III. DISCLOSURE

Recent FDIC proposals have heated up discussions of how much information financial institutions should be required to disclose. What specifically should be disclosed and how?

Full Disclosure: The SEC’s Requirements Relating to Bank Holding Companies

Federal securities laws require that investors in a publicly traded company be furnished with complete and timely information about the firm and its securities. This full disclosure concept is critical to the efficiency of our capital markets and the protection of investors. During the 50 years since the securities laws were enacted, the Securities and Exchange Commission has developed a comprehensive disclosure system as well as an effective enforcement program to ensure compliance with that system. This article will review generally the commission’s present disclosure system and will discuss specifically the requirements applicable to the approximately 800 bank holding companies (BHCs) that file disclosure documents with the commission.

The SEC’s Disclosure System

Requirements

Under the Securities Act of 1933, issuers making public offerings of securities are required to make certain specific disclosures in registration statements when they bring securities to market. Periodic reporting is required of these issuers in the Securities Exchange Act of 1934. The SEC recently adopted a single, comprehensive disclosure system for domestic issuers. It makes disclosure requirements uniform under both acts and allows Exchange Act periodic reporting to satisfy disclosure requirements of Securities Act registration statements whenever possible.

Under integration, there is a three-tier system for the registration of securities by domestic issuers. This system requires the same basic information package to be included in the registration statement of all registering companies. Specific requirements differ primarily in the extent to which the required information can be incorporated by reference from other documents.

—Form S-3: Disclosure of information is streamlined for the largest companies, primarily by incorporating by reference in the prospectus information in the latest annual Form 10-K and all other periodic reports filed since the end of the fiscal year covered by that form.
— Form S-2: Registrants in the middle tier are allowed to comply by using their annual report to shareholders as the main part of the prospectus.
— Form S-1: Issuers that do not meet the eligibility standards for streamlined treatment or that otherwise elect not to use the other forms set forth required information in a more extensive prospectus delivered to investors rather than incorporated by reference.

Domestic registrants are subject to the Exchange Act’s continuous reporting requirements as well as proxy solicitation regulations. Among other things, the Exchange Act requires that companies file annual, quarterly and current reports and proxy statements.

The annual report on Form 10-K is the cornerstone of the SEC’s integrated disclosure system. That report is in a four-part format and requires:

- Part I
  - a comprehensive discussion of the issuer’s business;
  - a discussion of properties owned by the issuer;
  - a summary of pending legal proceedings;
  - information regarding matters submitted to a vote of security holders;

- Part II
  - market and related shareholder matters;
  - selected financial data for five fiscal years;
  - management’s discussion and analysis of financial condition and results of operations;
  - audited financial statements and supplementary financial data;

- Part III
  - information relating to the issuer’s officers and directors, including their remuneration and related transactions;
  - information on security holdings of management; and

- Part IV
  - certain exhibits and financial statement schedules.

The quarterly report on Form 10-Q updates the information in Form 10-K. The current report on Form 8-K provides timely communication of significant events, thus completing the continuous stream of information about the company. Form 8-Ks are filed to indicate:

- changes in control;
- acquisition or disposition of a substantial amount of assets;
- bankruptcy or receivership;
- changes of accountant;
- resignation of directors; and
- other information the issuer may wish to report.

Companies making proxy solicitations must comply with the SEC’s Regulation 14A, which requires a proxy (or information) statement. This statement provides shareholders with information necessary to make informed decisions on matters to be voted on in the proxy.

Uniform Procedures, Requirements and Other Guidelines

Under the integrated disclosure system, the commission has adopted various uniform procedural, disclosure and accounting requirements.

The commission’s principal accounting requirements are embodied in Regulation S-X (S-X), which governs the form and content of, and requirements for, most financial statements filed under federal securities laws. S-X covers such matters as qualifications and reports of independent accountants; time periods to be covered by financial statements; general footnote requirements; format requirements for financial statements of commercial and industrial, investment, insurance and bank holding companies; interim financial statements; pro forma financial information and supplemental schedules. The commission’s comprehensive review of Regulation S-X over the past several years has established uniform financial statement requirements applicable to virtually all filings with the commission pursuant to the Securities Act and the Exchange Act, as well as annual reports to security holders prepared in accordance with the commission’s proxy rules.

In order to provide companies and their advisors with current guidance, the commission also publicizes its views on various accounting and financial reporting matters in Financial Reporting Releases (FRRs).

In April 1982, the commission issued FRR No. 1 announcing publication of a codification of certain existing Accounting Series Releases (ASRs). The material included represents only those portions of the 307 ASRs issued since 1937 that are relevant today. Portions of 71 of the 207 ASRs dealing with general accounting issues were identified as providing current, meaningful guidance to registrants, independent accountants...
and others in complying with commission requirements. The codification is indexed and provides a useful reference for the commission's current published views on accounting and auditing matters relating to financial reporting. It has been updated periodically by the issuance of new FRRs.

In a related action, the commission published Accounting and Auditing Enforcement Release (AAER) No. 1 as the first in a new series of releases to announce accounting and auditing matters related to commission enforcement activities. AAER No. 1 includes a topical index for the material included in the 100 enforcement-related ASRs to facilitate reference to specific areas addressed by the commission in those releases.

The commission staff gives further guidance through periodic Staff Accounting Bulletins (SABs) as a means of informing the financial community of its views on accounting and disclosure issues. During the past year, the staff published SABs on various financial reporting topics including: (a) application of the purchase accounting method to business combinations involving financial institutions; (b) implementation of the commission's revised requirements for separate parent-company-only financial information; (c) presentation of certain information in connection with business combinations; (d) valuation of certain assets acquired from related parties; (e) disclosure by BHCs about foreign outstanding; (f) financial statement requirements involving the formation of a one-bank holding company; (g) accounting for sale of stock by a subsidiary; (h) terminations of defined benefit pension plans; and (i) financial statement requirements involving the guarantee of securities by a parent or by a subsidiary. While SABs are not official rules, the staff expects the guidelines to be followed in SEC filings.

For financial statements filed with the commission, issuers and registrants also must comply with generally accepted accounting principles (GAAP), as established by private sector standard setting organizations such as the Financial Accounting Standards Board.

Application of SEC Disclosure Requirements to Bank Holding Companies

The commission has been a leader in the last decade in establishing timely disclosure standards for BHCs. Article 9 of Regulation S-X sets forth financial statement disclosure requirements and Industry Guide 3 calls for detailed statistical disclosures about operations, assets and liabilities. The staff has also issued various SABs dealing with the subject. Taken together, these rules and guidelines provide for a comprehensive disclosure system for BHCs.

Article 9 of Regulation S-X

Article 9 sets forth detailed captions that must appear on the balance sheets and income statements as well as certain footnote and schedule requirements. The current requirements grew out of a period of more independent commission actions on BHC reporting. In April 1977, the commission proposed to establish for the first time a comprehensive set of SEC rules for consolidated financial statements of BHCs. Until that time, such financial statements were prepared in accordance with an Article 9 provision which merely referred to the financial statement requirements of Regulation F of the Board of Governors of the Federal Reserve System.

The Securities Act Amendment of 1975 required the federal banking regulatory agencies having primary responsibility for application of the Exchange Act to banks to issue regulations substantially similar to those the SEC adopted for the protection of investors. In light of this amendment, the commission determined that it was no longer appropriate that Article 9 should refer to Federal Reserve regulations for the form and content of bank and BHC financial statements.

Article 9 underwent minor revision in 1980 in ASR 276 when the Commission amended the requirements for reporting amounts due from nonofficer directors and for reporting large time deposits.

In March 1983, the commission adopted a comprehensive revision of Article 9 intended to simplify and improve financial reporting requirements effective December 31, 1983 (FRR 11). The final rules generally reflect current financial reporting practices of BHCs, except for the income statement presentation of investment securities gains or losses, the disclosure requirements for loans to related parties and parent company financial information.

Certain disclosure requirements (previously included in Article 9 and thus required in the primary financial statements) have been relocated as
part of Guide 3. The most significant include information about short-term borrowings, disclosure of investment concentrations, and certain details about foreign activities. These disclosures are primarily analytical in nature and thus are similar to the other types of disclosures called for by Guide 3.

When the commission solicited public comments on the proposed revisions, most commentators expressed general support. Two areas frequently commented on were the proposed revision of requirements for reporting investment security transactions and the proposed modification of the disclosure requirements dealing with loans to related parties.

Investment Securities Gains or Losses.

The proposed rules called for a change in the income statement format to report gains or losses on investment securities as a separate component of income before income tax expense, rather than as a separate item (less applicable taxes) after the caption entitled "income before securities gains or losses." This proposed elimination of the so-called two-step format for reporting income both before and after investment security transactions was commented on by approximately three-fourths of the respondents. A majority objected to the one-step approach on the grounds that the two-step reporting format is a customary presentation which banks have used for many years, and that including the effect of investment securities transactions as a part of income from banking operations would be inappropriate. A few commentators objected for other reasons. Some said that banks should have the ability to restructure their investment portfolio without penalizing current "operating" income with the related losses, or that the proposed change would increase the potential to manage or smooth reported earnings through the timing and selection of securities transactions.

Although the rule met with considerable opposition, proponents indicated that conforming the reporting format used by BHCs to that used by virtually all other entities would eliminate much of the confusion surrounding a BHC's actual earnings. These commentators generally agreed with the commission that there is no conceptual basis for reporting investment transactions in a manner that implies the gains or losses represent something other than operating earnings. Further, the present reporting was viewed as being inconsistent with several other reporting practices.

After considering comments, the commission continued to believe that the two-step income format promotes the misconception that securities transactions are not part of normal banking operations, and that this format detracts from the primary importance of net income. For these reasons, and because of the potential for inappropriate reporting of certain transactions as security gains or losses, the commission adopted the proposed one-step income statement, with one change. The final rules call for the presentation of investment securities gains and losses as a separate subcategory of other income. The commission emphasized its belief that the revised reporting format should have no bearing on prudent decision-making. Furthermore, the commission's existing disclosure requirements require specific disclosures about the content of the investment securities portfolio and its yields. Such disclosures should provide users with the information necessary to evaluate management's investment policies and strategies.

Some commentators had warned that the one-step format would increase the potential for registrants to manage earnings. In response, the commission emphasized the responsibility of BHCs, as well as all other registrants, to identify clearly and explain the nature and impact of all special, discretionary, or nonrecurring items having a material effect on reported financial condition, changes in financial condition and operating results.

Loans to Related Parties.

The proposed rules included a comprehensive revision of existing requirements relating to loans to BHC insiders and other parties related to the BHC. These changes would have made various definitional changes to correspond with revisions proposed to Regulation S-K. Also proposed were certain required footnote disclosures when (1) a significant portion of related-party loans are nonperforming and (2) any such material loans were made outside the ordinary course of business, and (3) the amount of such loans at the balance sheet date was significantly less than the weighted average amount outstanding during the year. Finally, the proposed revisions would
delete Schedule I, which requires detailed disclosure of certain loans to individual related parties.

After public comment, the requirements regarding related-party loan disclosures were modified in two significant ways. The commission's final rules apply only to members of the "immediate family" of covered persons. This revision will include more relatives than were encompassed by the former rules, but will be significantly less burdensome than the proposal. Second, commissioners deleted a proposal to require that the amount of related-party loans include loans to any corporation or organization of which an executive officer, director or principal shareholder of the registrant or any of its significant subsidiaries is an officer (but not a principal shareholder). The revised final rules require an analysis of the aggregate loans to related parties from the beginning to the end of the period for the latest fiscal year. The commission believes this disclosure should adequately inform investors as to the significance of loan transactions with related parties without imposing an undue burden of calculating a weighted average of such loans or, in some cases, discussing individual loans.

Parent-Only Statements

The operation of banking subsidiaries are subject to broad regulatory restraints that affect the transfer of funds to the parent. Because of the particular relevance of such restrictions to BHCs, the commission in its 1982 release proposing amendments to Article 9, asked for specific comments on the need for parent company financial information for BHCs. The final rules require that condensed financial information of the parent company be presented in the notes to BHCs' consolidated financial statements.

The rules set forth certain minimum disclosures that must be included with the condensed parent company information. These include (1) the disclosure of investments and indebtedness of bank subsidiaries separate from nonbank subsidiaries and (2) similar separate disclosure of the amount of cash dividends paid to the registrant for the previous three years by such bank subsidiaries, as distinguished from other subsidiaries.

Industry Guide 3

Industry Guide 3, adopted in 1976, requires historical statistical information about BHCs in seven areas:

- Average balance sheets and analyses of changes in net interest earnings.
- Investment portfolio categorized by type of securities and maturities.
- Information about the loan portfolio, including types of loans, maturities and sensitivities to changes in interest rates, and problem loans.
- Summary of loan loss experience.
- Deposits by category.
- Returns on equity and assets.
- Short-term borrowings.

This analytical information provides an extensive database for analysts and investors to assess sources of earnings potential and risks. While no substantial changes have been made to the guide since its adoption in 1976, numerous refinements were made in 1980 and this past March and August.

Guide 3 grew out of the 1974 recession. The commission became concerned about the impact of severe recessionary conditions on financial institutions' loan loss reserves because of problems in the real estate and other industries. As an initial response to these concerns, the commission issued ASR 166 in December 1974, emphasizing the responsibility of all registrants to disclose the potential impact of increased uncertainties on their financial statements. BHCs were cautioned that normal disclosures should be expanded to highlight such factors as increased risks in the loan portfolio because of significant doubts as to collectibility, increased delinquencies and loans extended or renegotiated under adverse circumstances.

During 1974 and 1975, the staff developed and refined disclosure guidelines that formed the basis for statistical disclosures required by the staff for BHC filings. The staff's administrative policies were proposed for comment in 1975 and adopted in August 1976. The commission took this action notwithstanding the concerns expressed about the possible impact of detailed disclosures on a BHC's ability to raise capital and the sensitivity of the detailed foreign disclosures called for.

In August 1983, the commission amended Guide 3's Item III.C. "Nonperforming Loans," to establish a new section—"Risk Elements." The terminology "nonperforming loans" is no longer used in Guide 3 since it is too narrow to encompass all the disclosures required by the new section. This section calls for four categories of disclosure:

- Nonaccrual, past due and restructured loans.
- Potential problem loans.
— Foreign outstandings.
— Loan concentrations.

The first category contains three of the four classifications which are designated as nonperforming loans in the current Item III. C. of Guide 3. The commission’s existing criterion for determining a restructured loan is replaced by the criteria of FASB Statement of Financial Accounting Standards No. 15 for troubled debt restructurings. A significant change in the amended guidelines for disclosure of nonaccrual, past due and restructured loans is the exclusion of certain instructions present in the current Guide which allowed for the use of alternate criteria, and permitted exclusion of certain loans. This change has the effect of enhancing comparability of disclosures among registrants. Users of this information, particularly financial analysts, have stressed the importance of comparability in this area.

The second category, potential problem loans, corresponds to “serious doubts” criterion for classification in the pre-August 1983 Version of Item III. C. These loans are not disclosed as part of the first category described above, but information known by management indicates that the borrower may not be able to comply with present payment terms.

The third category calls for “foreign outstandings” disclosures. This new category is a codification of the substance of the alternative table disclosures of SAB No. 49, “Disclosures by Bank Holding Companies About Certain Foreign Loans”. This area is discussed further below. The fourth category calls for disclosure of “loan concentrations,” defined as amounts loaned to multiple numbers of borrowers engaged in similar activities that would cause them to be similarly impacted by economic or other conditions. A disclosure threshold of 10 percent of total loans has been provided.

The commission staff believes that these revised guidelines (which become effective on December 31) will improve BHCs’ disclosures by focusing more broadly on the various risk elements involved in lending activities. They also require more uniformity in disclosures by registrants, a factor important to analysts and other users of the data in accessing risk.

The amended guidelines pertaining to “nonaccrual, past due and restructured loans” as well as “foreign outstandings” are consistent with the federal banking agencies’ present and planned disclosure requirements. Uniformity in the bases for presenting information by BHCs in commission filings and by banks in supplementary disclosures for bank regulatory purposes will reduce compliance burdens and enhance the disclosure reports’ usefulness to investors and the public.

Disclosure About Foreign Activities

The commission has taken specific action to ensure adequate disclosure about BHCs’ foreign activities in view of the unique risks associated with these activities.

Article 9 requires financial statement disclosure of the following information about foreign lending activities:

— Aggregate amount of foreign loans outstanding.
— Identifiable assets associated with foreign activities.
— Amount of foreign revenue, pretax income and net income.

The last two items must be presented for each significant geographic segment in which the bank does business (Europe, Latin America, and so forth) and in the aggregate for all other geographic areas.

Additionally, Guide 3 provides for disclosure of:

— Foreign loans in each of these categories:
— governments and official institutions,
— banks and other financial institutions,
— commercial and industrial entities,
— other loans.
— An analysis of the allowance for loan losses related to foreign activities.
— Analyses of yields on average foreign assets and rates paid on average foreign liabilities.
— Information regarding deposits in foreign offices.
— The amount of foreign nonaccrual, past due and restructured loans.

In addition to longstanding commission requirements, the staff has recently taken initiatives to ensure disclosure to investors of appropriate information about loans to foreign countries experiencing liquidity problems. On October 26, 1982, the staff issued SAB 49 to express its views regarding disclosure by BHCs about loans to public and private sector borrowers located in countries experiencing liquidity problems. On January 18, 1983, the staff issued SAB 49A concerning the necessity of providing additional disclosures about restructurings of existing debt.
of these countries, funding of additional borrowings and other related matters.

SAB 49 generally calls for BHCs to disclose any material outstandings to countries experiencing liquidity problems. The objective is to elicit disclosures about material exposures in countries in which political or economic conditions may cause borrowers difficulty in making timely interest or principal payments. The risks inherent in such transactions are considered by many to be separate from the normal credit risks associated with bank lending.

SAB 49A sets forth the staff’s views regarding the need for additional disclosures about material subsequent developments regarding outstandings to foreign countries experiencing liquidity problems. For example, it notes that certain countries are negotiating with or have entered into agreements with U.S. lenders, other foreign banks, international lending agencies and others to restructure existing sovereign debt and to obtain additional new borrowings. The SAB calls for disclosures about these matters, including their impact on the maturities of existing debt principal and on unpaid interest, commitments to extend additional borrowings, and other arrangements such as agreements to maintain deposits with government banks.

In the recent amendments to Guide 3, the commission codified the substance of SAB 49’s alternative table disclosure for foreign outstandings. Disclosure of outstandings to individual foreign countries in excess of 1 percent of consolidated outstandings is required for a three-year period. Such reporting identifies the registrant’s significant cross-border exposures and allows investors to arrive at their own conclusions as to any potential or actual transfer risks involved.

The revised guidelines also call for additional disclosures when a foreign country is experiencing liquidity problems because of economic or political conditions expected to have a material impact on timely payment. Finally, in addition to disclosures about individual countries whose outstandings exceed 1 percent of total assets, the guidelines call for aggregate disclosures for countries where outstandings are between .75 percent and 1 percent of total assets. This disclosure format is consistent with that proposed in the federal banking agencies’ Country Exposure Report.1

The guidelines call for separate disclosure by governments and official institutions, bank and other financial institutions, commercial and industrial, and other. Registrants have presented similar breakdowns, and users of reported information have commented that this disclosure is important in assessing a registrant’s exposure in certain countries.

The amendments call for disclosure of outstandings repayable in dollars or other non-local currency; they do not require that gross amounts repayable in local currency be disclosed. Many commentators asserted that most loans repayable in local currency are substantially funded by local operations and that unfunded amounts normally do not reflect significant transfer risk. The revised guide provides that any material volume of local currency outstandings not hedged or not funded by local currency borrowings should be reflected in cross-border outstandings. The amendments allow any legally enforceable written guarantees of principal or interest by domestic or other non-local third parties to be netted against the amounts of foreign outstandings presented. The commission agreed with respondents who asserted that, when the repayment of outstandings is assured by third parties, and the registrant is clearly not exposed to transfer risk because of this recourse, presentation of amounts net of such guarantees more appropriately reflects the registrant’s exposure to risks. The amendments allow collateral value to be netted against the cross-border outstandings of a foreign country in certain limited circumstances.

### Disclosure of Financial Problems

During periods of economic difficulty, BHCs face particular disclosure challenges. Traditionally, the commission and bank regulatory agencies have differed over the disclosure required of publicly held financial institutions in serious financial trouble. While the commission has always emphasized the responsibility of publicly held companies to make full and accurate disclosure of their financial condition for the benefit of public investors, bank regulatory agencies traditionally have favored nondisclosure of financial difficulties for a period of time to allow a financial institution to work out its problems. However, some bank regulatory agencies have recognized recently that the increasing emphasis on market

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1 Federal banking agencies have announced their intention to provide for increased and more timely disclosures about banks' country exposures. These disclosures would be based on information called for by revised item 111.C of Guide 3 and would be available to the public upon request.
forces instead of government regulation to discipline financial institutions may require greater public disclosure.

The commission has emphasized publicly-held financial institutions' responsibilities to disclose serious financial problems. For example, Guide 3 emphasizes disclosure items that could signal financial difficulties. In addition, in a recent enforcement action, the commission has maintained that an agreement with a bank regulatory agency materially restricting a financial institution's business activities must be disclosed to shareholders. Finally, in a Report of Private Investigation, the commission emphasized that public statements and releases by a financially troubled institution concerning its financial results must go beyond recitation of numbers and must disclose their significance to its financial viability.

Dynamics of Disclosure

This article has outlined the SEC's general disclosure system and specifically discussed disclosures applicable to BHCs, including recent changes. In my view, the disclosures that BHCs provide to their investors and shareholders are more comprehensive and sophisticated than those of most industries. Nonetheless, financial institutions in general and BHCs in particular will continue to face financial reporting challenges in a constantly changing economic, competitive and regulatory environment. The commission and its staff will continue to monitor developments in this area closely, and stand ready to modify existing requirements or to issue additional guidelines to ensure that the investing public continues to receive full and accurate disclosure.

—Edmund Coulson


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