Appendix I. —Other Models of Information Disclosure: Truth-in-Lending Act and Securities and Exchange Commission

Truth= in= Lending Act

Background

Fifteen years ago, if an individual wanted to take out a $1,000 loan for 3 years at the best interest rate available, and called several different financial institutions to compare interest rates, the person might have heard:

- $6 per $100,
- $1,000 at 7 percent interest, and
- interest amounts to a 10 percent annual percentage rate

While the first two quotes might have appeared to be the best buy, the annual percentage rate (APR) on these two offers could have been as high as 12 and 14 percent, respectively. Therefore, it is the last loan offer that might have given the consumer the least amount of interest payment.

Before the Truth-in-Lending Act (title I of Public Law 90-321, the Consumer Credit Protection Act) was passed in 1968, consumers who shopped for loans were easily confused by the different methods used by creditors and financial institutions to compute interest rates on loans. Because there was no standard terminology to inform consumers of the real cost of a loan, it was impossible to compare interest rates on loans without a great deal of difficulty (258).

The Truth-in-Lending Act provides for disclosure of the price and terms of consumer credit. 1 The act has two primary purposes: to enhance competition between lenders and to promote the informed use of credit.

In its original form, the Truth-in-Lending Act consisted of three chapters which provided for credit cost disclosures and regulated the advertising of credit. The act did not attempt to prescribe the conditions under which credit could be made available, but rather required creditors to make accurate and complete disclosures of credit costs and terms and prohibited misleading or inaccurate advertisements for credit. Since the time of its passage, the Truth-in-Lending Act has also been used as a vehicle for the regulation of other areas.

In 1974, the passage of the Fair Credit Billing Act amended the Truth-in-Lending Act by adding a fourth chapter, titled "Credit Billing, " which regulated the activities of credit card issuers. In 1976, the passage of the Consumer Leasing Act added a fifth chapter, titled "Consumer Leases," which extended the coverage of the Truth-in-Lending Act to regulate the disclosure of terms and costs of leases of goods for personal use for individuals.

The Truth-in-Lending Act applies to all extensions of credit for which a finance charge is or may be imposed, except for areas such as stockbroker margin loans and utility charges subject to State regulation, and credit for agricultural purposes above a specified amount. The act distinguishes two major types of consumer credit: "open-end" and "credit other than open-end" or installment credit. Open-end credit, such as bank or oil company creditor credits and store charge accounts, allows consumers to incur debts from time to time under an agreement which prescribes charges in return for use of the privilege. Installment credit is extended once in a specific amount and the credit balance outstanding reduced by one or more subsequent payments. There are separate disclosure requirements for open-end and installment credit.

The Truth-in-Lending Act also regulates advertising of credit. Specifically, the act prohibits credit advertisements which indicate that credit will be available in certain amounts or with certain down payments, unless the creditor usually makes credit available to consumers under time terms; and prohibits advertisements which set forth certain specific credit terms, unless other terms are also set forth. The purpose of these provisions is to promote consumer reliance on the full range of credit terms rather than on single items which might be misleading.

Another provision of the Truth-in-Lending Act provides consumers with the right to rescind certain transactions in which a security interest in a residence is taken.

The Truth-in-Lending Act provides for criminal and civil penalties for noncompliance. In 1974, the passage of Public Law 93-495 distinguished civil penalties to which creditors would be subject in class actions.

The Board of Governors of the Federal Reserve System has the responsibility for issuing regulations to enforce the act, Enforcement is divided among the following agencies: the Board of Governors of the Federal Reserve System for all State chartered member banks, the Comptroller of the Currency for national banks, the Board of Directors of the Federal Deposit Insurance Corporation for all federally insured banks other than

[1]The remainder of this section is condensed from Curtiss Martin, *Federal Consumer Protection: A Summary and Overview*, February 1977 (168).

members of the Federal Reserve System, the Federal Home Loan Bank Board for all federally chartered or insured savings and loan institutions, the Administrator of the National Credit Union Administration for all federally chartered credit unions, the Civil Aeronautics Board for all air carriers subject to the Federal Aviation Act of 1958, the Secretary of Agriculture for entities subject to the Packers and Stockyards Act, the Farm Credit Administration for any Federal Land Bank and Federal Land Bank Association, Federal intermediate credit bank, or production credit association, and the Federal Trade Commission for all other granters of credit.

Discussion

The experience of operating under the Truth-in-Lending Act, in effect since 1969, has led to some questions about its effectiveness. The question of primary concern has been whether the act is overly complex. The answer to this question as a practical matter, however, is dependent on a number of narrower questions. These include the questions of whether the emphasis and scope of the required disclosures provide the most important information to consumers in a manner which best enables them to comprehend and utilize it; whether the civil liability provisions of the act are achieving their intended objective of compelling compliance in a cost-effective manner; and whether the benefits of the act outweigh the administrative costs imposed. Other areas of concern arise in connection with certain specific provisions and trends in the types of provisions which were added to the act.

Examinations of the effect of the Truth-in-Lending Act in its present form have been limited primarily to tests of consumer awareness of finance charges and percentage rates, but have also included some examinations of consumer behavior. Collectively, the information available (see, e.g., 74,183,185) suggests the following:

- the Truth-in-Lending Act has increased consumer awareness of credit costs, although many consumers remain unaware of credit costs;
- studies based on consumer awareness of annual percentage rates show that awareness is greater among the more educated, higher income segments of society although lower income, less educated consumers may be equally aware of dollar finance charges;
- awareness of credit costs appears to be linked to comparison shopping for credit on the basis of price;
- awareness of credit costs does not appear to be associated with decisions to use or not use credit; and
- to an extent, creditors compete on the basis of terms such as amount of down payment and length of repayment time as well as annual interest rate. In the case of retailers, competition in the form of the quality and price of the goods or services offered largely overshadows price competition in the credit area.

Although this information is useful to the extent that is assesses the effect of the primary provisions of the Truth-in-Lending Act on consumers, it does not provide a great deal of guidance about how to improve the act. None of the studies conducted has examined the question of whether consumers benefit from the disclosures other than the annual percentage rate and the finance charge. The studies have not addressed the question of whether the extensiveness of disclosures impedes the understanding of individual disclosures. This information could provide a great deal of guidance in any attempts to improve the functioning of the act.

Like their purchases of credit, consumers' purchases of medical care under procompetitive proposals would involve decisions about matters of high technical knowledge and risk. Experience with the Truth-in-Lending Act provides an instructive example of the benefits of a standard terminology for specified consumer transactions that are otherwise subject to misunderstanding and possible abuse. Standardization in the area of credit has had the apparent effect of increased consumer information and improved comparison shopping. Federal, State, or local governmental standardization of the format and distribution of information about insurers and providers merits further examination in the context of proposals to increase competition in health care.

Securities and Exchange Commission

The Securities and Exchange Commission (SEC) was created by section 4(a) of the Securities Exchange Act of 1934. Establishment of SEC to police the Nation's capital markets was an attempt "to purge the securities exchanges of those practices which have prevented them from fulfilling their primary function of furnishing open markets for securities where supply and demand may freely meet at prices uninfluenced by manipulation *or* control" (265).

Widely regarded as one of the more prestigious and effective of the Federal regulatory agencies, SEC has the broad charge of protecting investors and maintaining fair and orderly markets. This charge grew out of the stock market crash of 1929 and the perception that fraud, security price manipulation, short selling, pooling, and other unsavory investment practices were the root of the ensuing Great Depression. SEC, which actually was not launched until nearly 5 years after "the crash, " was perceived by the public as the mechanism that would offer protection against unscrupulous inside traders and security issuers and perhaps even against future security losses.

The major responsibilities of SEC fall into two areas, which have bases in the historical development of capital market regulation. First, the commission is most active in managing corporate disclosure programs, via oversight of accounting organizations and exchanges. Secondly, the commission is concerned with establishing and enforcing codes of conduct for brokers and dealers, particularly with respect to fraud and stock price manipulation (221).

SEC is directed by five commissioners, no more than three of whom may be from the same political party. Members of the commission are appointed by the President of the United States with the approval of the Senate. Each commissioner is appointed for a 5-year term, with one member's term expiring in June of each year. The President designates one member to chair the panel. The commission is assisted by a staff of professionals including accountants, engineers, examiners, lawyers, and securities analysts that staff the five SEC divisions—Corporation Finance, Market Regulation, Enforcement, Corporate Regulation, and Investment Management Regulation (249).

The SEC disclosure system requires public reporting of standardized information through certain periodic reports from registered corporations and certain reports registering newly issued securities. In 1975, 56,640 periodic disclosure reports were filed by approximately 10,000 corporations, and 2,813 new issue registration documents were accepted by SEC.

Once a decision is made by a corporation to raise capital through a public offering of securities, the corporation must register and report information to SEC through standardized agency forms or statements. There are more than 20 different forms for various types of companies and special situations. Regardless of the form used, certain information is common to all: 1) nature and history of the issuer's business; 2) its capital structure; 3) a description of any material contracts including bonus and profit-sharing arrangements; 4) a description of the securities being registered; 5) salaries and securities holdings of officers and directors; 6) details of any underwriting arrangements; 7) an estimate of the net proceeds and the uses to which such proceeds will be put; and 8) detailed financial information, such as a summary of earnings, certified balance sheets, profit and loss statements, and supporting schedules (249).

As securities are traded continuously over many years, there is ongoing disclosure of company activities through annual, quarterly, and special reports. The annual reports are scrutinized by SEC to ensure that a policy of satisfactory financial reporting is practiced. Information is reviewed for compliance with specific statutes, and for completeness and fairness of disclosure. Most of the material is available to the public (249).

The number of companies reporting and the types of reports required have grown substantially since the enabling legislation was passed in the early 1930's, and this expansion of the corporate disclosure system appears to be accelerating. Some examples of this expansion include disclosure by bank-holding companies, disclosure of management perquisites, overseas payment, replacement cost accounting, and segmental or line-of-business accounting (221).

In noting the registration process and the SEC reporting requirements, it is important to keep in mind that SEC's intent is not to judge the merits of securities offered for sale. Furthermore, the SEC review process does not guarantee completeness or accuracy in the reports filed with SEC, although severe penalties are imposed for presenting false and misleading information and other fraudulent acts. Any deficiencies are the responsibility of the company and the individuals involved, and the final judgment on any investment opportunity presented by an offering rests with the potential investor.

A second important point to make is that SEC registration involves a significant amount of corporate time and expense. Registration is a detailed, often lengthy process, and can require simultaneous attention in several corporate divisions. It is estimated that the average cost of initial registration of securities with SEC is now over $200,000. Likewise, the continuous reporting requirements and related costs of being a "public company" may be substantial. For many small companies, such overall information disclosure costs are prohibitive (249).

But, like most regulatory programs, SEC's corporate disclosure system was designed to remedy a perceived market failure. In this case, the market failure involved an allegedly fragile capital market where securities prices were said not to reflect available information and price manipulation was considered to be rife. The main rationale for corporate disclosure was that better information about corporations would improve the pricing mechanisms through the buying and selling activities of better informed investors. According to this theory, if investors know more of the truth about the corporation, they will be able to make more intelligent investment decisions. Through this market activity, the stock would be more fairly priced, and the task of price manipulators would be more difficult (221).

State, local, and Federal bodies, following the SEC model, could require health plans to provide basic minimum information such as premiums, ambulatory and hospital utilization rates, disenrollment rates, board certification, and so on, As with SEC, health plans would have to attest to the accuracy and truthfulness of presented data, subject to civil and criminal penalties (79,156,175).