SOME PROBLEMS OF DISCLOSURE

An Address By

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At the outset I wish to express my appreciation for the honor you have bestowed upon me. I have spent more than twenty-five years at the Securities and Exchange Commission under five presidents. The Commission itself is almost thirty-five years of age and has developed a fine tradition of service to the nation. We are, however, relative youngsters when we recall that this University has served the State of Illinois and the nation so well and faithfully for a century--a century which has seen more progress as well as more suffering than nearly any other century in our history. Our nation is now beset with grave problems in its international relations and commerce and equally grave--if not more serious and more difficult--problems on the domestic scene.

These problems are complicated by the fact that our economics, our industry, our financial institutions, and indeed the government itself, are now in the throes of transition--a transition which is moving much more rapidly than many of us can follow. The electronic marvels that are developed each day are undoubtedly stretching our minds and capabilities. But some of us who have never been subjected to the "new math" are having growing pains.

The Commission which I have the honor to head has been grappling with these changes for some time. As you know, one of the main objectives of the SEC is to secure full and fair disclosure of significant information about companies whose securities are publicly offered or traded. We have recently been studying carefully ways in which our disclosure requirements might be improved, and simultaneously simplified, to meet current conditions.

Our studies have focused on two areas. One relates to the techniques of obtaining full disclosure. We are searching for the best methods by which the relevant information can be put into the hands of the people who make investment decisions, at the time they need it and in a form in which they can use it, without imposing unnecessary burdens on those who must supply the information. We are currently conducting a study to determine how the Commission's requirements and practices can best be adapted to the achievement of those objectives. This of course is not a new idea. The Commission has been modifying, simplifying, and rearranging its requirements to meet the needs of investors and businessmen ever since it was established. Just recently, we put out a new simplified form of registration for securities offered by certain categories of well-established companies. I would like to describe at greater length our work in this area, but I am afraid that would carry us too far into the University's second century.

The second area on which we have been focusing is the content of disclosure--what the reports and statements and other documents actually tell the investor about the company. Here, our problem now, as it has been for the past thirty-five years, is to be sure that our disclosure requirements are tailored to the type of information investors need to make informed and current investment decisions.

This is an area with which the Commission is now greatly concerned. Our concern may seem strange to you, in view of the great progress made over the years in improving disclosure standards as a result of the efforts of the Commission and of industry and professional groups, as well as those who maintain their permanent bases in the faculties of our universities. In the past few months, I have had occasion to compliment the American Institute of Certified Public Accountants and the Financial Executives Institute for constructive steps they have taken to improve the quality of financial disclosure.

It is probably unnecessary for me to remind you that the FEI study of financial reporting by widely diversified companies--sometimes referred to as conglomerates--which merited the Commission's praise was headed by your distinguished Professor Mautz. He impressed us all by the quality of his work and the speed of his achievement. We wish to thank the University for making it possible for Professor Mautz to devote his time and attention to a problem which is almost universally recognized as urgent and important.

I wish also to extend personal as well as official thanks to the University for two other actions. For almost three decades now, Andrew Barr, our Chief Accountant and an illustrious alumnus of Illinois, has served the SEC--or, more accurately, the American investing public--

with great distinction. He has received about every reward it is possible for the government and professional groups to bestow upon a certified public accountant in the government service. The other action is a reflection of the wisdom demonstrated by all of you who live in this Congressional District. It has been my privilege to know and to work with Congressman Springer. I need not tell you of his great accomplishments in that role. I can only add that, as the senior Republican member of the Interstate and Foreign Commerce Committee, our parent Committee, he has always displayed a great interest in and understanding of the work of the Commission, and a sensitivity to and sympathy for the needs of the investing public.

There is no doubt that, in past years, techniques have been developed which achieve a high level of disclosure and comparability in reporting the financial condition and results of operations of a company which is engaged in only one activity or group of related activities and has had no recent significant changes in its business or corporate structure. There is, however, serious question whether these techniques produce adequate information with respect to the operations of the increasing number of widely diversified and rapidly changing enterprises. While there is not unanimity of opinion, I think it is generally conceded that they do not. This raises the further questions whether and to what extent we can meet and overcome this challenge.

Disclosure of meaningful financial information serves a number of purposes. It is useful to actual and potential creditors, whether private lenders or public purchasers of debt securities and, for this reason, absolutely essential to the issuer seeking credit. It is useful to investors in equity securities, at least to the extent that equity investment is not made solely on the basis of market and other technical factors. It seems almost a truism which, nevertheless, bears repeating, that the fundamentals must in the long run control the value and marketability of publicly traded issues, no matter what the current investment fads. Adequate reporting is, of course, essential to any informed analysis of the past history, and assessment of the future prospects of the issuers of such securities.

But, perhaps of equal importance, in the case of a publicly held company, proper financial disclosure serves as an "objective" method for assessing the performance of the managers of the company and the wisdom of their expansionist or other policies. I cannot agree with those who suggest that, in view of the great reliance of corporations on retained earnings rather than new capital to finance their expansion, the equity markets, and the underlying financial information which supports them, do not serve as an effective control on corporate managers.

Even if a publicly held corporation contemplates no new financing whatever, its managers are still likely to be extremely concerned over the market price of its common stock, for a number of reasons. In the first place, a decline in market price of the stock is a potential threat to their positions, either because they may be voted out of office by aggrieved shareholders or because it may provide an incentive for outside corporations or individuals to seek a controlling interest in the company. In the second place, an increasingly large part of executive compensation now consists of non-cash compensation, principally in the form of stock options. A recent study has indicated that more than half of the compensation of executives of our largest corporations is in non-cash form. To the extent that this compensation is measured by the market price of the company stock, it provides management with a keen interest in the price at which the stock is traded and a strong incentive to provide the type and amount of information that may attract investors, with consequent upward influence on the market price of the stock. Conversely, it may create a reluctance to disseminate information which can be expected to have the opposite effect on the price of the stock.

At first glance, it would seem that there is nothing inherently wrong when the managers of a corporation are so motivated. It has been suggested that this gives the managers an identity of interest with the public shareholders of the company, thus ameliorating to some extent the separation of ownership from control which has been recognized as a prime characteristic of our corporate system for more than 30 years now.

To the extent that this incentive motivates the managers to improve the actual performance of the company in whatever activity it is engaged, there is no doubt much merit in this proposition. But, in recent years, performance seems to have become more and more confused with growth; in fact, the term "performance" is now colloquially used in the securities markets to mean "growth". This, in turn, has brought an emphasis not on how well the company is actually performing its self-appointed tasks, but on numbers--principally on the numbers that purport to represent sales, earnings and earnings per share.

There are many ways to create an appearance of earnings and growth when they are not really present. One troublesome practice is the regular distribution of so-called "stock dividends" or their equivalent by companies which either have no earned surplus or earned surplus which is substantially less than the total market value of the shares being distributed. The Commission has today announced a proposed rule under the anti-fraud provisions of the Securities Exchange Act of 1934 to deal with the misleading implications of this kind of activity.

There are also ways to increase a company's reported sales and earnings without improving performance--and here I speak of performance in its traditional sense. The easiest way, perhaps, is simply to add the sales and earnings of another company through merger or acquisition. If the applicable accounting rules permit such simple addition, as though both companies had in fact been divisions of one company all along, the astute manager interested only in improving the reported sales and earnings of his company could hardly be blamed for trying to journey along this easy road to fame and possible riches. And if, as has happened in some cases, the combined sales and earnings are compared with the unadjusted figures of the acquiring company for earlier periods, the increase in sales and earnings appears even more dramatic.

This accounts, in part at least, for the current rash of acquisitions--hundreds, thousands of acquisitions--and for the growth of the conglomerate company. One acquisition may be made because the acquired company has good management, another because it has bad management. In some cases the acquisitions turn out well, in others badly. But in a disturbing number of cases, nobody outside the company may ever know whether or not the acquisition turned out well, since the reporting practices presently in effect frequently do not provide any means of eliciting this very significant information.

Of course, the desire to show larger sales and earnings is not the sole reason for mergers and acquisitions. There is safety and comfort in size and reasonable diversification, and there are provisions of the tax laws, the antitrust laws, and the securities laws which may enhance the attractiveness of conglomerate mergers and acquisitions. It is probably unnecessary for me to do more than to note, at this point, that our decisions in this area as to what disclosures are appropriate and necessary, whether by conglomerate companies or others, are based on conclusions as to the needs of investors and not on determinations of tax policy or antitrust policy.

An imaginative corporate manager may also seek to effect a merger or acquisition in a manner which will permit him to show increased earnings per share as well as larger sales and earnings. Frequently this may be accomplished through the use of convertible preferred stock. If the combined earnings of the two companies, after deducting the dividend requirement on the new preferred, are divided by the outstanding stock of the acquiring company alone, there is usually an impression of an increase in earnings per share which no caveat or qualification, either in fine or regular-size print, can dispel. In this situation, adequate disclosure requires that earnings per share be shown on a basis which clearly reveals the nature of the transaction and the effect of the additional stock to be issued upon conversion of the preferred stock issued in the transaction.

Of course, not all acquisitions are made through the issuance of additional stock. An increasing number of acquisitions these days are made for cash, which has raised disclosure problems of another sort. Stockholders of a company faced with a cash take-over bid at present receive limited assistance from the disclosure requirements of the federal securities laws in coping with the welter of confusing claims and counterclaims with which they are often bombarded in the course of these activities. In this respect, their position is considerably less attractive than that of stockholders whose proxies are solicited for a merger or whose shares are sought by means of a prospectus offering a stock-for-stock exchange. The tender offer bill which has passed the Senate and is now pending before the House Commerce Committee, would be a useful step in closing this significant gap in the statutory disclosure requirements.

Whether or not their various acquisitions have been digested, these omnivorous companies may discover they have lost their identities in the process. Their industrial outlines are blurred, their once-descriptive names frequently are reduced to meaningless initials, and they must now turn to the image builders of Madison Avenue to give them a new identity which will be appealing to equity investors and those who advise them. Two-page spreads in financial and general interest magazines and newspapers seem to be a favorite technique at present for bringing the glittering images to the attention of the investing public.

As I indicated at the outset, I do not believe our standards of financial disclosure have developed sufficiently to afford investors an adequate means of determining the realities which lie behind these glittering facades. Nor have we fully developed standards and rules appropriate to meet the challenges offered by the ingenious copywriters who produce the glittering images, sometimes conveniently located next to the stock tables in the business section of the daily newspaper. There are dangers in this situation. A company whose true financial condition is unknown to the public--and perhaps not even fully known by its own management--is more likely to wind up in serious financial difficulty than a company in which adverse trends can be spotted before they have gone too far. The Commission is already deeply engaged in the reorganization proceedings of one conglomerate which appeared for a time to be growing rapidly but which got out of the control of its keepers and brought hardship to many thousands of public investors. I do not suggest that there are other potential reorganization candidates among the rapidly growing and changing conglomerates that, at least until very recently, seem to enjoy such popularity, but I am concerned about the potential danger to public confidence which may result when so much is invested where so little is known.

There may also be serious erosion of our capital markets as efficient allocators of corporate resources and of public savings when large enterprises are combined under common management not because their actual operations go well together but because their financial statements look good together. As some of you may recall, a large part of the Commission's time in the 1930's and 1940's was devoted to undoing and simplifying the complex public utility holding company structures that grew out of the financial legerdemain of the 1920's. I am struck by the parallel between these two situations. We must develop and apply preventive therapy at an early enough stage to avoid the type of radical surgery that was necessary in the public utility area.

It has always been difficult to define the responsiblities of corporate managers to their public shareholders and to the other constituencies whom their actions affect, such as employees, customers, competitors and others. It is even more difficult today. (I might say at this point that the growth of institutional investors, which at one time was thought to point the way to a resolution of these problems, seems at the moment to have simply doubled the problem by adding another group of managers seeking legitimacy.) However, there was a time in the past when corporate managers assumed some responsibility to meet accepted standards and the felt needs of a particular industry or related group of industries, or perhaps to a particular geographical area. With the development of the conglomerate, even that sense of responsibility is gone. It has been suggested that the only allegiance conglomerate managers have now is to a set of figures which they themselves have extensive power to control. As the head of one large conglomerate himself put it: "Our sole product is profit".

I am not suggesting that current inadequacies of financial disclosure are the sole cause of the present crises in corporate management. Nor will improvements in disclosure solve all the problems, some of which are not within the responsibilities of the Commission. Nevertheless, we must do what we can to bring about improvements in financial and other disclosures if we are to maintain confidence in our system of public investment in industrial enterprises. An important start has already been made by the Financial Executives Institute and others in defining the reporting obligations of the conglomerate company on a continuing basis. I believe it is equally urgent that we give attention to the problems springing from current practices with respect to pooling of interests and the reporting of changes in capital structure and earnings per share.

In my view, the pooling of interests concept has been distorted beyond its limited beginnings and purposes. It has become an aspect of the current performance fad and adds fuel to the fires of speculation. I cannot stress too strongly the urgency of appropriate solutions to the problems the current practices create.

As one who has spent most of his adult life insisting upon candor by others it would be unfortunate if you gained the impression from what I have said that the Commission does not share some responsibility for the current situation or that it does not have authority and responsibility to deal with it. Not by way of apology but rather by way of explanation, I do wish to point out that we have traditionally encouraged industry and professional groups to face up to developing problems and to fashion appropriate solutions with the understanding that, if such action is not promptly undertaken and the problems adequately resolved, we would, of course be compelled to develop the rules ourselves.

Finally, it is important to emphasize that I do not imply by the tone of my remarks that we are in imminent danger of sinking into the quicksand of utter obfuscation. But, uncertainty regarding certain aspects of corporate growth and change has, for the time being, outpaced meaningful financial reporting. It will take a determined combined effort on the part of all persons interested in, or affected by, the changing corporate scene to bring order and light out of current confusion and to assure the continued healthy development of American enterprise.