view, to require disclosure by issuers of municipal securities. To the maximum extent practical all issuers of any given type of municipal security ought to provide the same kind and amount of disclosure. Of course, disclosure standards should vary for different types of securities. Different information will be important depending of whether the municipal security being sold is a short-term note, a long-term general obligation bond, or a revenue bond. The disclosure system to be established must have sufficient flexibility to permit varying standards to be set for different types of municipal debt instruments.

Uniform accounting standards for issuers of municipal securities are also an important part of uniform disclosure because otherwise an investor, or an underwriter, cannot compare with confidence the strengths and weaknesses of various municipal securities being offered for sale.

H.R. 15205 provides a sound basis for implementing the goal of uniformity. We believe, however, that it should be made clearer in the bill that the amount of information

and the type of information to be contained in the distribution statement could vary with the type of debt instrument being offered. In addition, further study is necessary to determine precisely how many issuers would be reached by the $50 million annual report threshold and the $5 million distribution statement threshold. If the number of issuers subject to those requirements s too small, then the goal of uniformity in disclosure will not be achieved and we would support lower thresholds. Issuers that do not make disclosures about themselves may be at a disadvantage in selling their securities, so it is not improper to require every issuer to comply with some disclosure requirements, appropriately adjusted to reflect the issuer's size.

One of the most important issues that any federal legislation will have to deal with is the appropriate institution to prepare the disclosure standards and administer the law. The issue is a sensitive one because the issuers of the securities with which we are dealing are states and their political subdivisions. Thus the relationship between the federal government and the issuers must be structured with great care, and must not do damage to the principles of federalism. We think that the question of the proper institutional structure is one primarily for the Congress and the representatives of municipal issuers to resolve. As underwriters our concern is with the substance of the rules and with the administration of the law. The rules must provide for the disclosure of sufficient information to enable underwriters and investors to make sound judgments without placing an unreasonable burden on the issuer, and the law must be administered in a way that promotes an efficient municipal market.

The central purpose of federal legislation requiring disclosure will be to assure that investors in municipal securities have available to them the information needed to

make reasoned investment decisions. The responsibility for assuring that the information provided does not omit a material fact and is not misleading must rest with the issuer. This is so because the issuer is obviously in the best position to determine whether the information about itself in its disclosure documents is complete and accurate. Accordingly, an investor ought to be able to look to the issuer for compensation for damages suffered on account of material misstatements or omissions in disclosure documents. The issuers here are units of government, and to have them bear this responsibility does no more than recognize their public responsibilities.

It seems to us entirely proper for the Congress to provide that any issuer who wishes to use interstate commerce to sell municipal securities should waive whatever jurisdictional defenses arising out of its governmental status it might otherwise have against suits by investors. We recognize that the Supreme Court's recent decision in National League of Cities v. Usery may raise a question concerning Congress' power to require States and localities to make full disclosure or be subject to suit. We have been advised, however, that the Usery case is not necessarily an obstacle to carefully drawn legislation, and we believe that Congress should use the full extent of its constitutional powers to protect investors all across the country and to assure the integrity of the Nation's capital markets for the benefit of all issuers.

In our view, officials of the issuer ought to be protected from personal liability in the event they acted reasonably. But there should be anti-fraud provisions which contain criminal sanctions for fraudulent actions by any issuer official who willfully and knowingly makes a misstatement or omission in a disclosure document relating to municipal securities. This would be consistent with the present structure of the Securities

Exchange Act of 1934. While we believe that H.R. 15205 is consistent with these principles, we also believe that the bill could profitably deal with issuer responsibility more clearly and in more detail.

In our view H.R. 15205 has properly utilized an annual report supplemented by a distribution statement as the basis for municipal securities disclosure. Since many issuers are already required by local law to prepare annual reports or do so as a matter of practice, basing a disclosure system on such reports minimizes the burden and cost to issuers. And using a distribution statement that provides information about the underwriting and the use of the proceeds, and updates material information from the last annual report, will, at least for those issuers who are subject to the annual report requirement, permit an issuer to go to market quickly and without any unnecessary red tape. We suggest that, in order to protect investors who purchase municipal securities, and in order to permit secondary market purchases and sales of municipal securities to be made with confidence, the Committee consider establishing a mechanism by which an issuer would make public announcements of material events affecting its creditworthiness between annual reports.

Finally, we support the provisions in H.R. 15205 that call for independently audited financial statements in annual reports. Independently audited financial statements, the most important information contained in any disclosure document, provide a high degree of investor protection and investor confidence. The primary objection to such audits, as we understand it, is their cost. It is possible that this problem could be alleviated by the use of auditors other than those in private firms. The critical requirement for an auditor is, in our view, independence from the issuer. It should be

possible to structure a disclosure system in such a way that a government agency with adequate assurances of independence from the issuer can perform the auditing function called for by the bill.

I will turn now, Mr. Chairman, to the DBA's primary concern: the role of the underwriter in the municipal securities market. The obligations and liabilities of an underwriter of municipal securities today are tested only under the general anti-fraud provisions of the securities laws. Recent Supreme Court rulings have clarified the obligations of an underwriter to some extent, holding that to be held liable an underwriter must have had an intention to deceive. However, such decisions are always subject to interpretation by the lower courts, particularly with regard to the evidence that will suffice to demonstrate the requisite intent. We think certainty should be provided in this area by congressional specification of the circumstances under which an underwriter could be held liable. In particular, the legislation should make clear that a municipal securities underwriter, at least in a competitive bidding situation, need not make a separate investigation into the state's or city's affairs.

As I said earlier, a municipal securities underwriter will typically be part of a successful syndicate only a quarter of the time he participates in the competitive bidding process. Accordingly, there are severe practical problems of time and access to information that keep an underwriter from performing the sort of independent investigation that would be needed to determine whether the issuer has provided complete and accurate data. This sort of investigation can be done and is required with respect to the underwriting of corporate securities, where negotiated bids are customary. But in the municipal market almost all securities are sold to underwriters by competitive

bids. And since competitive bidding keeps costs to the issuer (and the issuer's taxpayers) low, it is highly desirable as a matter of public policy to preserve competitive bidding in the municipal market. This in turn requires carefully defining the issuer's and the underwriter's obligations and liabilities.

It should be stressed that we are dealing here with issuers that are governmental entities, raising funds for public purposes, not issuers that are private organizations raising funds in the hope of private profit. Thus, many of the reasons that justify compelling an underwriter to make an independent investigation about the accuracy and completeness of the information provided by an issuer of corporate securities are not applicable when one is dealing with municipal securities. Further, there are checks on a governmental issuer of securities that do not apply with equal force to a corporate issuer -- government in the sunshine laws, periodic elections and press scrutiny of local governments are examples.

Finally, the costs of an extensive underwriter investigation of the accuracy and completeness of the information provided by an issuer, even if it could practicably be done, would have to be passed on to the issuers and would substantially raise the cost to the issuer of selling municipal securities. The issuer's cost would increase both because the underwriter's cost of doing business would escalate, and because there are many smaller underwriters who would stop bidding rather than arranging for and conducting extensive investigations into the accuracy and completeness of the information provided by an issuer. The issuers would have to bear the increased cost, and this would have the effect of increasing taxes or decreasing services in virtually every state, county and city in the country. The increased cost might even discourage some local governments from

raising the funds needed for essential public projects. And some issuers might find it impossible to raise funds at all.

In light of these factors as well as the history of the market, we do not believe that the costs that would be imposed on issuers by requiring extensive underwriter investigation of the accuracy and completeness of the information provided by an issuer are worth the small benefits to be gained. Meeting disclosure requirements alone will impose new costs on issuers; and while that cost can be justified by the investor protection it provides, the additional costs of a second level of investigation by an underwriter cannot be expected, when we are dealing with local government securities, to provide enough additional protection to make it worthwhile. This seems to us particularly true if the bill that is adopted by Congress provides, as H.R. 15205 does, for certified financial statements and issuer responsibility for the accuracy and completeness of the disclosure. These provisions assure the investor the protection he needs in this market; there is no reason to impose on the taxpayers any additional expense.

Accordingly, we believe that the underwriters of municipal securities under any new disclosure system should not be called upon to perform an independent investigation concerning the accuracy and completeness of the information contained in a disclosure document prepared by an issuer. In our view reliance on the statements of public officials is entirely reasonable unless an underwriter in fact has different information. In the absence of knowledge of an omission or misstatement, an underwriter should have no liability for a misstatement or omission by an issuer of municipal securities. This is essentially the same public policy already reflected in Section 11(b) (3) (D) of the Securities Act of 1933. Under that provision an underwriter may rely in good faith on

statements made by an "official person" or copies or extracts from a "public official document" which are contained even in a corporate prospectus. And it reflects a standard consistent with the most recent Supreme Court ruling interpreting the anti-fraud provisions of the securities laws.

H.R. 15205 in its present form does not deal with these questions. The Chairman's statement suggests, however, that H.R. 15205 was intended to be the vehicle for the development of legislation, and not necessarily a final, concrete proposal. We agree with that approach, and we believe that there are sound and persuasive reasons of public policy for adding to H.R. 15205 provisions assuring that an underwriter of municipal securities will be liable only for an issuer's misstatements or omissions of which he had knowledge.

I appreciate the opportunity to appear before this Committee on a matter of great importance to the DBA and to the municipal securities market as a whole.

Thank you.