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INVESTOR PROTECTION--A SHARED RESPONSIBILITY

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I appreciate the opportunity to participate in this fifth annual presentation of "Banks and the Securities Laws," which is designed to deal with practical problems confronted by banking officials and those who provide legal and accounting advice to banks and bank holding companies. During the next two days, there will be ample opportunity to discuss the technicalities of various rules, regulations, guidelines, studies, enforcement actions, judicial decisions, and legislative matters. As the details are considered, it is important not to lose sight of the fact that the major purpose of the securities laws is to protect investors and each of us has a role to play in the fulfillment of that purpose.

In 1933, Congress determined that the primary regulatory mechanism through which investors were to be protected was a requirement that all issuers of securities provide full and fair disclosure of material information with respect to the character of the securities and the operations and financial condition of the issuer. Those who participated in the preparation of disclosure documents and the financial statements therein, were also given important responsibilities to assure that these documents

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were properly prepared. For reasons that are not completely clear, securities issued or guaranteed by a bank were exempted from the registration provisions and all but certain of the anti-fraud provisions of the Securities Act. The next year the Securities Exchange Act was adopted in order to provide for the regulation of securities markets. As part of that statutory pattern, listed companies were made subject to periodic reporting, proxy regulation and insider trading requirements. Inasmuch as securities issued by banks were not listed on stock exchanges, as a practical matter banks were exempt from this statutory pattern. In 1964, based on the Commission's "Special Study of the Securities Markets," Congress significantly amended the continuous disclosure requirements of the Exchange Act to cover all public companies with assets over a million dollars and more than 500 shareholders. At that time, however, Congress provided that the three federal bank regulatory agencies would be responsible for periodic reporting, proxy regulation and insider trading requirements with respect to publicly owned banks. Thus, banks were effectively exempted from all direct SEC regulation, other than anti-fraud actions.

In recent years there has been a gradual erosion of the special treatment provided in the securities laws for banks as issuers of securities. The advent and explosive growth of bank holding companies in the late 1960's was one of the most significant factors in this change because bank holding companies are subject to all provisions of the federal securities laws, including registration and continuous disclosure requirements. Moreover, the special provision adopted in 1964 for regulatory jurisdiction over publicly owned banks has been amended so that the federal bank agencies must "issue substantially similar regulations" as those adopted by the SEC unless they specifically find that such regulations are not necessary or appropriate in the public interest or for the protection of investors, and publish such findings. As a result of these changes, most major banks today are significantly affected by the SEC's continuously developing disclosure requirements.

There have been many recent developments in the disclosure area that affect banks, some of which will be discussed during this Conference. Foremost among these developments was the Commission's adoption last year of Guide 61, entitled "Statistical Disclosure by Bank Holding Companies." When this guide was first proposed in October 1975, it was vigorously contended by many parties, including bank regulators, that increased disclosure by banks might result in withdrawal of deposits and the failure of particular banks, and might even destroy confidence in the entire banking system. I believe that the events of the past two years have shown that the fears expressed were not well founded. It was also alleged that investors would be misled by detailed bank disclosure. In this regard, a recent report from the research department of a large retail brokerage firm stated that Guide 61 is "probably the most important change in bank disclosure ever" and the portion of the guide dealing with loan portfolios and requiring a breakout of non-performing loans is "one of the most valuable." In an effort to further improve bank disclosures, the SEC has also proposed the adoption of Article 9 of Regulation S-X relating to comprehensive financial statement requirements for bank holding companies and banks. As you are probably aware, these proposals have created much controversy, particularly with respect to the treatment of gains and losses from sales of investment and trading accounts securities.

Although it does not appear on the Conference schedule, another disclosure trend that may well be discussed because it is a topic of some interest to the banking community at this time, is the disclosure of management remuneration. In November of last year the SEC proposed extensive amendments to the disclosure requirements relating to management background including some changes with respect to compensation of management During the first few months of this year the Commission commenced several informal inquiries and formal investigations and filed three actions against public companies alleging that the value of personal benefits received by management had not been appropriately disclosed. Because of many inquiries on this general topic, just last month the Commission published an interpretive release emphasizing its long-standing view that the securities laws and our rules presently require disclosure of all forms of management remuneration including salaries, fees, bonuses, and certain personal benefits popularly known as "perquisites." In its release the Commission stated:

> Among the benefits received by management which . . . should be reported as remuneration are payments made by registrants for the following purposes: (1) home repairs and improvements; (2) housing and other living expenses (including domestic service) provided at principal and/or vacation residences of management personnel; (3) the personal use of company property such as automobiles, planes, yachts, apartments, hunting lodges or company vacation houses; (4) personal travel expenses; (5) personal entertainment and related expenses; and (6) legal, accounting and other professional fees for matters unrelated to the business of the registrant. Other personal benefits which may be forms of remuneration are the following: the ability of management to obtain benefits from third parties, <u>such as favorable bank loans</u> and benefits from suppliers, because the corporation compensates, directly or indirectly, the bank or supplier for providing the loan or services to management; and the use of the corporate staff for personal purposes. (emphasis added; footnote omitted)

As part of our review process, the Commission's staff has begun asking some bank holding companies about favorable bank loans not only to officers and directors of banks and bank holding companies but also to management of public companies which do business with the bank. The general topic of whether more detailed or comprehensive disclosure of management remuneration and transactions should be required is being carefully considered in the SEC's current re-examination of rules relating to shareholder communications, shareholder participation in the corporate electoral process and corporate governance generally, on which hearings are scheduled to begin later this month in Washington followed by additional hearings in Los Angeles, Chicago, and New York.

The application of the securities laws to banks is not limited to their role as issuers of securities. In fact, one of the major topics to be considered in this Conference is the regulation of bank securities activities. When the Exchange Act was enacted in 1934, to provide for the regulation of securities markets, banks were singled out for special treatment by means of an exclusion from the definition of a "broker" or "dealer." Despite the fact that they were able to engage in offering certain securities services similar to those offered by securities brokers and dealers, banks which were subject to regulation by federal bank agencies were excluded from regulatory requirements established and enforced by the SEC. This treatment of bank securities activities may have been necessary and appropriate at the time but the propriety of this regulatory approach has been, and still is, subject to serious questions.

In the past several years, major banks and major securities firms have been expanding their operations in order to become one-stop financial service institutions. Among the most controversial services to be offered by a bank was Chemical Bank's now aborted program providing securities brokerage services; equally controversial is Merrill Lynch's announced experiment to offer cash management accounts. Generally, I believe the opportunity for competing institutions to develop and offer new services can be in the public interest. Nevertheless, there are many important policy issues involved in these recent trends, not the least of which is the need for a re-examination by Congress of issues relating to the application of the Glass-Steagall Act. The SEC's interest, however, is primarily to assure appropriate regulation protecting all investors regardless of whether a bank or a securities firm is offering the services.

In adopting the Securities Acts Amendments of 1975, Congress dealt with the regulation of certain bank securities activities. Those Amendments granted the Commission "broad authority to oversee the implementation, operation and regulation of a national market system for securities transactions." As part of this broad mandate, Congress determined that the Commission should have regulatory jurisdiction over "every facet of the securities handling process involving securities transactions within the United

States" including the securities processing activities of banks. In recognition of the fact that the federal bank regulators would be examining banks and enforcing banking rules and regulations, Congress provided that the inspection and enforcement of Commission rules and regulations over bank transfer agent and clearing agency activities would be primarily the responsibility of the bank regulators. However, the Commission's general investigative and enforcement powers, which extend to all Exchange Act provisions, are equally applicable to transfer agents and clearing agencies which are organized as banks.

The Securities Acts Amendments of 1975 also included provisions to regulate the activities of municipal securities brokers and dealers. Because the industry is composed of commercial banks already subject to supervision by federal and state bank agencies, diversified securities firms already subject to regulation by the National Association of Securities Dealers and the SEC, and independent firms dealing solely in municipal and other exempt securities which were not previously subject to any form of federal regulation, Congress responded by establishing a new and unique regulatory framework. A Municipal Securities Rulemaking Board was established as the primary rulemaking authority for the industry. However, Commission approval was required for substantive MSRB rules to become effective. The Commission was also granted authority to abrogate, add to, and delete existing Board rules in any respect consistent with the Act, and the SEC's direct rulemaking authority to control fraudulent, manipulative, and deceptive acts and practices was enhanced. Primary inspection and enforcement authority over bank municipal dealers, which include banks and separately identifiable municipal securities departments, was vested in the bank regulatory agencies. Again, as in the case of other securities activities, the amendments made it clear that the SEC has broad inspection and disciplinary authority over all municipal securities professionals, including banks.

In addition to subjecting these bank securities activities to Commission jurisdiction, the 1975 Amendments directed the Commission to conduct a study, commonly referred to as the "bank study," to determine the extent to which persons excluded from the "broker" and "dealer" definitions of the Securities Exchange Act were engaged in securities activities and whether the exclusions are consistent with the protection of investors and the other purposes of the Act. The Commission's study examined various bank securities activities including four bank-sponsored brokerage-type services, bank corporate financing services and trust department securities trading activities of banks. In our final report to Congress on the bank study, the Commission concluded that to remove the exclusion of banks from the definition of "broker" and "dealer" would result in duplicative and unduly burdensome regulation, but that some changes should be made to assure adequate investor protection.

Upon receipt of our report, Senator Harrison A. Williams, Chairman of the Securities Subcommittee of the Senate Committee on Banking, Housing and Urban Affairs, requested the Commission to draft a legislative proposal implementing our recommendations and I understand our proposed draft legislation will be transmitted to members of Congress today. Our proposal is consistent with the regulatory patterns established in the 1975 Amendments for the municipal securities activities and securities processing activities of banks, which indicated that, while seeking to enhance investor protection, Congress would like to maintain the regulation of bank activities by the federal banking agencies to the extent practicable.

In addition to certain definitions, we proposed to amend the Exchange Act by adding a new Section 15C which would require the federal banking agencies to establish personnel training and competency standards, recordkeeping requirements, and examination procedures to regulate the conduct of banks effecting securities transactions for others, as necessary and appropriate in the public interest and for the protection of investors. In performing their functions, the bank agencies would be required regularly to consult with and request the views of the Commission and coordinate with each other in order to assure adequate investor protection and uniform rules and procedures to the extent practicable. Compliance with these rules and regulations would also be enforced primarily by the bank agencies. However, the Commission would have authority under Section 21 of the Exchange Act, to conduct investigations to determine whether any person has violated, is violating, or is about to violate any provision of Section 15C and rules and regulations thereunder, to subpoena witnesses, take evidence and require the production of books and records, invoke the aid of any U. S. court in conducting investigations, and seek the aid of any U. S. court to ensure compliance with such requirements as are established by the banking agencies.

The bank agencies would be required to advise the Commission quarterly of the banks for which examination reports have been completed or received and upon request would furnish to the Commission those portions of examination reports regarding a bank's securities transactions for customers. In addition, whenever a bank agency has reasonable cause to believe that there may be a violation of federal securities laws by a bank under its jurisdiction or an associated person, the agency would be required to notify the Commission of that fact and the grounds for its belief.

I support this cooperative approach to the regulation of bank securities activities on the theory that it will result in comparable standards of investor protection for banks and other institutions offering competing securities services, without unnecessary duplicative regulatory burdens. Hopefully, experience with the municipal securities legislation, the securities processing legislation, and the bank study legislation if enacted, will prove that view to be correct. Otherwise, it may be necessary to subject all bank securities activities to direct SEC regulation and enforcement.

When the Securities Acts Amendments of 1975 were being considered, there was considerable concern that the provisions relating to the regulation of municipal securities brokers and dealers might indirectly result in the imposition of disclosure requirements on municipal issuers. In response to these concerns, specific provisions were included in the legislation to assure that the Municipal Securities Rulemaking Board would not be able either directly, or indirectly through municipal brokers and dealers, to require municipal issuers to provide any information with respect to themselves or their securities. Before the legislation was even enacted, however, events occurred in New York City which highlighted the fact that municipal securities were not without risk of default and thus, disclosure of material facts with respect to municipal securities and the responsibility on the part of participants in the offer and sale to assure appropriate disclosure became important issues.

Federal legislation was introduced to apply the disclosure requirements of the Securities Act to municipal issues. The SEC opposed that legislation but supported limited federal legislation that would establish minimum standards of disclosure. There was general support for such legislation while crisis conditions continued, but as the crisis subsided, so did interest in the legislation.

As you know, late last month, the Commission released a staff report on its 19-month investigation of events that occurred in connection with the issuance and sale of New York City securities prior to the time the public debt-market was closed to the city. Although the staff investigation has not been completed, and the Commission has not determined whether to instigate enforcement actions against the city or other participants in the distribution of city securities, the report concludes that thousands of investors purchased securities without being adequately informed of material facts which were known to the issuer and others such as underwriters, bond counsel and rating agencies who participated in the distribution process.

The Commission's staff report also concludes that the accounting practices used by New York City and the system of internal controls were such that the City's financial information was unreliable and its real financial condition was obscured. It has been alleged that New York City's accounting practices are no different than those of other cities. If these allegations are true, then it would appear appropriate to establish a requirement that municipalities comply with acceptable government accounting standards and that their books be reviewed by an independent party.

The staff report concludes that the underwriters, most of whom were banks, had knowledge of the financial crisis but failed to adequately disclose adverse information with respect to the city's financial problems and the fact that the city might well be foreclosed from public markets from which it was necessary to obtain funds to meet current revenue needs. It has been suggested that underwriters of municipal securities do not have the same responsibility to investors as they have in underwriting an industrial issue. The law may not be as well developed with respect to municipal securities, but I believe it is clear beyond doubt, that when underwriters are aware of material information with respect to a municipal issue, they have a responsibility to assure that investors are provided with that information.

In October of last year I publicly expressed the view, which I had come to reluctantly, that although the publication of voluntary disclosure guidelines by the Municipal Finance Officers Association had been very helpful, there was an apparent need for federal legislation which would establish minimum required standards of disclosure for municipal issuers. In addition, I recommended that the legislation contain liability provisions for issuers, underwriters and experts patterned after Section 11 of the Securities Act. Early this year, the Commission sent proposed draft legislation embodying those recommendations to members of Congress, and there have been recent indications that such legislation will soon be introduced with possible hearings later this year.

Another securities area in which banks are very active and in which eventually there may be a need for some limited form of legislation is the government securities markets. At this time, the Commission has no evidence of any significant abuses by major banks or other major government securities dealers in these large, important markets. We are aware, however, of serious abuses by some small broker-dealers engaged exclusively in the purchase and sale of government securities, particularly Government National Mortgage Association modified "pass through" securities. Last month the Commission filed an injunctive action against Winters Government Securities Corporation, an affiliated broker-dealer and seven individuals alleging violations of the anti-fraud provisions of the federal securities laws. At this time several other investigations pursuant to formal orders and other informal inquiries are being conducted by our staff. It appears that unscrupulous individuals, some of whom have been forced out of the municipal securities markets in the past few years, have entered the government securities markets where there is a regulatory void, including the complete absence of any margin requirements, and have engaged in a disturbing pattern of conduct such as: the utilization of boiler room techniques; unauthorized trading, churning of accounts, excessive mark-ups and mark-downs, over-extending customer positions and sham accounts. These pernicious practices by a few unethical government securities dealers have jeopardized their customers, which are frequently small banks and credit unions. Moreover, such practices can have a significant impact on banks and other legitimate originating dealers who do business with these unethical government securities dealers. Hopefully this problem will be adequately dealt with by industry self-regulation, enforcement actions by the SEC and by the bank regulatory agencies. Otherwise, legislation may be necessary and appropriate.

In conclusion, let me suggest that the trend toward increased SEC regulatory impact on bank securities activities seems clear. It also appears that in an effort to minimize duplicative regulation the responsibility to assure that banks provide appropriate investor protection will be shared with the bank regulatory agencies, unless this approach proves to ineffective. Finally, as bankers and professional advisers to banks and bank holding companies, you have the front line responsibility to provide investor protection.