NEWS

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SHOULD BANK INVESTORS KNOW

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During the past two or three years, increasing attention has been focused on the differences between the regulatory philosophy of the Securities and Exchange Commission which emphasizes disclosure of material facts and public enforcement and the regulatory approach of the federal bank agencies which emphasizes non-public regulation and enforcement. One of the basic issues regarding these regulatory differences is whether the SEC approach or the banking approach should be applicable to the capital raising efforts and securities activities of banks and bank holding companies.

In view of the Glass-Steagall Act, which prohibits banks from engaging in certain securities activities, and the specific exemptions provided for banks and bank securities under the securities laws, it would appear that there should not be very much overlap of bank and securities activities, and thus little need for coordination or confrontation between the SEC and bank regulators. While this may have been somewhat the case previously, the development of bank holding companies, which are subject to most securities laws, the expansion of bank securities activities in recent years, and the enactment of new legislation have increased the jurisdiction of the Securities and Exchange Commission over banks.

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Although the SEC has not expressed an agency position on the degree to which banks should be allowed to engage in securities activities, the Commission does believe that when banks engage in similar types of activities as securities firms, they should be subject to comparable regulation and enforcement, and that the best way to achieve this result is to bring bank securities activities under SEC jurisdiction. On the other hand, while bank regulators have generally supported an increase in bank securities activities as being in the public interest, they have not been enthusiastic about SEC jurisdiction and regulation over such activities partially because of the differences in regulatory philosophy.

This jurisdictional controversy sets the stage for either a head-on collision between the SEC and the bank regulators in which the public could well be the biggest loser, or a cooperative inter-agency effort to develop a means of obtaining the public policy goals and objectives of each regulatory system to the maximum extent possible. Although not necessarily indicative of the attitude of bank regulators, a collision approach was taken not too long ago when a bank regulatory spokesman, perhaps in frustration, leveled a broadside attack against the entire disclosure philosophy of the securities laws. He stated that, "their provisions are primarily destructive in effect," and that this type of regulation "is no longer the most appropriate means for our

government to approach business." He added, "For we can no longer expect new businesses to rise to replace those that fail, nor can we tolerate the loss of a major industrial company." His proposed solution was to replace a disclosure system with a "covert system" of regulation in which the government would protect businesses from failure. He added, "And if business failures were reduced to the level of bank failures in number, the number of investor losses might be reduced to an acceptable figure."

I do not believe that this is an appropriate time or place to debate the issue, but I can say that I have faith in the ability of other businesses within our system to replace those that fail, and I can express my view that, if the government did what would be necessary to reduce business failures to the level of bank failures, it would be a disaster for our free enterprise system. Furthermore, inasmuch as the differences in the SEC and bank regulatory approaches are partly inherent in the banking and securities statutes, I believe it can be much more productive for the regulatory agencies to devote their efforts to a resolution of existing conflicts instead of attacking each other's philosophy. In resolving such conflicts, it would appear appropriate that present legislative trends should be taken into consideration.

A review of recent legislation indicates that the SEC regulatory philosophy will have an increasingly important

impact on banks, and that it will be increasingly necessary for the SEC and bank regulators to cooperate and coordinate their regulatory activities. On October 28 of last year Congress passed H.R. 11221, which contained a provision that, without fanfare and almost unnoticed, amended Section 12(i) of the Securities Exchange Act of 1934 to require all financial regulatory agencies to conform their regulations relating to periodic reporting, tender offers, proxies, and insider trading transactions to those issued by the Commission within 120 days after the bill's enactment, unless they find that it is not necessary or appropriate in the public interest or for the protection of investors and publish such findings and detailed reasons for the findings in the Federal Register. The regulatory agencies are also required to follow the same procedures for any subsequent amendments to these particular SEC regulations within 60 days of the Commission's action. It seems evident that the purpose of this amendment is to subject banks to substantially the same regulations and standards as those established by the SEC for other public corporations.

Within a few days the President is expected to sign into law an omnibus securities bill, S. 249, which, among other things, grants the SEC additional jurisdiction over some of the securities activities of banks. One section of the new law provides for a regulatory mechanism over the activities of

municipal securities dealers, including bank dealers. Such regulation is to be established through a Municipal Securities Rulemaking Board which will be appointed initially by the SEC. Subject to Commission review, the Board will promulgate registration and recordkeeping requirements, as well as other operational standards for both bank and non-bank municipal securities dealers. The law provides that one-third of the fifteen Board members will be representative of bank municipal securities dealers, and that the periodic inspection and enforcement of rules and regulations applicable to bank dealers will be administered by the appropriate bank regulatory agency. However, the SEC also will have inspection and enforcement authority over bank dealers. While it is not required by law, the Commission has invited the bank regulators to participate in selecting applicants for appointment to the Rulemaking Board.

Another section of the new law deals with securities clearing agencies, depositories, and transfer agents, and the SEC is granted general rulemaking authority over these entities, regardless of whether they are banks or non-banks. In some areas, however, the Commission and the appropriate bank regulatory agency have concurrent responsibilities and coordination and cooperation will be required in order to avoid duplicative or otherwise inappropriate regulation.

There is also a provision in the new law requiring institutional investment managers, including banks, who

exercise investment discretion to file reports with the SEC disclosing their securities holdings with respect to accounts having $100 million or more of equity securities registered under the Exchange Act or issued by an insurance company or a closed-end investment company and to disclose securities transactions involving at least $500,000. The SEC has authority to raise or lower the reporting levels and could require the disclosure of additional details on reported transactions, including such information as who holds the voting power. Promptly after the filing of such reports, the Commission will make the information conveniently available to the public except in instances where the non-disclosure of such information is appropriate under the Freedom of Information Act or where the Act excludes certain kinds of information from such disclosure requirements.

The Commission is directed to undertake steps to achieve a uniform, centralized reporting system for institutional holdings and transactions that is neither duplicative or burdensome on institutional investment managers, and, as part of the directive, the Commission is instructed to consult with state and federal authorities and self-regulatory organizations to help coordinate its reporting requirements with other organizations.

In addition to recent legislation, the Commission has taken actions under its present authority that have an

impact on banks. One of these actions, SEC Accounting Series Release No. 166, which relates to SEC disclosure requirements for registrants, is attracting a great deal of attention at the present time and is requiring the greatest cooperative effort between the Commission and bank regulators. In the fall of last year, a number of major public accounting firms who audit banks and bank holding companies indicated to us that they were experiencing more than the usual difficulties in evaluating loan loss reserves in the light of changing economic conditions. They believed that additional disclosures might be necessary and appropriate in order to communicate adequately the year-end condition of bank portfolios and suggested that it would be helpful to them if the Commission were to speak on the need for such disclosures.

The Commission's staff was already considering a statement dealing with current uncertainties in various areas of financial reporting, and it seemed appropriate that a discussion of bank loan portfolios be included. Therefore, when the Commission issued Accounting Series Release No. 166 on December 23, 1974, among other things, it called for substantial and specific disclosure of changes in the risk characteristics of loan portfolios. Since this release is an exhortatory expression of disclosure policy rather than a formal rule, no public exposure was required. However, before issuing the release, the Commission directed the staff to

expose it to the federal bank regulatory agencies for their consideration and revisions were made responsive to their comments before the release was issued.

The objective of the section of the release referring to banks is to obtain for investors adequate disclosure of the changing risk characteristics of loan portfolios which, in most cases, amount to more than 50 percent of bank assets. The Commission does not believe that a single valuation reserve figure can adequately communicate the uncertainties involved in the portfolio which may be important to investors in appraising current and prospective earnings. The Release suggested that:

> Additional disclosures should also be considered in cases where there have been substantial changes in the risk characteristics of portfolios, even when increased provisions for losses have been made. Where, for example, loans which are considered doubtful as to collectibility have materially increased, or where there have been large increases in delinquencies, loans extended or renegotiated under adverse circumstances, or evidences of changed risk, registrants should expand on normal disclosures to highlight such factors.

Over the last six or eight months, there has been a substantial amount of adverse publicity about bank problems in newspapers and national magazines. Statements by bank regulators, including Chairman Arthur Burns of the Federal Reserve Board and President Alfred Hayes of the New York Federal

Reserve Bank, indicate that banks have significantly expanded their activities without increasing their capital, that economic conditions has spread a certain degree of loan weakness throughout the banking community, that bank capital should be increased, and that banks should seriously consider raising equity capital even though it would result in some dilution of present shareholder equity if current market prices are below book values. The Comptroller of the Currency, James Smith, is reported as predicting that "loan losses by banks in 1975 'will be historically abnormal' because of the state of the economy, real estate defaults and depressed conditions in certain countries abroad where many banks have participated in large loans." In addition, Andrew Brimmer, a former member of the Federal Reserve Board, reportedly said, "The real story is that the Fed gave commercial bankers instructions not to permit real estate investments trusts and public utilities to fail, and to be sensitive to the credit needs of airlines and certain retailers."

In view of this, the Commission could not fulfill its responsibilities to the investing public without raising questions as to whether additional disclosures of the financial condition of individual registrant bank holding companies ought to be provided. It would not be fair for bank holding companies which may have serious undisclosed financial problems to have access to our capital markets on the same terms as those which are in strong financial condition. Therefore, the staff of the

SEC has requested bank holding companies to provide relevant supplemental information for their consideration in processing registration statements and such requests would have been made even in the absence of ASR 166.

In discussing SEC disclosure procedures, I have found that many people do not understand that a request for information by the staff does not necessarily mean that its disclosure in a registration statement will be required. The staff requests information on a supplemental basis for the purpose of evaluating the adequacy of the information to be disclosed in the prospectus or to determine what comments, if any, should be made, and the Commission insists that its staff receive such supplemental information in order to fulfill this function and to meet our statutory obligation.

Another apparent misconception which should be dispelled is the idea that it is inappropriate for the Commission's staff to comment on a pending bank holding company registration statement if they did not raise the same comments on a registration statement filed by the bank holding company in the recent past. Additional staff comments may be raised because there may have been changes in the results of operation, financial condition or business activities of the issuer since the date of the last filing. Moreover, the prior filing might have received cursory review by the staff as distinguished from full review accorded to the current registration statement.

Further, it could very well be that the staff should have raised the comments at an earlier stage, but failed to do so through inadvertence or human error. The SEC is under a statutory obligation when it orders a registration statement effective to have due regard for the adequacy of information about an issuer for the protection of investors. Accordingly, even if the staff did not comment on an issue previously, it is not precluded from doing so at a later time. On the other hand, our staff is conscious of time schedules and accordingly will do its best not to raise "eleventh hour" comments.

I have also found that there appears to be some confusion regarding the statutory standard of materiality. Frequently it is asserted that a certain piece of information is not material in terms of the total dollar amount of a bank's loan portfolio. This is not the appropriate standard of materiality under the securities laws. The Supreme Court has defined materiality generally as that information which a reasonable investor might consider important in making an investment decision. It should be clear that the Commission does not determine materiality, but only that the information in a prospectus must be adequate before the Commission can declare it effective. A registrant always has the obligation to make full and fair disclosure of all material facts in a prospectus covering a public offering, and the Commission's review process is designed to assist registrants to meet that

standard. The items of information specified in a registration form or in guidelines are minimum instructions, and notwithstanding the absence of a form item, the staff has issued comments in the past and will continue to issue comments calling for additional disclosure when appropriate.

There is no routine recipe as to the disclosure that should be made in a prospectus, and the Commission has not followed a formula approach with regard to the kind of disclosure which it has required of bank holding companies. Such disclosures have been developed on an individual basis through cooperation of the registrant, the SEC, and the appropriate bank regulatory agency. In some cases, bank holding companies have indicated that there were no material changes in bank portfolio risk characteristics. In other cases, disclosure has been made of particular loan categories and the magnitude of loans in the portfolio on which interest is not being accrued currently or other information based upon companies' own internal systems. In the final analysis, the disclosure which is appropriate for each registrant must be tailored to the facts of the situation and to the nature of data available to the management.

Ideally, the disclosure requirements relating to banks should be based on measurements which are consistent throughout the banking system and which are relevant to investors in understanding the underlying economics and

functions of banking operations and appraising the risks associated with such operations. Hopefully, some form of loan classification can be agreed upon which would enable investors to compare different banks in a more meaningful fashion.

Perhaps even more important than the information which is presently being required is the development and disclosure of data which will indicate the sensitivity of bank loan and investment portfolios to changes in the interest rate structure of the economy. For example, it might be useful to have instruments categorized by yields and maturities so that an analyst could make a reasonable determination of the extent to which future income streams will be affected by investments already on hand.

We have been told by banks and bank regulators that our disclosure requirements for banks are not meaningful or material for investors and, in fact, may be misleading and counter-productive. Moreover, the SEC has been asked not to require disclosure of information on bank loan portfolios because such disclosure could restrict banks from raising the capital necessary to finance a strong economic recovery. Obviously, the Commission does not want to thwart or inhibit economic recovery, and I do not believe that the type of bank information the SEC has required to be disclosed has had such an effect. Although Chemical New York Corporation's proposed

$100 million offering was withdrawn, other bank holding companies have provided the information required by the Commission and have sold their offerings without difficulty.

However, because of this concern and after several meetings between the SEC and bank regulators, a Bank Disclosure Coordinating Group composed of top level representatives from the three federal banking agencies and the SEC was formed early in April. The purpose of this group is to develop a proposal for bank disclosure guidelines and a special drafting committee directed by SEC representatives has been named to prepare a preliminary draft of proposed guidelines which, when approved by the Coordinating Group, will be submitted to the Commission for its consideration.

The development of guidelines for bank holding company disclosures is a high priority project because such guidelines should be helpful to bank holding companies in submitting registration statements for new capital issues for Commission processing. However, the Commission staff will be required to continue to process such submissions on an individual basis, both until the guidelines are developed and after they are approved, to assure that the disclosure is appropriate in the facts and circumstances of each case.

I believe that the disclosure philosophy which has been developed and applied for over forty years is sound and meaningful. It has demonstrated its dynamic capacity to adjust

to unique and peculiar circumstances in meeting the needs of those who provide funds as well as those who seek funds in our capital markets. While appropriate bank disclosure represents another challenge, I am confident that the application of the disclosure concept to bank holding companies is not misguided, and that the Commission, assisted by the recommendations of the Bank Disclosure Coordinating group, will be able to protect investors and the public interest and at the same time assure that bank holding companies have access to our capital markets.