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High Finance and Goldfish Bowls

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The views expressed herein are those of Commissioner Treadway and do not necessarily represent those of the Commission, other Commissioners, or the staff.

Introduction

The opportunity to appear before this gathering hosted by the Nevada Development Authority is a pleasure indeed. Not only has it given me the opportunity to become better -- albeit briefly -- acquainted with this part of the country, with the Nevada Development Authority and its spokesmen, but it provides the occasion to spend time with some old friends. Having talked to representatives of the Development Authority about their ambitions for this region, I better appreciate the seriousness of your intent to make this another economic success story, like California's Silicon Valley or Boston's Route 128.

Of course, such an economic transformation requires capital, and the ability of American companies to raise capital -- particularly equity capital from public sources on the scale we take for granted -- is an uniquely American phenomenon. Our capital markets are fairer, more accessible, more liquid, and more honest than anywhere else in the world. That has led to some rather remarkable economic results.

During the recent bull market, initial public offerings -- companies raising public capital for the first time -- surged. In 1982, 4,400 registration statements were filed with the Commission; 1,200 were for initial public offerings. */ During 1983, this increased to 6,100 registration statements, covering $243 billion of securities. About 2,000 -- one third -- were for initial public offerings for equity securities. For a recent eight month period, **/ registration statements filed with the Commission numbered almost 4,000. Initial public offerings of equity securities numbered almost 1,300, covering $40 billion. That filing rate is significantly ahead of last year's pace, notwithstanding the proclaimed weakening of the bull market.

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*/ The Commission's fiscal year ends September 30. These figures include all offerings of securities by issuers not previously subject to Commission reporting requirements, including recapitalizations and exchange offers. Thus, the amount of securities issued by companies going public for the first time is a smaller figure.

**/ Through May 31, 1984.

The capital formation represented by such statistics has spawned entire economic subcultures. I mentioned Silicon Valley as an example. We in the Washington area hear frequent speculation that, with our concentration of scientists and engineers, we are a candidate to be another Silicon Valley. Other areas, many in the Sun Belt like you, have similar visions of economic transformation. That is all to the good -- more industry, higher employment, more profits, higher tax revenues.

But as you move forward collectively as a business community and as individual companies to tap the mother lode called the public capital markets, let's engage in a bit of reflection. The Nevada Development Authority and the Securities and Exchange Commission are on the same side, in that we're both pro-capital formation. But there is a difference -- the Commission is a regulatory and law enforcement agency. So I'm going to try today to share some observations about raising capital publicly, some of the problems and pitfalls we see, and, I hope, offer some guidance.

Going Public

Venture magazine recently hosted a seminar on "going public." Panelists included issuers, investment bankers, accountants, lawyers, and public relations experts.

One declared going public as "excruciatingly tedious, time-consuming and gut-wrenching." Another complained that, once public, a company's performance "is suddenly measured by the quarterly progression of earnings," and a "mountain" of disclosure is required by law. Commenting on the "inescapable" trauma of the initial public offering, one panelist said: "I spend a fair amount of time talking companies out of going public." */

As these comments suggest, being public has drawbacks. Much jealously-guarded information must be disclosed, and in no uncertain terms. Those items, which never before saw the light of day, include management salaries, seemingly innocent transactions between the company and its management or entities affiliated with management, competitive position, and the identity of significant customers and suppliers, even if that information is ultra-sensitive.

Corporate decision-making becomes more cumbersome as the company attempts to move from a tightly controlled, entrepreneurially oriented company to a professionally managed enterprise

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*/ Corporate Financing Week, July 2, 1984, at 4, col. 1.

where ownership and management is divorced and interests sometimes conflict. Corporate paraphernalia and procedures expand; matters previously thought corporate niceties suddenly assume much greater legal and accounting significance. For the first time, decisions good over the long-term may have an adverse short-term impact, particularly on earnings. If the decision is wrong, it may be manifested promptly in the company's stock price, which is closely followed by shareholders, analysts, and others important to the company, not to mention the fact that it may be the major asset of members of management.

Almost invariably an attitudinal adjustment is necessary. This was recently highlighted in a Wall Street Journal article entitled "Growing Pains: It Isn't Easy to Turn Entrepreneurial Firm Into a Big Company." */ It focused on the common problems of "mix[ing] creativity with business acumen to turn a small, science-oriented company that has made little money into a big, commercial one that makes sheaves of it." Part of the problem "is due to wrenching change imposed on an organization that was once a reflection of its founder's personality." Executives of newly-public companies invariably face new legal, accounting, and administrative problems -- in essence, a whole new way of doing business.

Why, then, is going public so popular? Why do entrepreneurs want to share ownership of their company and join life in the goldfish bowl? Various reasons have been given. **/

- Going public raises money. If it is common stock, it does not have to be repaid.

- The use of proceeds from the sale is generally unrestricted. They may be used to increase working capital, conduct research and development or expand plant and equipment, retire existing debt, or diversify or expand operations -- no more bankers tying your hands.

- Public companies can acquire other businesses with stock, without depleting precious cash. They have a different form of currency available.

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*/ Wall Street Journal, July 18, 1984, at 1, col. 6.

**/ See Schneider and Manko, Going Public Practice, Procedure and Consequence, 15 Vill. L. Rev. 283 (1970) and Wheat and Blackstone, Guideposts For a First Public Offering, 15 Bus. Law. 539 (1960).

- Management often experiences, or at least perceives, an increase in prestige and reputation through public ownership. The stock becomes publicly traded, analysts and others begin to follow the company's fortunes, and articles begin to appear in the press. The corporate officers become public figures.

- Other financing alternatives may improve. Borrowing, institutional investing, and additional equity offerings may be available at favorable terms.

In the interests of full disclosure, let's look at the flip side of the coin.

- Going public increases the number of shares outstanding. Greater earnings must be achieved to avoid reducing per share earnings. The proceeds received must be wisely managed to avoid the dilutionary impact.

- If the price of your securities declines, your company may lose the flexibility of issuing stock to make acquisitions. Too many shares have to be issued to interest a prospective target, or the stock is simply unattractive to others.

- When stock prices fall, management usually is personally blamed. In response, they sometimes retreat into a bunker mentality; they become shortsighted. Inadequate disclosure of bad news -- required by law -- sometimes occurs.

- Other financing alternatives may evaporate if a company is perceived in trouble.

- If the stock price declines dramatically, particularly soon after the offering, expect litigation, probably against everyone involved. Witness a recent article entitled "Litigators Replace Capitalists as Kings of the Silicon Valley." */ The content of the article is entirely predictable.

But let's assume management has thought through these pro's and con's and has decided to go public. What next? How does a company make it through the "going public" process? What are the pitfalls? How can they be avoided?

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*/ Legal Times, July 2, 1984, at 1, col. 2.

The Importance of the Participants

I have always viewed the first task as the assembly of the proper team. That sounds so mechanical when I say it, but team is the key word. The process involves selecting an underwriter, accountants, counsel, and perhaps some new directors. It's an extremely sensitive process, and frequently there is no way to avoid offending people -- perhaps even old friends.

Let's talk first about the underwriter. The decision is most personal. Investment banking firms have strengths and weaknesses. Some specialize in handling initial public offerings. Others may not handle them at all, or may do so only for certain industries. Some may be eager but inexperienced. Some may have experienced regulatory problems that potentially taint your offering.

Distribution capacity is important. Nationally-known firms generally have a widely recognized reputation and a broad distribution network. Yet, smaller, regional firms may have a greater familiarity with the local area and local investors, in effect better regional distribution capacity.

In short, an underwriter appropriate for one company or one industry may be inappropriate for another. In addition to technical ability, personalities and confidence in each other also should not be ignored. The relationship is one that legally requires that the company tell all -- good and bad -- to the underwriter and that the underwriter investigate all aspects of the company thoroughly and skeptically. Properly done, the process is one of severe and uncompromising self-examination. Not only that, but to speak ecclesiastically, the confession must be full and specific -- general confessions are not allowed.

The selection of lawyers and accountants is equally sensitive. The registration process is complex, coupled with absolute liability for the company for material misstatements or omissions -- regardless of good faith or motive. It's a veritable minefield. Matters can be exacerbated if counsel is not fully up-to-speed on securities matters. Retention of special counsel experienced in securities matters to aid the company's regular counsel if they do not regularly practice in the securities area has become common. Obviously, telling your regular counsel, who helped you get started, is a personal confidant, sits on your board, and charged you below-market rates during tough times, is hardly easy. I certainly do not wish to leave any impression that long-time, competent counsel should be cast aside cavalierly. But remember that malpractice insurance in the securities field is the most expensive of any specialty. That carries a message.

It can be even more tricky with the accountants. Right or wrong, quality isn't the only criterion. Often an underwriter will request, or virtually demand, a change to a "Big Eight" or nationally prominent accounting firm. Various reasons may be given -- it's better to have a bigger, better-known firm in the prospectus; it enhances marketability; it's our firm's policy. But there may be unspoken reasons -- the underwriter may view a large accounting firm as insurance in the event of litigation. Replacing the company's accounting firm can be a most uncomfortable decision for company management -- resentment is not uncommon -- but underwriters sometimes can be quite unyielding on this point.

So far I've told you that before you raise one single dollar, even before you begin to draft the registration statement, you have to consider replacing your directors, replacing or supplementing long time counsel with some law firm you don't really know, and doing the same with accountants.

That's precisely what I've said. But the teamwork approach -- advance planning and coordination, open and frank discussions, the right people -- avoids later confrontations and problems -- including time delays and liability.

Getting Through and Living with the Commission

Once the group is assembled, preparation of a registration statement to be filed with the Commission begins. Specific disclosure required include factors that make the offering speculative -- if that's the case -- use of the offering proceeds, how the offering price was determined, and any dilution of the purchaser's equity interest. The company must describe its business, its properties, and any pending legal proceedings. Directors and officers -- and their compensation -- and any transactions between them and the company must be disclosed. The prospectus must disclose the details of the underwriting, the plan for distributing the securities, and a description of the securities being registered. It can be gut-wrenching self-examination.

Audited financial statements and other financial information must be included. The Commission pays special attention to the financial statements contained in initial public offerings. Some on our staff believe a view has recently developed on the part of some issuers that playing a little loose with generally accepted accounting principles is a risk worth taking; it either will slip by or will result only in a request to change the accounting method used.

If you ever find yourself in that position, don't make that mistake. It can be costly. The Commission -- through stop orders, injunctive actions, and administrative proceedings against accountants and lawyers -- will not tolerate those who engage in slippery accounting. The capital formation process works only if companies competing for capital do so fairly -- and that means accurate financial statements.

But let's return to the registration process. When completed, the registration statement is filed with the Commission and reviewed by our Division of Corporation Finance. Ours is a disclosure review. We have no authority to pass on the merits of a particular offering. No matter how speculative the investment, no matter what the background of a company's management, an offering will satisfy federal law if all relevant and material facts are disclosed. The goal is disclosure of all information material to a potential investor, unlike some states that regulate the merits of offerings.

After the registration statement is reviewed by the Commission's staff, any deficiencies are communicated to the company. The company then may file amendments to the registration statement to respond to these comments. In some instances, if a registration statement is so poorly prepared, the staff will advise the issuer that they will not comment on the filing. That's called a "bedbug" letter -- and you don't want one. And, of course, our ultimate authority over defective registration statements are injunctions, stop orders, and administrative proceedings.

Some Recurring Deficiencies and Problems

That's the procedure in a nutshell. Let's go now to substantive problems. Disclosure deficiencies usually involve one of four elements:

- The firm's financial statements are misstated or generally accepted accounting principles are not followed.
- Management's background and experience is misstated or not fully disclosed.
- The current state of the firm's business, or the uses of the offering proceeds, or the feasibility of its products are not fully described.
- Statements are made during the selling effort that are inconsistent with disclosures in the prospectus.

The accounting abuses we see are limited only by creativity. But there are three that I would focus on.

The first involves the transfer by promoters of assets of questionable or no value to a company planning to go public, with those assets then being written up in the balance sheet, sometimes by millions of dollars with no justification. Sometimes these assets are passed through a series of companies controlled by the promoters and their comrades in an effort to conceal the improper valuation and make the assets appear more legitimate.

The second abuse involves procedures designed to accelerate improperly the recognition of revenue -- that means generate phony revenue and income. Our recent stop order proceeding against Chipwich, Inc. illustrates the point. */ Chipwich was improperly accounting for the transfer of mobile vending units -- street carts -- to independent contractor vendors. Chipwich claimed these were sales, and that revenue could be recorded. The Commission claimed that the proper accounting treatment was to treat these transactions as financing transactions, not sales. Chipwich's improper revenue recognition procedures caused reported revenues to be overstated by over 100%.

To illustrate the third abuse, let's look at our stop order proceeding against Pro-Mation, Inc. **/ There, the company was engaged in certain developmental activities that were generating losses. The company in effect "deconsolidated" these losses by transferring the developmental operations to a purportedly independent company that Pro-Mation continued to control and ultimately acquired.

The other recurring disclosure abuses we commonly see, as I said earlier, involve the failure to fully disclose management's background and experience. Some issuers go to great lengths to rationalize why they are not disclosing prior legal problems of management, or prior business reverses in other companies they started, or similar information.

I mentioned the failure to disclose the current state of business and product development -- again, an area frequently a problem. Companies simply cannot continue to discuss the up-side potential of a new product without also disclosing known problems with development, production, delivery, efficacy, and customer rejection.

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*/ In the Matter of the Registration Statement of Chipwich, Inc. (Securities Act Release No. 6491, September 30, 1983).

**/ In the Matter of the Registration Statement of Pro-Mation, Inc. (Securities Act Release No. 6522, March 30, 1984).

One final bit of advice. As you process the registration statement, don't dissemble or deceive the staff. If you are perceived as less than cooperative or forthright, you will encounter delay, expense, and run the risk of your filing becoming the focus of our Enforcement Division.

Being Public in a Nutshell

The process of going public takes several weeks to months and months. Total costs may be 12%, 15%, perhaps 20% of total proceeds.

Once you're public, you have the Commission to deal with on an on-going basis by filing quarterly reports -- containing mostly financial information -- and annual reports much like your original registration statement.

The "ins" and "outs" of being public deserve a full speech in and of themselves, for they are just as complex as going public. But those comments will have to await another day.

Conclusion

I would like to divide my concluding comments into two parts -- one directed to individual companies and the second directed to the corporate community at large. I hope it will be practical advice.

For the individual company, going public marks an historic moment. It often is the springboard for greater growth and success. But once the decision is made, be prepared to accept the obligations the process imposes. Look hard at your company. Is it ready? Can your business withstand the disclosure of sensitive information, not just once but on an on-going basis? Is management prepared to share control with and answer to a group of faceless shareholders? Are you really prepared to operate in the goldfish bowl?

Too much is at stake for management, from public reputation to legal liability, to fail to recognize the changes that must be made. Quality professional advice will never be so important. Do not be afraid to make necessary personnel or procedural changes. In fact, the public offering process can be the impetus for needed change.

For the corporate community at large, there are also lessons in building your version of Silicon Valley. The initial public offering boom we have recently witnessed underscores the strength of our capital formation process, but it also exposed some weaknesses. As I mentioned earlier, the federal role is largely limited to full disclosure. We do not evaluate the merits of particular offerings, although we may be there later with subpoenas and an enforcement proceeding. Yet, local cooperation and the local corporate culture is just as important as our regulatory role in keeping markets honest. Local jurisdictions and a corporate culture that tolerates fraudulent practices -- the penny stock markets of Denver and Salt Lake come quickly to mind -- ultimately, I believe, drive good capital away.

Raising capital does not have to be done at the expense of investor protection. In this regard, responsible local self-policing is vitally important. A local attitude that tolerates shoddy practices will only attract more shoddy operators and ultimately drive good money away. Once an area acquires a reputation for manipulation and abuse, that reputation is difficult to overcome. I offer you no precise roadmap to achieve the proper corporate culture, but the attitudes and persuasive powers of those in this room offer a good starting point.

I wish all of you success as you become the next Route 128 or Silicon Valley. May your dealings with our agency always be pleasant.

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