REMARKS OF RICHARD B. SMITH, COMMISSIONER,
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BEFORE THE NATIONAL ASSOCIATION OF SUPERVISORS OF
STATE BANKS, LOS ANGELES, CALIFORNIA
SEPTEMBER 13, 1968

"Disclosure and Banks"

I first express my appreciation for the honor you have done me by your invitation to speak here. I wonder though, in asking an SEC Commissioner to a conference of bank supervisors, whether you are being either remarkably indifferent or mildly masochistic. One might have thought that your relationships as state bank supervisors with the three separate federal banking agencies would be confusing and difficult enough. Now you have chosen to hear from a member of a fourth federal agency -- one with which, presumably .... and prayerfully .... you really have nothing directly to do. My thanks to you anyway, because possibly we do have something we can talk about.

I.

Perhaps our small dialogue today is merely a reflection of the newer world of finance that is upon us. Structures are changing and different patterns emerging in the harnessing of private savings by financial intermediaries for ultimate productive investment in the economy. It is with that broad, essential and ever dynamic process in our national life that we are both, in our respective fashions, involved.

The banking and securities reforms of the early 1930's of course, effected a relatively neat, surgical division of the financial intermediaries and institutions that you and the federal banking authorities supervise, and the financial intermediaries and institutions which the Securities and Exchange Commission was then created to regulate. That separation of commercial and investment banking functions and the resulting segregation of institutions has since been a cornerstone of the regulatory regime. It is generally felt, I believe, that this separation has been a salutary one, but current developments in our financial markets seem to make the separation a less tidy one in a number of areas.

There are many examples of the growing competition and overlapping in the general field of financial services, where banks, as well as others including the insurance companies and the finance companies, are exhibiting an increasing interest in reaching outside their traditional niches.

Banks have entered the credit card business, long-term leasing arrangements, computer services and the travel agency business. I am sure you are also familiar with the pending litigation and legislation concerning bank efforts to underwrite municipal revenue bonds and bank efforts to organize and sell their own version of mutual funds. Mutual savings banks are offering life insurance and mutual fund shares to their depositors. Insurance companies are either setting up their own mutual funds, or purchasing mutual fund managers. At least one insurance company has set up a broker-dealer that has joined a regional securities exchange. Several mutual fund managers have done the same. At the same time other types of companies, often holding companies, have been expanding into the finance area. Whereas banks buy computers and lease them to others, we also find computer leasing companies acquiring control in one case of an insurance company and in another case of a finance company. American Express Company has acquired an investment banking firm.

Another evidence of these changes is the proliferation of bank holding companies, or perhaps more accurately, companies some or all of whose holdings include banks. Because the exemption for bank securities contained in the federal securities legislation does not extend to holding companies, and because shareholders of most sizeable banks are not limited to one state, the newly formed holding companies are required to register their securities with the SEC. In the five years to the end of 1967 there were more than 50 such holding companies that registered securities with us. Thus, seemingly inexorably, to the extent these amalgamating trends continue, the SEC is drawn into performing its disclosure role in the public financing and shareholder relationships of enterprises ultimately engaged in whole or in part in commercial banking.

II.

Disclosure of corporate information to investors is, I believe, generally accepted as an essential for real access by that corporation to our nation's capital markets. Presumably if an enterprise wants a public market for its securities it wants one with a sufficient degree of liquidity and depth so as to provide the fairest valuation for the securities by that market. To do this on a long-term, healthy basis, it must make extensive information concerning itself available to the investing public and their investment advisers. It is this open availability of information material to investment decision that is the hallmark and genius of the American public capital markets.

Within the past two years two major studies were conducted in Europe of the European capital markets, one by the EEC and the other by the OECD. It is significant that both concluded that a primary reason for the weakness of the European capital markets was a lack of information concerning the issuers of securities.

The tradition in America of open accountability by management to their shareholders has had relatively limited application on continental Europe. The emphasis on public disclosure in America, the elaborate apparatus for the production and dissemination of such information and the broad availability of investment analysis and advice has not generally prevailed in Europe, and consequently the equity markets on the continent have been almost rudimentary. Investors, particularly small investors, have been extremely reluctant to commit funds to an enterprise on a long-term basis such as equity investment. The markets do not have sufficient depth and liquidity to give such investors any confidence in realizing cash by resale when they wish. Those who do invest, because they can learn so little about the enterprise and because there is no strong secondary market, insist on high earnings payouts, thus depriving industry of the most efficient means of funding new plant and equipment by a plowback of retained earnings.

The Europeans would certainly seem to have the technology, the affluence and the private savings to emulate the massivity and strength of our American capital markets. One thing they lack and which they have analyzed as a highly important ingredient in the efficiency of the American markets is the fine attention here that has been given to the protection of investors and their equities. And protection of investors is the basic purpose behind the disclosure requirements. That disclosure built confidence and participation in depth in our stock markets.

My own sense of the matter is that to achieve mass public involvement in the securities markets, to attract the capital at all, the public must feel -- and I emphasize feel -- as well as reason two things. One, that true, meaningful information is available about the bulk of securities in the marketplace upon the basis of which informed choice and trading takes place, not necessarily their own informed trading, but also not informed trading limited to insiders. Second, that the financial intermediaries and the trading mechanisms of the marketplace are essentially fair and not overreaching. Without these two elements

of belief, I don't see how there can be public confidence in the securities markets, and without confidence I don't believe many people would part with their money, at least in the form of long-term financial claims. And if they are not willing to do that, to invest, the vital core of our system of private capital formation -- and people's capitalism, if you will -- is seriously weakened.

As commercial banks and other financial institutions increase their competition for customers, they are presumably increasing their competition for capital investment. As banks seek better access to those markets they do so in an environment attuned to full disclosure. It does not seem likely that the markets would merely rely upon the general bank reputation for stability and worth or on the general knowledge that banks are highly regulated. Information, and rather detailed information, is sought to justify an investment decision which must always represent a weighing of alternatives. It seems likely that the balance would usually be tipped in favor of the alternatives which provide sufficient information.

The federal bank regulatory agencies, and some state banking departments, have now rather fully come to the view that banks should provide information to their securityholders. I can't help but believe the process will widen and become even more systematized.

III.

Securities issued by banks are, of course, exempt from registration under the Securities Act of 1933. Thus, there are no specific disclosure requirements imposed upon the issuers of new bank securities. Prior to 1964, banks were also statutorily exempted from the registration, periodic reporting and proxy requirements of the Securities Exchange Act of 1934, unless their securities were listed on a national securities exchange. Even if the securities were so listed, they were exempted under a rule promulgated by the Commission. The 1964 Amendments to the Exchange Act provide that banks with over $1 million in assets and more than 500 shareholders shall be subject to the registration, periodic reporting and proxy requirements, but that the administration of these provisions is vested in the federal banking agencies rather than the SEC.

It might be helpful at this point for me briefly to summarize the type of disclosure requirements which we at the SEC impose. While I do not pretend to be expert in the bank disclosure requirements promulgated since 1964 by the three federal banking agencies, to the extent that I can I will indicate broadly where the banking requirements differ from ours. In general, they are actually modeled on our requirements.

As you know, the Comptroller's requirements (which are most different from ours) govern national banks, those of the Federal Reserve Board govern its member state banks, and the FDIC requirements apply to insured state banks that are not members of the Reserve System. There are approximately 5,000 national banks, of which about 500, or 10 percent, are covered by the Comptroller's disclosure regulations. There are approximately 1300 state member banks of the Federal Reserve System, about 125 of which, or again roughly 10 percent, are covered by the Federal Reserve Board's disclosure regulations. Of the 8,000 FDIC banks that are not members of the Federal Reserve System, about 175, or two percent, are covered by the FDIC disclosure requirements. I understand that there are about 200 commercial banks, and an equal number of mutual savings banks, that are not insured by the FDIC, and of course there are no federal disclosure requirements applicable to them. Thus, there are a total of about 800 banks, out of a total universe of almost 15,000 banks, that are now subject to federal disclosure requirements. I understand that thought is being given by the FDIC to broadening the requirement for an annual report to shareholders beyond the larger banks to all insured banks, as the Comptroller has already done with respect to national banks.

New York last year adopted regulations effective this year to the effect that all its state chartered banks, regardless of size or number of shareholders, be required to mail to shareholders an annual report containing detailed financial information. The terms of the 1964 amendments -- $1 million assets, 500 shareholders -- applied to only 42 of the 132 banks chartered by that State. However, the Superintendent noted that investors tend to stay away from companies where financial information is not available (this is the same point made by the European studies I referred to earlier). He also pointed out that in the absence of adequate financial information it is difficult to value securities either for estate purposes or in order to use them as collateral for a loan. The New York Banking Department apparently felt that unless the smaller

banks made available meaningful financial data they would not be able to compete for new capital with the larger banks that were providing such information. In periods of tight money, the ability to raise additional capital of course becomes increasingly important. At the present time, New York has no requirements as to proxy solicitation or insider trading.

But to come to the Commission's basic disclosure rules, they were developed in the context of public offerings of new securities. The disclosure is contained in the customary prospectus with which most of you are familiar. It requires information in some detail about the business and properties of the issuer, its management and principal shareholders. It requires a detailed description of the company's capital structure and the securities to be offered, the amount of money to be raised by the offering and the use to which the proceeds will be put. The identity of the underwriters and the terms of the offering are also required to be set forth. A balance sheet and income statements for the last three years, all certified by independent public accountants, are required to be shown. A summary of earnings for the last five years is also required. Neither the Federal Reserve Board nor the FDIC has comparable prospectus requirements for bank securities. The Comptroller does require use of an offering circular for new securities although the detail required is measurably less than that required by the SEC.

With respect to outstanding securities, the SEC requires annual financial reports to be filed with the Commission by the issuer and distributed to shareholders. The report distributed to shareholders must contain an audited comparison of the last two fiscal years as well as an audited year-end balance sheet. All three federal banking agencies have generally comparable requirements, although the accounting categories are naturally different and there is no requirement that the financial statements be certified by an independent public accountant.

This is a rather fundamental difference between our agency and the banking authorities. I understand that while the American Bankers Association has indicated its opposition to any independent audit requirements, some banks are voluntarily using independent public accountants for this purpose. Presumably they are doing this on the basis that this is what most investors and their advisers have come to expect and perhaps because they feel that supervisory bank examinations for the purpose of protecting depositors do not approach the scope of an audit made in accordance with generally accepted auditing standards for the purpose of informing investors.

The Commission also requires the distribution of proxy material in connection with any meeting of shareholders. The Commission's proxy rules are quite detailed and require a full description of the matters to be voted upon at the meeting, a description of directors if they are up for election, a statement of management compensation, any material transactions between the company and its management and the granting of any stock options to management. The federal banking agencies have generally comparable requirements although the disclosure required by the Comptroller with respect to management compensation is considerably more abbreviated.

The Commission also requires that purchases or sales by officers, directors and 10 percent shareholders be disclosed monthly to the Commission. This information is made a matter of public record and is published monthly by the Commission. The Federal Reserve Board and the FDIC have comparable filing requirements. The Comptroller requires reporting of only substantial changes of position.

The banking agencies have powers to enforce their requirements, as does the Commission. The securities laws contain a number of provisions giving investors express private rights of action for violations of the disclosure requirement. In addition, the courts have implied rights of action for violations of the disclosure requirements and there has been a significant amount of private litigation that has resulted in recoveries by private investors. The Comptroller in his regulations has sought to exclude implied rights of action for violation of his disclosure requirements. It remains to be seen whether it is within his power to do so.

IV.

Banks and bank securities have always been subject to the general antifraud provisions of the federal securities acts, and they remain so. The exemptions in the acts are not applicable to those provisions. Section 10(b) of the Exchange Act and Rule 10b-5, which are the broadest of these provisions, in essence prohibit all deceptive or manipulative practices in connection with securities transactions. The law under these provisions has been developed in common law fashion by the federal courts and by the Commission in its administrative proceedings. A rather elaborate legal system to protect the integrity of securities transactions has been developed under these provisions and is continuing to develop at an increasing pace.

As you are no doubt aware, there has been a recent significant development under Section 10(b) and Rule 10b-5. A month ago today the full bench of the United States Court of Appeals for the Second Circuit handed down its landmark decision in the Commission's action against Texas Gulf Sulphur Company and various of its officers, directors and employees.

In its application to banks, one aspect of the Texas Gulf case ties in directly with the registration and reporting requirements imposed by the Exchange Act. Any registration statements and reports filed by banks pursuant to those requirements must, of course, be complete and accurate. Procedures for enforcing those requirements are provided. In Texas Gulf, however, the court of appeals concluded that public statements by a corporation, even though not affirmatively required by law and of a less formal nature than reports and other statements that are so required, can have an equally significant impact upon the securities markets. It therefore held that such statements are subject to Section 10(b) and Rule 10b-5 irrespective of the absence of any securities transactions by the corporation or its insiders and irrespective of the absence of any motive to affect the market. For example, press releases issued by banks to the financial or general news media may be subject to the prohibitions against deceptive and manipulative devices. Moreover, the court also held that a corporation is required by those provisions to use due diligence to insure that its public statements are not false or misleading. This duty may be enforced by an injunctive action brought by the Commission. In this respect, banks have the same legal responsibility as any other publicly held corporation. I do not think that any of you would disagree that there should be adequate means for preventing false or misleading information about banking institutions that adversely affects the markets for their securities.

More difficult questions are raised in determining whether or not to shift the burden of any loss that may already have occurred from the investing public to the corporation that disseminated the information. Any such shifted loss ultimately falls upon the public shareholders of the corporation who are usually innocent of any personal involvement in the particular matter. Private rights of action for damages are customarily implied in favor of investors injured as a result of violations of the securities acts, and large numbers of persons may rely upon public statements by issuers. Thus, in generally subjecting

corporate publicity to the prohibitions of Section 10(b) and Rule 10b-5, a real problem of possibly excessive damages could be created. Five of the nine judges in the Second Circuit appear to believe that an award of damages against the corporation would be inappropriate when the only fault has been a lack of due diligence on the part of its officials. Thus, the court has attempted to balance the interest in protecting the securities markets generally against the interest in also protecting the public shareholders of corporations.

So much for the provisions of the securities acts affirmatively requiring disclosure and those protecting the integrity of such disclosures as are made, whether required or not. There is another aspect of the Texas Gulf case that may indirectly compel extensive public disclosures even by banks that are not subject to the registration and periodic reporting requirements of the Exchange Act. Indeed, more extensive disclosures than are expressly provided may indirectly be compelled even for those banks that are subject to the requirements. In Texas Gulf certain officers, directors and employees of the corporation were held to have violated Section 10(b) and Rule 10b-5 by purchasing securities of their corporation on the New York Stock Exchange on the basis of what the majority of the court found were highly promising results of drilling for valuable copper, zinc and silver deposits on its property in Canada. Their purchases constituted violations because the information had not already been disclosed to the public and was not disclosed to the shareholders of the corporation who sold their stock to these insiders. The significance of this legal principle is that, whether or not a corporation is directly required to make regular disclosures about its operations, its insiders will be disadvantaged unless it does so. This legal principle is equally applicable to the insiders of banks. Section 10(b) and Rule 10b-5 require equal availability of all material information about the corporation both to the insider and to those with whom he deals. Thus, a policy of silence on the part of the bank, even though otherwise permissible, will prevent its officials who know that information from adding to their personal holdings of securities in the bank or from disposing of any of those holdings when they act on the basis of the information.

V.

I rather puckishly suggested at the beginning of my remarks that your invitation to me might not really signify any great need on your part to know what my agency is doing. In fact, my being here somewhat reminds me of the three boyscouts who were

telling their scoutmaster of their good deeds for the day. The first scout said that he had helped an old lady across the street. The second scout said that he had also helped the lady across the street, and the third scout said decisively that he too had helped the lady across the street. The scoutmaster inquired why it was necessary for three scouts to help the same old lady across the street. The scouts replied, "She didn't want to go."

But all jesting aside, I am afraid that lack of knowledge of each other is no longer realistic if we are to do our jobs. This is a rapidly changing world. Commercial banks are expanding their activities into other related financial areas and even into some non-financial ones. Other financial institutions are competing with banks in these new areas and are expanding their own operations into the more traditional banking areas. This alone is breaking down the distinctions between the public disclosures customarily made by banks and those customarily made by non-banking financial institutions. But disclosure requirements themselves are changing just as rapidly, and that change has continually been in the direction of expansion. Commercial banks are more and more becoming part of the great mainstream of American business in which public knowledge of corporate operations and conditions is not only increasingly required but is also increasingly accepted as desirable.

As these various developments take place there are more and more contacts and common interests between the state bank supervisors, the federal banking agencies and the Commission of which I am a member. Work will always need to be done to continually refine disclosure concepts. That work can be done only if all of us who should have the responsibility for watching over their development take a comprehensive view of what makes the industries to which we attend productive. You know banks become great by protecting depositors and earning their confidence. I suggest they also become great by protecting investors and earning their confidence. The relatively new disclosure concepts for banks are aimed at this and it seems likely they will become increasingly significant in your work. For this reason I have been particularly pleased to be able to speak to you. While I spoke only for myself this morning, I know I can speak for my colleagues in offering you every service at the Commission we can from our experience with disclosure regulation. I hope that in the future we shall have additional opportunities such as this to exchange views and get to know each other a little better. Perhaps in some small way we may have progressed a bit down that road this morning.

Thank you.