For Release on Delivery

STATEMENT BY CHAIRMAN MARTIN OF THE

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

BEFORE THE SUBCOMMITTEE ON SECURITIES OF THE COMMITTEE

ON BANKING AND CURRENCY OF THE SENATE ON JUNE 27, 1955

Mr. Chairman and Members of the Committee:

The Board of Governors of the Federal Reserve System is in complete agreement with the purposes of S. 2054.

Under the Securities Exchange Act of 1934, corporations whose securities are registered on a national securities exchange are subject to specified requirements covering publication of financial reports and related information, solicitation of proxies, and so-called "insiders' profits" resulting from trading in the company's stock. With certain exceptions, S. 2054 would apply those requirements to large corporations whether or not their securities are registered on an exchange.

These provisions would provide for the security holders of large corporations whose securities are widely distributed but not registered on an exchange, information and safeguards which the Securities Exchange Act requires with respect to securities registered on an exchange. As these provisions have been and would be administered by the Securities and Exchange Commission, the Commission is better able than the Federal Reserve to express an informed opinion regarding them.

However, section 3 of the bill directly relates to the responsibilities of the Federal Reserve System. Under this section any security of an issuer covered by the bill, unless excluded by the Board as "not comprehended within its purposes", would be subject to the margin requirement provisions of the Securities Exchange Act in the same manner as if the security were registered on a national securities exchange.

The bill contains certain exemptions. Besides the exemption of banks, which are specialized institutions, the bill would exempt the securities of all corporations which have less than $5 million in assets and also the securities of all corporations which have less than 500 security holders.

Since securities covered by the bill would be subject to the rules that now apply to securities registered on an exchange, let me outline those rules and how they differ from the rules that apply to unregistered securities.

Under present law, when brokers lend for the purpose of purchasing or carrying securities, they can lend on registered securities the amount specified in the Board's margin regulations -- now 30 per cent -- but they are forbidden to lend anything at all on unregistered securities. In other words, in a brokerage margin account registered securities have the loan value specified in the Board's regulations and unregistered securities have no loan value whatever. The rules that apply to loans made by banks also depend on whether a security is registered or unregistered. Loans made by banks to purchase or carry registered securities are subject to the standard margin requirements; loans made by banks to purchase or carry unregistered securities are exempt from the regulations.

Under S. 2054, securities covered by the bill would be entitled to loan value in brokerage margin accounts just as registered securities are, and loans by banks to purchase or carry securities so covered would be subject to the usual margin requirements.

Stated differently, securities covered by section 3 would in one respect be more favored than at present -- they would get the benefit of having loan value in brokerage margin accounts; and in another respect they would be less favored -- loans by banks to purchase or carry the securities would become subject to the usual margin requirements.

Both S. 2054 and the present law regarding margin requirements recognize that there are important differences between the securities of small, closely held companies on the one hand and large, widely owned companies on the other. The securities of small, closely held companies usually do not enjoy a wide or ready market. They are more likely to be purchased or financed on the basis of personal knowledge of the individual company, its conditions and prospects, and not on the basis of ready marketability. By contrast, the securities of large, widely held companies are usually more seasoned, more widely known, more readily marketable, and more likely to be traded on margin.

Section 3 says, in effect, that such securities should be treated for the purposes of the margin requirements in the same way that the law now treats securities that are registered on an exchange. Under the exemptions in the bill, a security would not be covered unless the issuer of the security has at least $5 million in assets and also has at least 500 security holders.

The Board believes section 3 would help to carry out the general purposes of the present provisions of law relating to margin requirements, and that enactment of such a provision would be in the public interest.

6/27/55

July 14, 1955

MEMORANDUM FROM CHAIRMAN MARTIN OF THE BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM SUPPLEMENTING HIS STATEMENT ON S. 2054

In connection with the exclusion of banks from S. 2054, questions have been raised as to the status of banks, the Federal regulation and supervision to which they are subject, and the practices which they now follow with respect to the matters covered by S. 2054. This memorandum is addressed to those questions.

Specialized Nature of Banks

Banks differ from most other corporations in several respects. Most of these differences are related to the unique position of banks in the national economy. They are the custodians of the bank deposits that form the bulk of the nation's means of payment, its money supply.

Because of the strong public interest in the safety and mobility of bank deposits, banks are subject to extensive Federal regulation and supervision, especially under sweeping banking legislation passed by Congress in the 1930's. The breadth of this regulation and supervision is outlined later in this memorandum.

Federal regulation and supervision of banks is primarily concerned with the protection of depositors. However, since deposits constitute such an overwhelming proportion of the total funds available to banks -- usually more than 90 per cent -- protection of the depositor becomes closely intertwined with protection of the stockholder. Even though protection of bank depositors and bank stockholders are not always identical, they are so similar that measures to protect depositors also protect stockholders. For example, the vigilance of the bank supervisory authorities against harmful self-dealing by a bank's officers, directors or large stockholders provides protection for both depositors and stockholders.

Similarly, limitations on the kinds of investments that banks can make and on the kinds of activities in which they can engage protect both depositor and stockholder. They tend to keep banks out of transactions that may result in heavy losses or spectacular profits. Officers, directors and large stockholders -- so called "insiders" -- of banks are thus less likely than those of other corporations to have "inside information" of the kind that would enable them to make heavy profits from short-term trading in their corporation's stock. The non-speculative nature of banking operations also causes bank stocks to be less volatile than most others, thus generally reducing both opportunities and incentives for profits from short-term trading in the stock.

Due to the large proportion of bank funds represented by deposits, a measure of size which would be appropriate for other businesses would be unsuitable for banks. Thus, if the provision of S. 2054 which excludes corporations with less than $5 million in assets were applied to banks, the results would be widely different from when such a test is applied to other corporations.

<u>Regulation and Supervision of Banks</u>

Federal regulation and supervision of banks is so extensive that an adequate discussion of the subject would go far beyond the scope of this memorandum, which merely touches upon certain aspects of the matter. In addition to being subject to Federal regulation and supervision, banks chartered under State law are also subject to State regulation and supervision, which is not covered in this memorandum.

The examinations of banks at least once each year is an important aspect of Federal regulation and supervision. National banks are examined by examiners commissioned by the Comptroller of the Currency, State member banks of the Federal Reserve System are examined by examiners commissioned by the twelve Federal Reserve Banks with the approval of the Board of Governors of the Federal Reserve System, and insured State nonmember banks are examined by examiners commissioned by the Federal Deposit Insurance Corporation.

These examinations are not detailed audits. However, they are concerned not merely with information as to the financial position of the bank, but also with its soundness and its general operations and practices. For example, examiners inspect the minutes of the meetings of the board of directors. They inquire into the adequacy of insurance coverage against defalcation and other such losses. They consider the stockholdings of officers, directors and principal stockholders. They are alert for any evidence of self-dealing by the bank's officers or directors which might conflict with the best interests of the bank.

These examinations delve into the affairs of the bank and develop extensive information, much of it confidential, about the bank, its directors, officers, employees, depositors and borrowers. Section 1906 of the United States Criminal Code (U.S.C., title 18, sec. 1906) illustrates the confidential character of this information. It provides criminal penalties for unauthorized disclosure by a bank examiner of information regarding a bank's borrowers or the collateral for its loans.

The supervisory authorities carefully review the reports of these examinations, and the management of the bank is called upon to correct any practices which appear to be illegal, unsafe or unsound.

Besides being examined by bank examiners, banks are subject to other supervision and regulation. National banks and State member banks of the Federal Reserve System must file a report of condition with the Federal supervisory authorities at least three times each year, and these reports must be published in a local newspaper. Insured State nonmember banks must file such a report at least twice a year and, although Federal law does not require their publication, most State laws do.

National and State member banks must file with the Federal supervisory authorities semiannual reports of earnings, expenses, profits, losses and dividends, and insured State nonmember banks must file such reports annually.

A bank cannot open a branch office without the approval of the Comptroller of the Currency if a national bank, the Federal Reserve Board if a State member bank of the Federal Reserve System, or the FDIC if an insured State nonmember bank.

The deposit insurance of a bank can be terminated for violations of law or for continued unsafe or unsound practices. Since it is not practicable for a large bank to operate without deposit insurance, a bank's management will not lightly incur such termination.

The Board of Governors of the Federal Reserve System may remove an officer or director of a member bank of the Federal Reserve System for continued violation of law or continued unsafe or unsound practices.

A member bank of the Federal Reserve System is forbidden to pay to any officer, director or employee a higher rate of interest on deposits than that paid to other depositors on similar deposits with the member bank.

A member bank may not make any loan to an executive officer of the bank; the only exception is for a loan not exceeding $2,500 made with the prior approval of a majority of the entire board of directors. If an executive officer of a member bank borrows from any other bank he must make a full report to the board of directors of his bank. The bank examiner can, of course, note these facts when he inspects the minutes of the meetings of the board of directors.

A member bank is strictly limited with respect to loans which it may make to institutions with which it is "affiliated".

A bank cannot engage in the business of issuing, underwriting or distributing securities other than obligations of the United States or certain State or municipal obligations, and a member bank cannot be "affiliated" with a company principally so engaged.

A member bank cannot buy any bonds, other than certain State or municipal bonds, unless they meet certain investment standards. It cannot purchase any stocks at all for its own account except in a few limited situations.

<u>Requirements of S. 2054</u>

S. 2054 would adopt specified requirements from the Securities Exchange Act of 1934 and apply them to certain large, widely held corporations. The requirements cover (1) publication of financial reports and related information, (2) proxy solicitations, and (3) so-called "insiders' profits" resulting from trading in the company's stock. Securities of corporations covered by S. 2054 would also be treated the same for the purpose of the margin requirements as securities listed on an exchange.

The apparent purpose of S. 2054, and of the Securities Exchange Act of 1934 on which it is based, is to provide protection for investors chiefly through supplying them with information. On the other hand, Federal banking policy has been to provide protection for depositors and stockholders of banks chiefly through regulation and supervision. Since almost no banks have stocks listed on an exchange, most banks are not subject to the requirements of the Securities Exchange Act. Accordingly, bank stockholders are not provided the same information that S. 2054 would require, but instead they have the protection of Federal bank regulation and supervision. As indicated before, Federal bank supervisory authorities not only obtain even more information about banks than would be required under S. 2054 but also exercise considerable supervision over them.

What has been said above applies, among other things, to the solicitation of proxies from bank stockholders. Since most banks are not subject to proxy rules which the Securities and Exchange Commission issues under section 14 of the Securities Exchange Act, banks generally do not follow those requirements. For example, in soliciting proxies bank managements usually do not state the salaries or other compensation received by officers or directors, or the ownership of securities of the company by officers, directors or principal stockholders. Except in the case of some of the larger banks with more widely dispersed stockholders, the solicitation often does not include a list of proposed directors. However, it is understood that in solicitations of proxies for stock of larger banks, stockholders are customarily advised of the principal proposals for which the stock will be voted if the proxies are granted. Of course, other less important or routine matters may also come before the stockholders' meeting. It is also understood that managements of large banks customarily supply information regarding operations, salaries and stockholdings when specifically requested at meetings of stockholders. Less information may be provided in the case of small banks with comparatively few stockholders -- just as in the case of other small corporations with few stockholders -- but it is understood that S. 2054 does not attempt to deal with such closely-held situations.

Stockholders of banks, like those of other corporations, have the right to inspect the books of the corporation. This right, of course, involves procedures different from those provided under the Securities Exchange Act, but it affords some protection for bank stockholders in addition to the more comprehensive protection provided by Federal regulation and supervision of banks.

It may also be noted that the law specifically requires that each national bank keep at all times a "full and correct list of the names and residences of all the shareholders ..., and the number of shares held by each, in the office where its business is transacted. Such list shall be subject to the inspection of all the shareholders and creditors of the [bank] ... during business hours of each day in which business may be legally transacted." (R.S. 5210, 12 U.S.C., sec. 62) This provision of Federal law does not apply to State banks.

In attempting to distinguish between large, widely-held corporations and small, closely-held ones, S. 2054 excludes from the operation of the bill all corporations with less than $5 million in assets.

As indicated before, due to the special nature of banks, tests of this kind which would achieve reasonable results for most other corporations would not be suitable for banks. Banks differ so markedly from most other businesses that it does not seem feasible to use the same tests for both.

Summary

Factors such as those outlined above presumably led to the exclusion of banks from S. 2054. They may be briefly summarized.

The apparent purpose of S. 2054, and of the Securities Exchange Act on which it is based, is to protect investors chiefly by supplying them with information. On the other hand, Federal banking policy has been to protect depositors and stockholders of banks chiefly by a comprehensive system of Federal regulation and supervision.

To superimpose the requirements of S. 2054 upon the present system of Federal bank regulation and supervision would raise difficult problems of duplication and inconsistency. If it should be thought desirable by the Committee to provide additional protection for the stockholders of banks, it would be preferable to consider the question separately as a banking problem involving possible amendments to the specific laws that relate to banks and the Federal bank supervisory authorities.