STATEMENT OF
THE HONORABLE HAROLD M. WILLIAMS,
CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION
BEFORE THE
SUBCOMMITTEE ON FINANCIAL INSTITUTIONS
OF THE
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS
UNITED STATES SENATE
May 17, 1978

STATEMENT OF THE HONORABLE HAROLD M. WILLIAMS, CHAIRMAN OF THE SECURITIES AND EXCHANGE COMMISSION, BEFORE THE SUBCOMMITTEE ON FINANCIAL INSTITUTIONS OF THE SENATE COMMITTEE ON BANKING, HOUSING AND URBAN AFFAIRS, REGARDING S. 2096, THE PROPOSED "RIGHT TO FINANCIAL PRIVACY ACT OF 1977"

May 17, 1978

Mr. Chairman and Members of the Subcommittee:

I am pleased to have the opportunity to appear this morning before this Subcommittee to comment on S. 2096, the proposed "Right to Financial Privacy Act." The Commission concurs with the basic objectives of this bill—to ensure that governmental authorities behave responsibly toward sensitive personal records, and to preserve a reasonable expectation of privacy for records of a personal nature. However, we are concerned that the bill as drafted would have a severely inhibiting effect on the regulatory and investor protection activities of the Commission.

The Commission is concerned with this legislation from two different perspectives. First, the Commission is responsible, either directly or indirectly, for regulating disclosures made by publicly-held banks, and investigating their securities-related activities; and, as you know, these securities-related activities have been increasing in recent years. Consequently, we are concerned with any legislation involving the authority of federal agencies over banks. More importantly, the Commission's primary mandate—to protect the integrity of the nation's securities markets—integrally involves us in the regulation of brokers and dealers in securities, and other entities involved in the securities industry, as well as in the reporting affairs of almost every major corporation and in the securities-related activities of both corporations

and individuals. Access to records of financial transactions is vital to the Commission's ability effectively to enforce the securities laws with respect to these persons and entities.

The regulatory responsibilities of the Securities and Exchange Commission are unique. We are the federal agency primarily charged with the responsibility for safeguarding the integrity of the capital markets for the public investor. We have a responsibility for the financial security of millions of American citizens who have a stake in the capital markets, either through their own direct investments or indirectly through mutual funds and similar investment media.

Ready access to records of financial transactions is critical to our most basic functions. To adequately protect the investing public, the Commission inevitably must be able to review the financial transactions that are at the very heart of the complex financial world that encompasses the securities industry and the large corporation. The procedural obstacles that this bill would put in the way of the Commission's ability to obtain access to records of these financial transactions would, in many instances, seriously impair, if not eviscerate the Commission's ability to continue to perform these important functions.

We are concerned with the manner in which this bill attempts to provide financial privacy. We are concerned that the Commission may have to litigate a great number of the subpoenas that its officers lawfully issue for the bank records of corporations and persons involved in our investigations of financial misconduct. We are concerned that the costs and other burdens of this litigation will place an impossible burden on the Commission, as well as on the federal judiciary — that the Commission's productivity will be seriously impaired and that the already overburdened judiciary will be unable to respond. We are concerned that the real delay in actual access to the records we need to do our job, in those very cases where quick access may be most needed, will not be fourteen days, but months and months. We are seriously concerned that, given the complexity of financial affairs today, as we progress toward a "cashless" society, and given the intricacies of the capital markets and the ever-increasing sophistication of those who engage in financial misconduct, these procedural impediments will frustrate our ability to investigate and even to detect abuses that siphon off millions of dollars of investment interest at the expense of the public investor. We are concerned that this Act, in attempting to provide financial privacy, may do so at considerable cost to another right, that of the American citizen to confidently invest in a fundamentally fair and honest securities marketplace.

I would like to give the Subcommittee, in my testimony today, an idea of the importance to the Commission of timely access to bank records in connection with the proper discharge of our responsibilities. I will then address the various problems the Commission sees with the bill as drafted, and particularly the problems we have with the bill's provisions relating to administrative subpoenas.

The Need for Bank Records in the Discharge of the Commission's Responsibilities

As the members of this Subcommittee are aware, the Commission's responsibilities under the federal securities laws include alleviating the impact and the effects on the marketplace for securities that are created by financial misconduct of various kinds, including insider trading, manipulative, fraudulent or otherwise illegal securities transactions, undisclosed kickbacks, bribes and other illegal payments, misuse of corporate assets, and mismanagement of public corporations. Bank records are often crucial evidence in investigations of such matters. In addition to conferring investigative powers upon it, Congress has authorized the Commission to take remedial action once violations of the federal securities laws have been uncovered. For example, the Commission is empowered to bring actions in the federal district courts seeking injunctions and related relief to stop on-going misconduct, undo its effects, and prevent its recurrence. Further, the Commission is authorized to institute administrative proceedings of various types and, in appropriate cases, to refer the results of its investigations to the Department of Justice for criminal prosecution. In many instances,

particularly those in which injunctive relief is appropriate, the ability to act promptly is essential to the discharge of the Commission's mandate. Violations of the federal securities laws often involve the diversion of large amounts of investor funds. If the Commission is to be in a position to trace and recover those funds it must frequently be able to investigate and seek judicial relief promptly.

Examples of investigatory activities in which timely access to financial records was critical to the success of the investigation.

I would like to take the time to give just a few examples of recent investigations where access to relevant bank records has been of crucial significance. The need of the Commission to inspect bank records pursuant to a valid administrative subpoena on an unimpeded basis was demonstrated in the Commission's 1976 case, Securities and Exchange Commission v. National Pacific Corporation, et al., C.A. No. 76-1784 (D.D.C., 1976). As one of its first investigative steps after obtaining a formal order of investigation from the Commission, the Commission's officer issued subpoenas to several banks where the various companies involved in the investigation maintained checking accounts. After examining the cancelled checks and other relevant financial documents obtained from the banks, the staff discovered that millions of dollars of union insurance premiums were being improperly diverted from the National American Life Insurance Company. Based on the information obtained through our inspection of these bank records, the Commission promptly brought an injunctive action in federal district court, and was successful in obtaining a temporary restraining order and preliminary injunction freezing all the improperly diverted funds and

appointing a receiver for the insurance company. There is no question that the ability of the Commission to obtain access in a timely fashion to relevant bank records was crucial in stopping this ongoing fraudulent activity and preserving the misappropriated assets from further diversion. If we had been operating under the bill as drafted, I believe that the persons responsible for this fraud would have been able to continue their activities for a substantial period of time, while they forced the Commission to litigate over our right to examine their bank records.

In a very recent case, the Commission's staff, pursuant to a formal order of investigation issued by the Commission, discovered that certain of the officers and directors of a company were systematically diverting hundreds of thousands of dollars of corporate assets to their own benefit through various schemes intended to conceal this outflow of cash, primarily through improper payments to an account with a name identical to a real creditor of the company. It was only as a result of subpoenaing and reviewing bank ledger accounts, cancelled checks, and new account information, that the Commission staff identified those having a beneficial interest in the account, and thus could trace the misappropriated corporate funds to the perpetrators of the fraud. Since the wrongdoers were still in control of the corporation and still engaging in further misappropriations while the investigation was taking place, it was essential that the staff act as quickly as possible to protect the public interest. In this case, the Commission was able to obtain a temporary restraining order halting further misappropriations within two weeks of obtaining indications that they were taking place. As a result of the Commission's prompt action,

the Commission was able not only to halt the fraudulent activity, but also to freeze hundreds of thousands of dollars in the hands of the wrongdoers. As it was, the slight procedural delays that did occur permitted the removal of some of the misappropriated funds, and, in this case, any further delay--even one day--would have permitted the removal of all the funds beyond the jurisdiction of the court and thus prevented the return of these funds to the defrauded corporation and its public investors. Under the draft legislation this Subcommittee is considering, the Commission would have still been waiting, at the end of two weeks, to examine the bank records it needed to make its case, since that is the absolute minimum period of time that we would have to wait for access to needed bank records.

Other recent cases in which it was necessary to issue a large number of subpoenas to banks, each of which would be subject to challenge under the draft bill, similarly illustrate the burden that the procedures outlined in the draft bill would create in situations where corporations utilize numerous bank accounts. In one case, the Commission issued subpoenas for the bank records of a corporation now in bankruptcy to approximately forty different banks out of a total of over 200 banks with which the company dealt. As a result of examining those records, the Commission was able to discover a significant volume of information crucial to its case against the corporation. If this information were available only after the substantial delay needed to give the notice required by the draft bill to the customer and, where necessary, litigate separate subpoena enforcement actions as to forty different accounts in federal district court, the Commission simply would not have had the time and resources

to develop the case. In another case, in order to pursue its investigation into serious violations of several provisions of the securities laws by a large corporation, the Commission's staff found it necessary to issue approximately sixty subpoenas to approximately thirty-five banks, seeking access to records of the financial transactions of the corporation and certain of its officers and directors. Under the proposed bill, each separate subpoena would have been subject to arbitrary challenge. If the Commission had not been able to obtain access or had been forced to litigate each subpoena, it would not have been possible to develop this case.

Another case in which bank records were of critical importance involved the sale of securities by a bank holding company. This company had been directed to divest itself of certain stock holdings by the Federal Reserve Board. The Commission's staff, pursuant to a formal order of investigation, discovered that the purchaser of the stock was acting merely as a nominee of the bank holding company and that there was an undisclosed repurchase agreement concerning the stock. This instance of financial misconduct came to light only following an examination of the bank records which evidenced the purchase by the bank holding company's nominee.

Investigations of violations of the margin requirements established by the Federal Reserve Board also frequently require access to bank records if an investigation is to be successful. In a recent case, the Commission's staff discovered that a bank was improperly extending credit in excess of the margin requirements to certain individuals who maintained accounts with the bank for the purpose of purchasing and selling securities. It

was only from the daily transaction sheets prepared by the bank for the individual investors that the violations of the margin regulations could be established, and action taken to stop further violations. Under the draft bill, this would be customer information that could be extremely difficult to obtain. Paradoxically, however, if the investor does his business with a broker instead of with a bank, we would have the right under our statutes to examine that broker's records and obtain immediate access to the information. It is quite likely that this significant disparity in treatment will encourage those who wish to conceal their transactions to take their business to a bank, rather than to a broker.

The Commission's staff is also presently involved in a private investigation involving a publicly traded, diversified holding company. A substantial portion of that investigation involves the examination of transactions between various top management personnel and the public corporation. Initial subpoenas to the principals and the corporation failed to produce sufficient relevant documentation, although the evidence clearly indicated numerous, substantial bank transactions related to the insider dealings. Subpoenas to, and prompt responses from, the banks involved established a clear "paper trail" from which the Commission's staff could piece together parts of the transactional puzzle and vigorously pursue the investigation of the insider transactions. Without the prompt responses to the subpoenas the Commission issued to banks, it is doubtful whether the staff would have been able to pursue and uncover what now appears to be a massive insider trading fraud on the issuer's public shareholders.

The foregoing illustrate some specific instances where the Commission required access to financial records. There are many different types of

investigations in which bank records are extremely important; I would like to mention only a few additional generic examples.

Insider trading cases. The Commission is frequently alerted to financial misconduct involving the misuse of inside information in connection with securities trading. Typically, the Commission's investigation will be triggered when our market surveillance unit observes that a large block of securities has been traded just prior to the public announcement of a significant corporate event. Frequently, a review of the trading records indicates that one or more banks are involved in the transaction, and only a review of these bank records will indicate who are the ultimate beneficiaries of this type of financial misbehavior. Where a number of banks or trading accounts are involved, the procedural impediments created by this bill could be a substantial deterrent to effective law enforcement.

Sale of unregistered securities. Another type of violative activity that the Commission investigates involves sales of securities that have not been registered with the Commission as required by law. In these situations, it is quite common for the wrongdoer to attempt to conceal the amount of such securities being sold and the persons on whose behalf they are being sold by selling them through a number of corporations and individuals who appear to be acting for themselves. Bank records are essential to establish the fact that such persons and corporations are acting as nominees for the true beneficial owners.

Stock manipulation cases. Similarly, it is customary for persons engaged in manipulative trading activities to effect transactions in the name of corporations and individuals to make the price movement of the

security appear to be the result of normal supply and demand. Their nominees may be widely scattered throughout the country, and their accounts located at a number of different brokerage firms or banks. The investigation must establish who caused the transactions to take place and who profited from the transactions. In establishing the identity of such persons, it is essential to obtain the financial records that establish the identity of the ultimate recipients of the illegal profits.

Misappropriation of corporate assets. Another type of investigation in which bank records are important involves the misuse or diversion of corporate assets. In some of these cases, it may be difficult to locate the responsible persons, who sometimes flee beyond our jurisdiction. To give notice to these people and require that, upon any objection, the Commission go to court to enforce its subpoenas would result in considerable delay and give the persons involved an opportunity to frustrate the Commission's work without even subjecting themselves to our jurisdiction.

Bank activities. Another category of activity that the Commission investigates involves the banks themselves and their officials. Such activities, for example, may involve the utilization of customer accounts by a bank officer in effecting improper transactions. To allow the bank to object to a Commission subpoena for the customer's records would effectively permit the bank to utilize this provision as a shield for the improper activities of its own officers. In addition, banks frequently effect securities transactions for their customers, acting essentially as brokers. Under this proposed Act, as I noted before, such brokerage activities would not be readily accessible to Commission scrutiny.

We may therefore anticipate that there will be a substantial increase in the number of transactions channeled through banks in order to take advantage of the cloak of secrecy that this bill would provide for such transactions.

The effect of the Tax Reform Act on the Commission's access to tax records.

The practical effects of the currently proposed legislation may, perhaps, best be seen in light of the Commission's experience with the Tax Reform Act of 1976. As the members of the Subcommittee are aware, that Act, which became effective on January 1, 1977, placed substantial restrictions on the ability of this Commission, among others, to obtain information from the Internal Revenue Service. Due to the breadth of the Act's provisions, the cumbersome nature of the procedural requirements, questions as to the liability of members of the Commission's staff if they should make an error, and other questions regarding the legal interpretation of the Act, the Commission has not sought access to any returns filed with the Internal Revenue Service since the enactment of the Tax Reform Act, and its prior limited use of tax return information has thus been completely eliminated.

Thus, I suggest to the members of the Subcommittee that, despite the inclusion in the draft bill of provisions which appear to permit access to information covered by the proposed legislation, the practical effect will be extremely onerous and will, as a practical matter, substantially curtail our ability to obtain bank records.

In view of the potential effects of this bill, I urge the Subcommittee most strongly to carefully consider the consequences of the bill as it

now stands. I appreciate the difficult path which the Congress must walk, in attempting to protect and strengthen the rights of the individual on the one hand, and to protect society against unlawful behavior on the other. In our view, the bill as drafted would unduly tilt the scales against the Commission's regulatory, investigatory and law enforcement efforts. The Commission, as the federal agency with primary responsibility for protecting the securities marketplace, is particularly concerned with the impact of this legislation on our ability to detect and successfully safeguard the public against financial misbehavior and corporate misconduct.

Analysis of the proposed Act.

The proposed bill seeks to protect the right of individuals to financial privacy in two principal ways:

(1) it would require notification when a federal agency seeks access to a bank customer's financial records; and

(2) it would afford the customer an opportunity to prevent release of those records.

The procedure provided by the draft legislation to challenge, and prevent, the production of records would establish a very serious obstacle to our law enforcement efforts. It would allow either a customer or the financial institution to deny access to records simply by filing a written objection. No reason need be given, and the procedure is so convenient as to invite its use on an almost automatic basis. Once an objection has been filed, a law enforcement agency would presumably have to apply to a district court for an order requiring production of the subpoenaed records. Access to the records would then be delayed pending resolution of all the issues raised before the district court, and further delayed

if an appeal were taken to the courts of appeals. In our experience, the resolution of a subpoena enforcement action and a resulting appeal can easily require well over a year's time, a delay that will often have a substantial disruptive impact in our investigations, diverting the staff from its principal investigative functions, and increasing the burden on the federal courts.

The proposed act also places new restrictions on the use of information obtained from financial records. It provides stringent civil and criminal penalties for violations of the Act's provisions, it reallocates the cost of producing the records from the financial institution to the Commission, and it subjects federal agencies to state laws granting broader financial privacy rights than this legislation. We are concerned about each of these provisions.

The Commission's Principal Problem with the Approach taken by the Bill--Unnecessary Restrictions on Administrative Subpoenas with respect to Bank Records.

Our principal objection, however, is that the bill imposes additional procedural requirements on administrative subpoenas that we consider unnecessary, in light of the safeguards the Congress has already provided in this area, and in light of the way the Commission actually operates. When the Congress created the Commission in 1934, it took care to provide the agency with the ability to discharge its responsibilities by providing what the Supreme Court has recently described as "flexible enforcement powers." 1/ One of the most important of these powers is the ability to issue adminis-

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1/ Ernst & Ernst v. Hochfelder, 425 U.S. 185, 195 (1976).

trative subpoenas in connection with formal investigations. 2/ Congress recognized in 1934 that we should have subpoena power comparable to the power of a grand jury, and the courts have often compared our authority in this regard to that of a grand jury. 3/ Congress also recognized in 1934 that the Commission would need unhindered access to the records of brokers and dealers in securities if it was to be able to fulfill its responsibilities. Today, however, financial transactions are often much more sophisticated and complicated than in 1934, and the Commission needs access today to the records maintained by banks for the same reasons that it has always needed access to brokerage records.

Our implementation and use of the subpoena power the Congress has given us has been fair and responsible. The fact is that no member of the Commission's staff is free to issue a subpoena for bank records merely on his own authority. Before authority to issue any subpoenas in an investigatory context is granted, the staff must make a showing to the Commission that specified persons or corporations appear to have violated, or appear to be about to violate, a specific provision of the federal securities laws. The Commission itself must make this determination, and then enter a non-public formal order of investigation, specifying the persons or corporations under investigation, the sections of the laws which the

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2/ See, e.g., Section 19(b) of the Securities Act, 15 U.S.C. 77s(b); Section 21(b) of the Securities Exchange Act, 15 U.S.C. 78u(b).

3/ See, e.g., United States v. Morton Salt Co., 338 U.S. 632, 642-643 (1950).

Commission suspects are being violated, and the names of the persons authorized to issue subpoenas in connection with this investigation. If the investigation is to go beyond these boundaries, the staff must return to the Commission and make a showing as to why the formal order of investigation should be amended. The Commission devotes substantial time and energy to a consideration of these matters.

In view of the fact that the Commission affords those under investigation such procedural protections, I believe it is unnecessary to superimpose the additional procedures prescribed by this legislation on the Commission's present procedure. While the judgment involved is one for the Congress to make, I must respectfully say that I believe the approach embodied in this bill tilts the balance far too much in favor of the person under investigation, and against the need of the Commission to have appropriate access to crucial records regarding financial transactions.

The approach I would recommend that the Subcommittee adopt is one that codifies the appropriate limitations and responsibilities of federal agencies, as presently embodied in the Commission's procedures relating to formal orders of investigation, not one that, in effect, makes us dependent upon the cooperation of the persons whose affairs we are investigating, cooperation that will often not be forthcoming. I believe such a statute can be devised, one which spells out in detail the stringent procedures an agency must follow, and thereby provides real protections to the individual, but does not impinge unnecessarily on the Commission's ability to enforce the federal securities laws. We will be pleased to draft and submit specific

statutory language to the Subcommittee; I recommend that the Subcommittee give consideration to this approach. In addition, members of my staff are available to meet with the staff of the Subcommittee, in order to explain more fully than I am able to in this testimony, the Commission's procedures relating to the issuance of subpoenas.

We are also aware that the Department of Justice has proposed a bill containing provisions relating to administrative subpoenas that would require that the party whose bank records are subpoenaed object by moving to quash the subpoena in an appropriate federal court. We believe that a statute that codifies the particular procedures relating to formal orders of investigation would be preferable, in that these are the specific procedures that the agencies were intended to use, and which this Commission has always observed. This approach, moreover, recognizes that responsibility for use of an agency's subpoena power should rest with the agency itself. Nevertheless, I do believe that a person who feels that he has a protectable privacy interest will not be deterred from taking the steps spelled out in the Department's bill, and we may wish to comment further on that proposal after we have had a chance to study it some more.

In summary, we believe the legitimate interest of citizens in protecting the confidentiality of their bank records can be served without creating an expensive and cumbersome procedural framework for the government that will allow a person suspected of violating the law to shelter his bank records from an authorized investigation for a substantial period of time. But, I fear that the bill as drafted would provide an opportunity for

persons or corporations involved in securities-related wrongdoing to force the Commission to enforce its subpoenas through a costly and time consuming procedure that will involve the federal district courts in a substantial number of the subpoenas the Commission issues, thus delaying the Commission's investigations for months. Where documentary evidence of past financial transactions is a key element of the evidence against a person or corporation suspected of violating the law, the delay may often be such that the Commission simply cannot meaningfully enforce the law. In addition, the diversion of Commission manpower and other resources that this bill would require would seriously reduce the effectiveness of our agency.

Congress has authorized the Commission to take preventive measures, primarily through bringing injunctive actions, to stop financial malfeasance and to protect the public interest from future financial misconduct. This is a job that must often be accomplished in a timely mannner, if it is to be accomplished at all. 4/

Other recommendations with respect to the Bill.

We have a number of additional specific suggestions to make concerning the bill, and I would like now to focus on some other aspects of this legislation that pose particular problems for the Commission,

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4/ Timeliness is an essential ingredient of the equity which the Commission must demonstrate to show its entitlement to injunctive relief. Delay in pursuing our investigations due to dalays in obtaining access to relevant bank records might not only destroy our equity in any injunctive action we bring, but might also allow the applicable statute of limitations to run with respect to any criminal prosecution that might have been appropriate.

and propose certain modifications that we feel would help alleviate these problems.

1. The Definition of a "Customer"

Section 3(a)(3) of the bill defines the term "person" to include "a partnership, corporation, association, trust, or any other legal entity." "Customer" is then defined as all "persons" using bank services.

The traditional view has been that business entities do not possess anything akin to the constitutional right to privacy that individuals may possess. 5/ Consequently, we believe the definition of "person" is far broader than is required to fulfill the stated purposes of the Act—the protection of "citizens' constitutional rights." 6/ The consequence of including in this definition corporations, including regulated broker-dealers and other corporate entities engaged in the securities industry, would be to severely impede the Commission's investigations of corporations by providing a corporation seeking to delay a Commission investigation with a very effective avenue to accomplish this. In general, we submit that the extension of the bill's protection to corporations goes far beyond any protections previously afforded these entities, and distorts the existing balance between regulatory agencies and corporations. We suggest that this problem might be alleviated by defining the term "person" in the same manner that the term "individual" is used in the Privacy Act of 1974,

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5/ With respect to bank records, even individuals have not been considered to have any valid expectation of a right to privacy, as the Supreme Court has repeatedly held. United States v. Miller, 425 U.S. 435 (1976); see also, Couch v. United States, 409 U.S. 322 (1973).

6/ Section 2(a)(1).

5 U.S.C. 552a(a)(2): "'individual' means a citizen of the United States or an alien lawfully admitted for permanent residence." The term "customer," defined as "any person who utilizes or has utilized services provided by a financial instituion," would then apply only to individual customers, not corporate customers.

2. Objections by a Financial Institution in the Absence of any Objection by a Customer

Section 7 of the bill outlines the procedure by which the Commission may obtain access to customer financial records pursuant to a duly authorized administrative procedure. Section 7(b) conditions access to customer records on the absence of an objection from either the customer or the financial institution. I can conceive of no rationale to support the right of a financial institution to assert an objection on behalf of a customer who has been fully advised that his records have been subpoenaed and has made no objection in his own behalf. We may anticipate that, if financial institutions have this authority, they will generally take a conservative posture when responding to subpoenas, and object as a matter of course, especially in view of the fact that the bill exposes banks to civil liability for damages resulting from their violation of the provisions of the bill (Section 13), as well as criminal penalties (Section 14). 7/

7/ For example, on September 29, 1977, in connection with an authorized investigation, a Commission officer issued a subpoena for certain customer financial records of the First Tennessee Bank, N.A. Memphis. The Bank refused to comply, basing its refusal on the requirements of the Tennessee Bank Privacy Act of 1977 (TCA §45260l(a) et seq).

(footnote continued)

We believe this provision grants an unnecessary veto power to the bank and, in effect, issues an invitation to banks to exercise their power to object to administrative subpoenas. Therefore, we suggest a revision of this section, to eliminate the authority of the financial institution to object to the disclosure of customer records when there is no objection on the part of the customer whose records are being sought. We also recommend consideration by the Subcommittee of a similar amendment to Section 9 of the bill, relating to judicial subpoenas.

3. Restrictions on the Use of Investigatory Records and Interference with Inter-Agency Cooperation

A major problem presented by the bill in its present form is the use restrictions imposed by Section 11. We feel we should object to the provision that a bank's records and, indeed, any financial information about an individual or corporation reported to the Commission pursuant to the disclosure provisions of the federal securities laws, shall not be used for any purpose other than the specific statutory purpose for which the information was originally obtained. Among other things, this provision would prohibit the disclosure of such information to any other governmental department or agency, regardless of whether it appears that vio-

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7/ (continued)

The Commission was forced to bring a subpoena enforcement action in federal district court, Securities and Exchange Commission v. First Tennessee Bank N.A. Memphis, 445 F. Supp. 1341 (W.D. Tenn., 1978), applying to the court for an order requiring the bank to comply. On February 27, 1978, five months after the original subpoena was issued, the court entered an order granting the Commision's application.

lations of the law have occurred which are the proper concern of that agency. Thus, financial records subpoenaed for one purpose would have to be reaccessed pursuant to a second subpoena if they were retained or used for another purpose, even within the same agency, as, for example, financial records subpoenaed in an investigation of corporate misconduct that revealed violations of the law by an individual officer.

This provision would radically affect our ability to cooperate with the stock exchanges and self-regulatory agencies which share responsibility with us for regulating the marketplace for securities. It would also seriously detract from our ability to provide meaningful information and assistance to state enforcement authorities, such as state securities agencies.

The Commission's present policy is to share with other concerned agencies such information as it obtains relating to potential violations of those laws which are within their jurisdiction. And the Commission has often been assisted in its investigations by information received from other government agencies. Not only other federal agencies, but state securities regulatory agencies and even foreign governments frequently request and obtain relevant information from the Commission. As the members of the Committee know, violations of the federal securities laws often overlap violations of the other provisions of the law; thus, the failure to disclose significant illegal activities to shareholders has often been the basis for Commission enforcement action. And conversely, if, for example, a Commission review of bank records were to suggest that a business had engaged in commercial bribery of a foreign official or illegal payments to a foreign

government, Section 11(b) would apparently prevent the Commission from bringing relevant records to the attention of the appropriate foreign authorities.

We would assume that the Commission could continue to refer to the Department of Justice records which it had lawfully obtained and which indicated that criminal violations had occurred, since these referrals are "specifically authorized by law," as required by Section 11. Nevertheless, the use restriction imposed by this Section ignores the practical realities of the investigative process and the requirements of successful law enforcement. Today, a maximum of cooperation between all concerned governmental authorities, as well as between concerned components within an agency, is needed. 8/

The Commission would not oppose a provision requiring it to give notice to the concerned individual that his records have been referred to another agency. However, we see no real interest to be served by requiring an agency to issue and possibly litigate an entirely new subpoena for records already in the possession of the government. This restriction would require agencies to duplicate, needlessly, the investigatory work of other agencies and, in addition, would create one more complicated procedural hurdle for the government to overcome.

4. Definition of "Supervisory Agency" and the Powers of Supervisory Agencies

The Commission also proposes that Section 3(a)(5) be amended to include the Commission as a "supervisory agency" under the bill, and

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8/ The use restrictions imposed by the bill also run counter to general Anglo-American criminal law, which recognizes that information legitimately acquired for one purpose may be used for any other purpose for which it is appropriate.

that the powers of supervisory agencies be clarified. To provide further background on this first point, I would like to give you a general overview of the Securities and Exchanges Commission's responsibilities with respect to banks, and then turn to some more specific observations on this aspect of the bill.

Historically, and until comparatively recently, the Commission has had quite limited responsibility with respect to banks. Securities issued or guaranteed by banks have been exempt from the registration provisions of the Securities Act of 1933 since its adoption, apparently because Congress believed that other regulatory bodies exercised adequate supervision over the issuance of bank securities. In addition, very few publicly-held banks were subject to the registration, reporting and insider transaction provisions of the Securities Exchange Act of 1934 prior to 1964 because, until then, that Act only applied to securities listed on exchanges. As a result, publicly-held banks were generally outside the statutory mechanism established by Congress to protect investors through full and fair disclosure of material information with respect to other public issuers.

In contrast, the antifraud provisions of the federal securities laws have always applied to sales and purchases of securities issued by banks. In addition, other securities-related activities of banks, such as trust account activities, are subject to the general antifraud provisions of the securities laws.

In 1964, Congress significantly expanded the number of corporations subject to the continuous reporting requirements of the Securities Exchange Act. That Act was amended at that time to include all banks with assets

exceeding a million dollars and more than 500 shareholders. Generally, however, in order to promote uniformity in banking regulation, authority with respect to the disclosure provisions of the Exchange Act as to banks was vested in the federal bank regulatory agencies.

In recent years, the Commission's involvement with bank disclosure has increased significantly because of the advent and growth of bank holding companies and related legislative action by Congress. Since bank holding companies are not covered by the narrow exemptions from the securities laws which Congress granted banks, the Commission reviews registration statements filed by bank holding companies offering securities to the public pursuant to the Securities Act, and administers the registration, reporting and insider trading provisions of the Exchange Act as they relate to any bank holding company with more than 500 shareholders and over one million dollars in assets. As a result of our jurisdiction over publicly-held bank holding companies, we have required such companies to emphasize, in their registration statements and reports, information with respect to the subsidiary banks which generally are their principal assets. Bank holding companies filing periodic reports with the Commission pursuant to the Exchange Act represent over two-thirds of the total bank assets in the United States.

The influence of the Commission over bank disclosure has also increased as a result of the amendment of Section 12(i) of the Exchange Act in 1974, requiring the banking agencies to "issue substantially similar regulations" as those adopted by the Commission unless they specifically find that such regulations are not necessary or appropriate in the public interest or for the protection of investors. Pursuant to Section 12(i), the Board

of Governors of the Federal Reserve Board, the Comptroller of the Currency, and the Federal Deposit Insurance Corporation have adopted rules which these bank agencies have indicated are substantially similar to the corresponding Commission rules. Therefore, most major banks today are significantly affected by the Commission's continually developing disclosure requirements, and as a result of the Commission's present jurisdiction over bank holding companies, I believe that disclosure is being improved, to the benefit of investors, depositors, and the general public.

As this brief overview indicates, the Commission today does have considerable direct and indirect authority with respect to banks. The Commission also has the responsibility of investigating many of the securities-related activities of banks. For example, the Commission may investigate the concealment of insider transactions in connection with a bank holding company, or may examine the investment activities of a bank trust fund. 9/ In addition, banks are increasingly assuming functions that have traditionally been thought of as brokerage activities, and many securities transactions, not just the funds involved, are actually handled by banks acting as brokers. It is important that the Commission be able to review the brokerage activities of banks as it now reviews the activities of broker-dealers.

9/ Other examples of the types of activities by banks and other financial institutions the Commission has recently investigated include:

(1) improper lending activities;
(2) manipulation of the prices of bank securities;
(3) manipulation of reported earnings;
(4) issuance of the securities of banks in violation of the securities laws;
(5) material misstatements in registration statements and prospectuses; and
(6) securities trading violations by banks in connection with their brokerage activities.

Section 10(3) of the bill specifically exempts "supervisory agencies" from the requirements of the statute when they are examining financial records in the exercise of their supervisory, monetary, or regulatory functions. If the Commission is not included as a supervisory agency, I am uncertain as to whether we can effectively exercise the authority which the Congress has given us with respect to banks. I urge the Committee, therefore, to include the Securities and Exchange Commission within the definition of a supervisory agency. In addition, since the Commission's authority with respect to banks is not, strictly speaking, "regulatory," "monetary," or "supervisory" authority, such authority being in the hands of the bank regulatory agencies, we suggest that the Commission's authority to obtain bank records when it is investigating a bank itself be clarified by providing, in Section 10(3), that the Act does not apply to the examination of financial records "in connection with the investigation of a financial institution by any agency having enforcement authority under federal law with respect to that financial institution." This provision will permit us access to customer records when that is necessary to enable us to determine if the bank itself is violating the law. 10/

5. The Imposition of New Personal Liability on Federal Law Enforcement Personnel

Sections 13, 14 and 15 of the proposed legislation would work a significant change in the present law, which generally extends immunity to gov-

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10/ Without these provisions, the Commission would be prevented, by a law intended to safeguard individuals, from investigating banks that might be victimizing their individual customers or investors. Access by subpoenas for customer records would not be practical, since the Commission would not necessarily know the names of the customers involved, and might thus have difficulty describing the records it needed with sufficient "particularity," as required by Section 4(a). In addition, the bank itself has the power, under the draft bill, to object to disclosure of customer records, a power it could exercise to cover up its own illegal activities.

ernment employees, involved in the process of investigating and prosecuting violations of law, and acting within the proper scope of their duties. Specifically, the bill would provide stringent civil and criminal penalties for violations of the procedural aspects of the proposed legislation, without any regard to the question whether the agency was in fact entitled to access to the information. Thus, the members of the Commission's staff would be liable for nominal, actual, and punitive monetary damages, and litigation to obtain such damages would be encouraged by a provision permitting the award of attorney's fees in such actions. Commission officials who violate the procedures established by this bill would also be subject to criminal liability.

As the Supreme Court has often recognized, it is "important that officials of government should be free to exercise their duties unembarrassed by the fear of damage suits in respect of acts done in the course of those duties—suits which would consume time and energies which would otherwise be devoted to governmental service and the threat of which might appreciably inhibit the fearless, vigorous, and effective administration of policies of government." 11/ As the subcommiteee will appreciate, even a frivolous action against an agency or one of its officials or employees—and the Commission has seen an increase in frivolous or dilatory litigation against individual staff members in recent times—can result in disruption to the work of the agency and have an inhibiting effect out of all proportion to the merits, or lack thereof, of the suit. That is, indeed, the rationale underlying

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11/ Barr v. Matteo, 360 U.S. 564, 572-573 (1958).

the doctrine of prosecutorial immunity.

The Commission recognizes the necessity for government officials to be fully accountable under the law, but we believe that fundamental changes in the law in this area should not be handled on a piecemeal basis. Major changes in the law such as this deserve separate consideration, so that all the aspects and implications of such changes can be properly considered. We recommend, therefore, that the bill be amended to delete the civil and criminal liability provisions of Sections 13, 14 and 15, to the extent they apply to government officials. In their stead, we recommend that the Committee provide for review of alleged violations of the provisions of the bill by the appropriate court in any action instituted against an individual, in which the individual claims that violations occurred in the course of the investigation that preceded the filing of the action. If such violations are found, the court should be authorized to afford whatever relief it deems appropriate, which could include suppressing illegally-obtained evidence or, in particularly egregious circumstances, dismissing the government's suit.

6. Interference with Federal Law Enforcement by Conflicting State Legislation

Finally, the Commission wants to bring to this Committee's attention the real possibility that the various states may enact their own financial privacy acts, as, indeed, some have already done. 12/ The last clause of Section 17 appears to give those states that grant broader rights to either financial institutions or customers precedence over this proposed federal

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12/ See e.g., the Tennessee Bank Privacy Act of 1977, TCA §45-2601(a), et seq.

legislation. A federal court has recently held, in connection with a subpoena enforcement action brought by the Commission, that the application of such state statutes to federal agencies acting within their lawful authority violates Article VI, Section 2, the Supremacy Clause of the Constituion. In addition to holding the state act unconstitutional as applied to federal activities, the court found that effective enforcement of the federal securities laws would be substantially frustrated if the Commission, and similarly situated federal agencies, were forced to comply with many different state regulatory schemes, all focused on restricting access to bank financial records. 13/ We think this finding was correct; the Commission is, therefore, concerned that Section 17 as drafted will invite the regulatory confusion that the court cautioned against in this case. Accordingly, I recommend that the clause "except those statutes which grant greater rights than this title" be deleted from this section.

CONCLUSION

Mr. Chairman and Members of this Committee, at the present time our reservations about certain provisions of the proposed "Right to Financial Privacy Act," and particularly the provisions relating to administrative subpoenas, are so serious that the Commission cannot support the bill as it now stands. We endorse the concept of financial privacy, and the principle that agencies must act responsibly when they are seeking access to personal information of any sort. However, for the reasons I have indicated, we believe that the bill goes far beyond this, and creates procedures which are not

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13/ Securities and Exchange Commission v. First Tennessee Bank N.A.-Memphis, 445 F. Supp. 1341 (W.D. Tenn., 1978).

only unnecessary, given the availability of administrative procedureal safeguards, but which are a serious impediment to continued effective regulation of the securities markets and protection of the investor. Therefore, I hope the Committee will carefully consider our suggestions.

Thank you for this opportunity to present the comments of the Commission on this legislation. I would be pleased to respond to any questions that the members of the Committee may have.