U. S. Securities and Exchange Commission
Washington, D.C. 20549 (202) 272-2650

News Release

CURRENT DEVELOPMENTS IN SEC REGULATION OF DEPOSITORY INSTITUTIONS

by

DANIEL L. GOELZER *

SNL SECURITIES SEMINAR ON
Proxy Contests and Investor Relations
in the Banking and Thrift Industries:
Practical Insight and Legal Framework

February 5, 1990

---

* The Securities and Exchange Commission, as a matter of policy disclaims responsibility for any private publication or statement by any of its members or employees. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission or its staff.

TABLE OF CONTENTS

Page

I. INTRODUCTION 1

II. SEC AUTHORITY OVER FINANCIAL INSTITUTION REPORTING AND DISCLOSURE 1

A. Commission's Jurisdiction 2

B. Disclosure Problems Raised by the Interplay Between Securities and Banking Law 3

C. Recent SEC Efforts to Strengthen Its Oversight of Financial Institution Disclosure 4

1. Division of Enforcement Task Force 4

2. Division of Corporation Finance Task Force . . 5

III. FUTURE DIRECTIONS 7

A. Disclosure Harmonization and Centralization 8

B. Securities Activities 8

C. Elimination of Competitive Barriers 9

D. Decentralized System for Regulation 9

IV. CONCLUSION 10

CURRENT DEVELOPMENTS IN SEC REGULATION OF DEPOSITORY INSTITUTIONS

DANIEL L. GOELZER

SNL SECURITIES SEMINAR ON
Proxy Contests and Investor Relations in the Banking and Thrift Industries: Practical Insight and Legal Framework

February 5, 1990

I. INTRODUCTION

Good afternoon. I am pleased to be here.

I would like to spend a few minutes giving you an overview of some recent developments at the Commission regarding financial institution disclosure. First, I will describe the current framework of Commission regulation and some of the problems the Commission has encountered as a disclosure regulator of depository institution holding companies. In that regard, I will outline the work of two task groups recently formed to analyze financial institution disclosure problems. Second, I want to touch more broadly on the future of financial institution securities activities and disclosure regulation and outline four objectives which I believe should guide reform in this area.

Of course, the views I will express are solely my own and not necessarily those of the Commission or of others on the staff.

II. SEC AUTHORITY OVER FINANCIAL INSTITUTION REPORTING AND DISCLOSURE

First, I want to focus on the present. What responsibilities does the SEC have for financial institution disclosure and how is it discharging those responsibilities?

The primary mission of the Commission is investor protection through full disclosure. In enacting the securities laws, Congress was guided by the belief that capital formation and investment would be encouraged and facilitated through disclosure. Congress's judgment has been borne out during the last fifty years. The strength and depth of the United States's capital markets are largely attributable to the confidence of the public in the securities law disclosure scheme.

The current disclosure system is not, however, perfect. An incident involving Manufacturers Hanover Bank illustrates this. In 1984, the value of Manufacturers Hanover stock dropped precipitously when rumors swept the markets that the company was having liquidity problems. As later reported in The Wall Street

Journal, these rumors appeared to have started at the bank's New York headquarters where people were buzzing over an alarming report that "the roof had caved in on Manufacturers Hanover." Later, it became apparent that the report was a garbled version of an earlier report that there were leaks in the roof of the company's office building in Chicago. The leaks in the roof were fixed quickly, and the crisis over the bank's pending collapse was averted -- in more ways than one. 1/

This incident illustrates, I think, the sensitivity of the markets to information, as well as the continuing need for prompt and reliable information in the public domain concerning all aspects of the operations of depository institutions and their holding companies.

A. Commission's Jurisdiction

Under the current regulatory system, jurisdiction with respect to financial institutions and their holding companies is bifurcated. The Securities and Exchange Commission regulates bank and thrift holding company disclosure, while the federal banking and thrift regulators administer the financial disclosures of individual banks and thrifts that are directly owned by the public rather than by a holding company.

The Securities Exchange Act of 1934 requires virtually all publicly-held companies to comply with the Commission's disclosure regulations regarding registration of classes of securities, periodic reports, proxy solicitations and information statements, and tender offer documents. Similarly, under the Securities Act of 1933, companies seeking to sell their securities in a public offering must file a registration statement with the Commission and wait for it to become effective before they can make their sales. However, securities issued directly by publicly-held banks and thrifts generally are exempt from this disclosure system: Under Sections 3(a)(2) and 3(a)(5) of the Securities Act, bank and thrift securities are exempt from registration. And, under Section 12(i) of the Exchange Act, publicly-held banks and thrifts file their periodic reports with their respective bank or thrift regulatory agency, rather than with the Commission.

The Securities and Exchange Commission, however, has antifraud jurisdiction over all securities, including those issued by banks and thrifts. This means that the Commission can

---

1/ This anecdote is taken from an outline prepared by members of the staff of the Division of Corporation Finance: A. R. Tow, S. Duvall, J. Murphy, L. Stegman, Application of the Federal Securities Laws to Bank and Savings and Loan Holding Companies 11 (Jan. 22, 1990).

bring a fraud case involving the securities of a bank or thrift, even though these institutions are not required to register their securities with the Commission.

B. Disclosure Problems Raised by the Interplay Between Securities and Banking Law

Certain unique disclosure problems arise from the interplay between the Commission's authority to regulate holding company disclosure and the federal bank and thrift regulators' substantive authority. In general, the Commission's mission is investor protection, while the bank and thrift regulators' mission is to promote safety and soundness. Moreover, there are differences in the information available to the Commission and that available to the bank and thrift regulators. Further differences exist between accounting under generally accepted accounting principles, or "GAAP," used by companies reporting to the Commission, and regulatory accounting principles, or "RAP," used by bank regulators. These problems have been compounded recently by the savings and loan crisis and the FIRREA requirement that depository institutions dispose of their high yield debt holdings.

The collapse of Lincoln Savings and Loan and the related bankruptcy of its holding company, American Continental Corporation, illustrate some of the financial institution disclosure problems resulting from the interplay between securities law and banking law. Lincoln was regulated by the Federal Home Loan Bank Board, while American Continental, to the extent that it issued securities and had publicly traded securities, was subject to the SEC's scheme of disclosure regulation. Lincoln sold ACC's subordinated debentures, or so-called "junk bonds," in the lobbies of Lincoln branches to depositors, many of whom apparently believed that they were buying insured certificates of deposit.

Pending legislation which would prohibit depository institutions from selling affiliate securities in their lobbies would address this problem. H.R. 3777, the "Depositor Protection and Abuse Prevention Act of 1989," was introduced by Congressman Charles E. Schumer on November 20, 1989, would prohibit any insured depository institution from offering or selling "any evidence of indebtedness of, or ownership interest" in any affiliate in "any part of any office of such institution * * * accessible to the general public for the purpose of accepting deposits." In addition, the bill would authorize each federal banking agency to prohibit or impose conditions on the sale by an insured depository institution of any evidence of indebtedness of or ownership interest in the depository institution itself if the instrument in question is "likely to be confused by the general public with an insured deposit." A similar bill, H.R. 3721, the "Depository Institutions Consumer Protection Act of 1989," was introduced by Congressman Thomas McMillen on November 17, 1989. H.R. 3721 would prohibit the sale or offer of any security, "other than an instrument which is evidence of a deposit," which was issued by the institution in an area "commonly accessible to the general public for the purpose of accepting deposits."

C. Recent SEC Efforts to Strengthen Its Oversight of Financial Institution Disclosure

Commission Chairman Richard Breeden has recently formed two task forces to address the types of disclosure problems which have arisen in the thrift industry and to increase the effectiveness of the Commission's oversight of bank and thrift holding company disclosure and sales practices.

1. Division of Enforcement Task Force

The first group is the Enforcement Division task force, created in December 1989. This group consists of 25 staff members who will concentrate on the disclosure and potential fraud problems of financial institutions. It is patterned in part on the Commission's successful penny stock task force. The objective of both groups is to bring together a specialized unit of staff members to focus on a particular problem area.

In my view, three factors lead to the formation of this unit. First, there is concern that a troubled financial institution with increasingly urgent capital demands may be tempted to engage in fraud. Experience shows that any type of firm with serious capital or liquidity problems may seek to conceal the crisis from the securities markets while management seeks to stave off collapse. Cases in which it appears that accountants, lawyers, and other professionals may have played significant roles in a troubled institution's efforts to camouflage its problems deserve special emphasis.

Second, as I suggested earlier, accounting issues that are unique to financial institutions have habitually proved troublesome. A body of Commission staff with expertise in those issues will lead to a more systematic, rather than episodic, approach to resolving them.

Third, there is concern that investors who purchase securities sold by financial institutions may be misled into believing that these investments are protected by federal deposit insurance. This is what some investors allege happened at Lincoln.

The task force will investigate financial fraud encompassing the traditional areas of focus in such cases, such as false financial statements and misleading disclosures. In addition, the group will examine financial institutions' sales of their own securities to the public in order to ascertain whether improper sales or disclosure practices have occurred in connection with those sales.

What types of cases are likely to result? It is, of course, impossible to say at this stage. The past may, however, be a guide to the future. The Commission has previously brought cases against several large financial institution holding companies for failure to establish adequate loan loss reserves. 2/ In most of these cases, the Commission made specific allegations that the institutions violated the federal securities laws by failing to maintain internal accounting controls sufficient to ensure, among other things, that transactions are recorded as necessary to prepare financial statements in conformity with GAAP. 3/ Other types of financial institution cases have involved insider trading, revenue recognition, failure to comply with generally accepted auditing standards, and related party transactions.

2. Division of Corporation Finance Task Force

The second task group is in the Commission's Division of Corporation Finance, which is responsible for the day-to-day policing of disclosure obligations. Ten accountants and certain additional staff have been assigned to the task group. The group will conduct comprehensive reviews of the financial statements, management discussion and analysis, and other disclosures of selected financial institutions. The companies targeted for review will be selected based on screening criteria intended to identify institutions whose financial characteristics is below industry averages. The task force is expected to review several hundred filings over the next year.

Some of the specific facets of financial institution disclosure that have proven troublesome in the past will undoubtedly be of concern to the task group. These include:

- Adequacy of management discussion and analysis, particularly mandatory, foreword-looking information.

2/ E.g., In the Matter of Texas Commerce Bancshares, Inc., Securities Exchange Act Rel. No. 24803 (August 17, 1987); In the Matter of First Chicago Corporation, Securities Exchange Act Rel. No. 24567/Accounting and Auditing Enforcement Rel. No. 134 (June 10,1987); In the Matter of Continental Illinois Corporation, Securities Exchange Act Rel. No. 24142/Accounting and Auditing Enforcement Rel. No. 128 (February 27, 1987).

3/ See Section 13(b)(2)(B) of the Exchange Act.

- Adequacy of loss reserves on loans, real estate owned, and other assets.
- So-called "big bath" write offs, which are write offs, particularly in the fourth quarter of the year, with no prior warning of problems in management discussion and analysis.
- Accounting for securities trading.
- Accounting and disclosure related to the acquisition of troubled financial institutions and related regulatory assistance.
- Disclosure with respect to the impact of the Financial Institutions Reform, Recovery, and Enforcement Act of 1989, especially its new capital requirements and requirement that thrifts dispose of their non-investment grade debt holdings.
- Disclosure and accounting for related party transactions.
- Appropriateness of gain recognition on sales of securities.
- Adequacy of internal controls.
- Disagreements with accountants.
- Meaningful disclosure concerning the quality of an institution's loan portfolio.
- Descriptions of recent administrative proceedings instituted by the appropriate bank or thrift regulator and the possible effect of those proceedings upon future operations.

In addition, as I mentioned earlier, an issue that both the Enforcement and Corporation Finance groups will be examining is whether improper sales or disclosure practices have occurred in connection with sales by financial institutions of their own or their affiliates' securities. In January of this year, the Division of Corporation Finance sent a letter to all bank and thrift holding companies subject to Commission jurisdiction seeking information concerning the extent to which uninsured securities that have been issued by the parent corporation or any of its affiliates (including its subsidiary bank or thrift) have been sold either on the premises of the institution or sold off the institution's premises by its employees. The staff is currently reviewing the results of this inquiry.

The Corporation Finance task force is also concerned about better coordination between the SEC and the bank regulators. The staff has begun an organized program of asking bank regulators to review holding company filings of their institutions. The object of this process is to determine if the bank regulator has information contrary to that in the SEC filing. In some cases, transaction filings will not be permitted to take effect until the relevant bank regulator's review is complete.

III. <u>FUTURE DIRECTIONS</u>

Let me now turn from the present to the future.

The two new task forces respond to the immediate need to strengthen the Commission's disclosure authority over depository institution holding companies. However, broader steps are necessary. To remain competitive in the international market for financial services, the United States must reform the current regulatory structure with respect to the application of the securities laws to financial institutions. From a securities regulation perspective, this reform should have four goals.

<u>First</u>, reform should ensure full and equal disclosure as to capital formation activities and secondary trading in the securities of all financial institutions. In the long run, capital flows to markets with full disclosure.

<u>Second</u>, reform should ensure reasonable and comparable levels of investor protection. Any institution that performs the functions of a broker-dealer should be regulated as a broker-dealer. As I discussed earlier, this is not the case today with respect to banks.

<u>Third</u>, competitive barriers to the efficient delivery of financial services should be removed. The Glass-Steagall Act and the Bank Holding Company Act require substantial modification to permit banks and securities firms to compete directly with each other on an equal basis.

<u>Fourth</u>, the principle of functional regulation must be adopted as the standard for financial institution reform. Under that principle, the SEC should be the regulator of all securities activities, regardless of the type of entity which engages in those activities.

I want to elaborate a bit on how each of these goals may be attained.

A. Disclosure Harmonization and Centralization

The first goal of financial institution regulatory reform should be the harmonization and centralization of disclosure for financial services providers. To accomplish that goal, all types of financial services providers should be subject to uniform and realistic accounting and disclosure standards and sales practices regulation administered and enforced by a single agency. Congress should implement the recommendation of the Bush Task Group 4/ to subject public offerings of securities by banks and thrifts to the registration requirements of the Securities Act -- by amending Sections 3(a)(2) and 3(a)(5) and to transfer administration and enforcement of disclosure under the Exchange Act to the Commission (by repealing Section 12(i). The current distinction between bank disclosure regulation and bank holding company disclosure regulation does not reflect sound policy. This distinction generally weakens enforcement of the securities laws, creates an unnecessary risk of inconsistent interpretations of those laws, gives rise to conflicts of interest, and requires larger total staffing than would be needed if all securities regulation were unified under the Commission.

B. Securities Activities

The second goal of financial institution reform should be to subject banks that engage in securities activities to the same Exchange Act registration requirements and regulations applicable to all other entities that engage in those activities. Currently, a bifurcation similar to that applicable to financial institution disclosure also exists with respect to broker-dealer regulation. Although bank affiliates' securities are subject to the Act's requirements, banks' own securities activities are exempt from Exchange Act broker-dealer requirements. For example, securities subsidiaries of bank holding companies permitted under Section 20 of the Glass-Steagall Act to engage in otherwise impermissible securities activities, so-called "Section 20 subsidiaries," are required to register as broker-dealers under the Act. As registered broker-dealers, Section 20 subsidiaries are subject to full SEC regulation, including the net capital rules. Section 20 subsidiaries are also required to join a self-regulatory organization supervised by the SEC.

All depository institutions should be required to conduct their securities activities through regulated broker-dealer affiliates. It is as illogical to allow banks to act as discount brokers subject to regulation by the bank regulators, rather than by the SEC, as it would be to authorize the SEC to regulate deposit-taking.

4/ Blueprint for Reform: The Report of the Task Group on Regulation of Financial Services 91 (July 1984).

To ensure adequate investor protection, Congress should subject banks that engage in underwriting, brokerage, and other securities activities to the same Exchange Act registration and regulatory requirements applicable to other entities engaging in these activities -- by removing the exclusions for banks from the definitions of "broker" and "dealer" in Sections 3(a)(4) and 3(a)(5). The Commission has supported this requirement and has recommended that any legislation to expand the securities powers of banks require banks to conduct most of their new and existing securities activities in separate entities subject to full Commission regulation. 5/

C. Elimination of Competitive Barriers

The third goal for regulatory reform should be to remove competitive barriers in order to create a level playing field for financial instruments.

Arbitrary barriers to entry into product markets should be eliminated. Congress should amend both the Glass-Steagall and the Bank Holding Company Acts to permit any type of corporation to have a bank affiliate without subjecting the corporate parent to the full regulatory system applicable to a bank holding company. Product deregulation should be accompanied by a strong and effective system of supervision and enforcement. This is necessary in order to avoid the types of problems which arose from the deregulation of the thrift industry.

Moreover, in the non-bank area, the relationship between the respective jurisdictions of the SEC and the Commodity Futures Trading Commission should be revised to prevent a phenomenon in which useful and important products are precluded from trading in the United States securities markets because of jurisdictional battles.

D. Decentralized System for Regulation

The fourth goal should be to develop a decentralized system of functional regulation with each agency having a narrow, focused mission.

To facilitate the effectiveness of this system, the functions performed by particular classes of financial institutions should be narrowed. Banks should be required to

---

5/ Memorandum of the Securities and Exchange Commission to the Subcommittee on Telecommunications and Finance of the House Committee on Energy and Commerce Concerning Financial Services Deregulation and Repeal of the Glass-Steagall Act 13-14 (April 11, 1988).

move their securities activities to securities affiliates or subsidiaries. This would reflect and promote the different purposes served by the banking and securities laws.

Finally, this approach would eliminate the need for a centralized financial institution regulatory agency as some have proposed. A centralized regulator would be likely to make securities regulation similar to banking regulation, thereby discouraging risk-taking and innovation in the securities market.

IV. CONCLUSION

The Commission's expertise is in disclosure and investor protection. In the next several months, the results of a special effort by the Commission's two new task groups to apply that expertise to bank and thrift disclosure should be apparent. More generally, over the next year or so the Commission will be actively engaged in urging Congress to implement functional regulation with respect to depository institutions' disclosure and securities activities. The United States cannot afford to enter the 1990's with the financial institutions regulatory system designed in the 1930's.

Thank you.