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THE SEC's ROLE IN FINANCIAL DISCLOSURE

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Introduction

This morning I would like to discuss the SEC's role in financial disclosure. The growing complexity of business transactions and the pressures exerted by inflation, recession and increased competition are taxing the ability of issuers and accountants to achieve fair disclosure. The Commission plays a central role in developing appropriate disclosure rules to address these challenges. Exactly what that role is -- and how it is performed -- is the focus of this speech.

Specifically, I will address two issues:

First, why does the Commission continue to support a mandatory system of disclosure?

Second, what is the Commission's role in setting accounting standards -- the keystone to financial disclosure?

A. Why the Commission Continues to Support A Mandatory System of Disclosure

An interesting question was unobtrusively introduced at a recent open Commission meeting. The Office of the Chief Accountant and the Division of Corporation Finance had jointly proposed amendments to our Bank Holding Company disclosure rules concerning nonperforming, high risk and foreign loans. The amendments were designed to require better disclosure about a bank's loan portfolio, so that the investor could evaluate the important risk elements.

The Directorate of Economic and Policy Analysis submitted to us a memorandum asking that the release inquire whether the additional disclosure was already being introduced into the market on a voluntary basis or would likely be introduced in the absence of the proposed amendments.

If you had been a Commissioner at this meeting, how would you have dealt with this request? For me, it raised a fundamental issue -- one that has come up from time to

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The views expressed in this speech are my own and do not necessarily represent those of the Commission, my fellow Commissioners or the staff.

time over the Commission's history. That issue is whether a mandatory system of disclosure is necessary. If DEPA's question were included in the release, and answered in the affirmative, should it follow that we ought not to require disclosure, assuming materiality? I thought not. If the data was materially important to investors, I believed we ought to compel disclosure. Therefore, I voted against asking the question. So too did the other Commissioners present.

Why mandatory disclosure is a fundamental question worth rehearsing. I thought it might interest you to understand the reasoning behind my conclusion on DEPA's proposal.

I think the mandatory disclosure program developed and administered by the SEC has been successful in achieving Congress' goals. Our current regulatory approach is supported, in large measure, by investors, issuers and securities professionals. The United States capital markets are recognized by the financial community as the most efficient and stable in the world. Restoring public confidence in the financial markets -- a major aim of Congress in enacting the securities laws half a century ago -- has been achieved. Indeed, the administrative technique of regulation by mandatory disclosure has become a Congressional favorite in other legislative areas, including various environmental statutes, the Occupational Safety and Health Act and ERISA.

This is not to say that mandatory disclosure is universally applauded. It is not.

One criticism is that disclosure by government fiat generates useless information. Here the assumption is that we in government have no special wisdom about the kinds of information investors need to know. And, in fact, we don't!

The Federal securities laws are based upon the flexible concept of disclosure of facts material to the investor, not the bureaucrat. But bureaucrats at the SEC do not divine what is material in some vacuum at 450 Fifth Street. For years the Commission has sought, and today continues to seek, the help of investors and financial intermediaries in establishing what is material to them. Thus, there is a continuous process of give and take between the SEC and the investment community, aimed at refining and improving the disclosure system to give investors the data they consider material.

A recent example of the process was the Research Forum convened by the SEC last November. The Forum included financial analysts from investment banking firms, rating agencies, investment advisors, institutional investors and representatives from shareholder groups. Its purpose was to elicit comments from these groups -- who in reality are the SEC's clients -- about the usefulness of what our disclosure rules produce. In March, the SEC met with representatives of the Financial Analysts Federation to discuss similar issues.

Both gatherings resulted in valuable feedback. They strongly supported the need for mandatory disclosure. They strongly favored the goal of comparability in financial disclosure. Participants felt that the criteria for determining business segments needed to be tightened to assure greater consistency from year to year. Comparative quarterly balance sheet information was requested. Almost all agreed that FAS 33 inflation data was not useful. There was also a call for more and better pension data. I look for continuing improvements in our disclosure rules as a result of discussions like these.

Another criticism of mandatory disclosure has come from recent economic studies of the stock market and investment process. These studies conclude that data disclosed pursuant to SEC rules is a case of "too little, too late."

The "efficient market" hypothesis -- that all relevant information swiftly becomes known to the marketplace and reflected in stock prices -- challenges the utility of mandatory disclosure. Champions of this theory charge that compulsory disclosure is inefficient and unnecessary -- in effect, that it is regulatory overkill causing a drag on the efficient workings of the capital markets. If the marketplace has already received and digested all relevant information prior to its disclosure in an SEC filing, the utility of an SEC filing, the argument goes, is diminished.

In response to these economic critiques, the Commission, in 1977, created an Advisory Committee on Corporate Disclosure to evaluate the disclosure system. The Committee concluded that "[m]arket forces and self-interest cannot be relied upon to assure a sufficient flow of timely and reliable information." I agree with this assessment. I believe mandatory disclosure is important for three reasons:

1. It provides a set of neutral rules applicable to all;

2. it provides "discipline" for the marketplace; and

3. it inspires investor confidence.

1. Mandatory Disclosure Provides Neutral Rules Applicable to All

Our system of mandatory disclosure provides a uniform set of rules for guidance and predictability. I believe that corporations, accountants, lawyers and the financial community derive enormous comfort from functioning under a single set of disclosure rules applicable to all. The system gives assurance that the competition for capital is fair -- that it will take place in a neutral arena with uniform rules.

Reaction to our current reappraisal of the shareholder proposal process provides a timely illustration of the comfort and predictability a set of rules can provide. To date, the Commission has received over 400 responses to its release, in which three alternative approaches were proposed. One would continue the SEC's current regulation with minor changes. A second would permit a company, upon shareholder approval and within certain parameters, to adopt its own plan. The third alternative would eliminate most of the present exclusions, permitting up to a specified number of proposals, if proper under state law, to be included.

Faced with these choices, including the opportunity to "opt out" of the SEC's current regulatory process, companies and shareholders alike have largely supported the status quo. In support of the present system, one company responded: "SEC regulation has to an extent introduced the elements of order, certainty and uniformity" into the process.

Perhaps we shouldn't find this so surprising. Corporations can become comfortable with regulation: they can learn to live with it and even become addicted to it. Thus, with increasing frequency in this deregulatory age, we have seen those subject to government regulation resist the efforts of those who would remove regulatory "burdens."

Of course, regulations often have anti-competitive effects, limiting a competitor's ability to, for example, lower prices, expand into new areas or offer additional services. Fortunately, this is not the case with mandatory disclosure. It prescribes no particular business conduct and constrains only that which companies are unwilling to expose to the investing public.

2. Mandatory Disclosure Provides Discipline in the Marketplace

Mandatory disclosure performs a disciplinary function in the financial markets. Absent our mandatory approach, much information currently available would not see the light of day -- except, perhaps, to those influential enough to compel disclosure. The Advisory Committee's findings were instructive. Analysts testified that, absent SEC requirements, they would be seriously handicapped in securing sufficient reliable and timely information.

A recent article in Dun's Business Month entitled "The Closed-Mouthed Companies" lends credence to this conclusion. The article stated that some companies "treat analysts who follow them as adversaries or spies for the competition and reveal as little as they can legally get away with."

Not surprisingly, the Advisory Committee found that "good news concerning a corporation is generally much more quickly and willingly forthcoming than bad news." Management, being human, is often reluctant to disclose information that will not be welcomed by the shareholder or analyst. In today's troubled economic climate where, according to a recent New York Stock Exchange economic study "each and every major indicator of corporate financial health is at a long-term or cyclical low," a voluntary system would be severely strained. It becomes tempting -- too much so -- for a company to slant corporate information in a manner more favorable to it or to delay the disclosure of unflattering news, always in the hope that, given additional time, capital or both, its problems will be solved -- and no one will be hurt.

The recent reaction of the bank regulators to a series of front-page bank problems is revealing. Historically, they have been reluctant to compel disclosure by banks of problem loans and the like. However, these problems have contributed to a reexamination of the bank regulator's traditional preference for secrecy. In a recent article, William Isaac, Chairman of the Federal Deposit Insurance Corporation, wrote that the FDIC is seeking ways to increase marketplace discipline. Recognizing that the marketplace must have information to perform its disciplinary function, the FDIC has decided for the first time to make public data on banks' problem loans and their vulnerability to interest rate changes.

This is a significant change in bank regulatory philosophy. It's one I applaud.

A recent report issued by The American Assembly on "The Future of the American Financial Services Institutions" supports this approach. This report, which I participated in drafting, identified as a goal of regulation that individuals have access to adequate information to make informed decisions among competing financial products. It recommended that the financial reports of banks and other financial services institutions accurately reflect "their present financial conditions, taking into account yields, maturities, and asset qualities, so that an assessment can be made of the adequacy of their capital and the risk they present to the public." Incidentally, this sounds a lot like present value accounting. But the point is that this type of information, while clearly material to an investment decision, is not likely to be forthcoming without a rule compelling its timely disclosure.

An important feature of our mandatory system is the serious consequences that flow from a failure to comply with the rules. Mandatory disclosure ensures a degree of accountability for corporations that would be lacking in a voluntary program. Without accountability -- in the form of liability to investors or SEC sanctions -- there would be little pressure on corporations to do a careful job in disclosing material facts to investors and the marketplace. Again, the Advisory Committee found that the mandatory disclosure system

> with its possible penalties not only for misstatements and omissions in filed material but in other corporate disclosure as well, provides a high degree of assurance that all information furnished by corporations, privately and publicly outside filings as well as in them, will be responsible and accurate.

The system also provides the professional with incentives to ensure full and fair disclosure of material information. My years in private law practice convince me that the disclosure rules are taken very seriously by accountants, investment bankers, lawyers and other professionals involved in the preparation of disclosure documents.

3. Mandatory Disclosure Inspires Investor Confidence

The foundation of healthy capital markets is public confidence. Fairness and honesty in the conduct of market transactions are essential to foster public confidence. I believe mandatory disclosure is an important factor in maintaining investor confidence by ensuring a steady stream of accurate information to all investors.

The Advisory Committee found that a voluntary disclosure system relying on market forces to bring forth information would create "unacceptable inequities" among investors. In The Transformation of Wall Street, Professor Joel Seligman's history of the SEC, he asserts that reliance on market forces would "subvert small investors' confidence in the securities markets." I agree. In a voluntary system much information that is important would flow only to those with the clout to obtain it.

The SEC currently has its hands full investigating and prosecuting cases involving insider trading. This is a priority because such abuses strike at the heart of our notion of fairness. If we were to rely on issuer self-interest and the clout of investors to achieve disclosure, the potential for abuse of material information would increase. This could hardly instill confidence in market participants.

Mandatory disclosure fosters investor confidence by ensuring all investors of equal access to corporate information. We do not tell people how to use this information, nor should we. Whether and how information material to investors is used by them is a matter of free choice. And the diversity of approach makes for interesting markets. Investor confidence comes from the knowledge that the information is equally available to all -- large and small.

B. The Commission's Role in Setting Accounting Standards

1. Background

I would now like to turn to the Commission's role in setting accounting standards that govern financial disclosure. Financial statements are the foundation of our disclosure system. The securities acts give the SEC authority to prescribe the form and content of all financial statements filed with it. In exercising this authority, the Commission has tended to rely on the private sector to develop accounting principles. In ASR No. 4, released in 1938, the Commission stated that, absent an articulated SEC position on the accounting principles in question, those with "substantial authoritative support" would be accepted. Those without such support would be presumed to be misleading or inaccurate. Since that date, the Commission has generally looked to the accounting profession, acting through the Committee on Accounting Procedures and its successor, the Accounting Principles Board, to take the initiative in standard setting.

In 1973, the Commission formalized its views on private sector initiatives in ASR 150. This release announced support for the newly created Financial Accounting Standards Board. The Commission acknowledged that in carrying out its statutory authority it had looked to the private sector to establish and improve accounting principles and standards. This was no abdication of responsibility. It was a pragmatic judgment of how best to get the job done. The Commission pointed to the availability of private sector resources, its expertise and its ability to detect emerging accounting problems at an early stage. It also observed that private sector standards could be applied to all companies whether or not publicly owned.

2. Standards Setting Today - A Joint Process

Some are critical of the Commission's failure to assert a more formal role in the accounting standards setting process. Professor Homer Kripke, for example, describes the accounting area as the Commission's biggest failure. Professor Joel Seligman voiced similar concerns in his recent book. Professor Kripke argues that "accounting principles have to be set jointly by the private profession and the Commission." He describes the current process as an "uneasy cooperation caused by the Commission's unwise exclusion of itself from an avowed role in the process and the guerilla warfare it therefore has to wage to influence the process."

I disagree with Professor Kripke. Under the Commission's current procedures, accounting principles are, in fact, set jointly by the profession and the SEC. The process is simply not exactly as Professor Kripke would fashion it. There is a productive tension between the Commission and the FASB, resulting from the Commission's oversight efforts. What to Professor Kripke is "guerilla warfare" was to former SEC Chairman Harold Williams the "prodding, guidance, and review necessary to ensure the profession meets its challenges." The Wheat study group on establishment of accounting principles called it a "continuing dynamic relationship."

The Commission's approach affords it considerable flexibility. On any particular issue, we can either:

1. Accept standards of financial accounting developed by the private sector, or

2. provide Commission standards or staff guidance through releases or staff accounting bulletins, or

3. override FASB standards by issuing a Commission rule when we disagree with its conclusions.

The first option, of course, is the most common, and demonstrates the efficiency of looking in the first instance to the private sector for leadership, while maintaining close oversight of its ultimate solutions. The second option is used when the Commission believes the private sector is reluctant to move or has not fully addressed all aspects of an issue or is unable to do so within a reasonable time. The override option is exercised infrequently, but the Commission's willingness to take such a step is important to assure that a timely joint process of standard setting continues to exist. The late Justice William O. Douglas, third Chairman of the Commission and forceful advocate of private sector regulation, made this point with metaphorical panache in 1937:

> Government would keep the shotgun, so to speak, behind the door, loaded, well oiled, cleaned, ready for use but with the hope it would never have to be used.

The Commission's posture with respect to its responsibility for accounting standards initiated by the private sector stands in contrast to its role in the rule-making process for self-regulatory organizations. Pursuant to a Congressional mandate adopted in 1975, Commission-regulated SROs such as the stock exchanges and the NASD adopt rules that become effective only after being approved by the Commission. Although the rules are not technically those of the Commission, they become final pursuant to the normal rule-making process prescribed by the Administrative Procedure Act. Some critics have urged that similar treatment be accorded accounting standards developed by the FASB. While this idea has some surface appeal, there are differences in the two processes that seem to justify the different approach taken by the Commission.

SRO rules regulate the activities of their own members. Private sector accounting standards are developed by a group that is independent of those for whom the rules are established.

SROs house, protect and promote, as well as regulate, the business of their members. The FASB and its predecessors were established solely to develop and improve accounting principles. And, in fact as well as theory, that is <u>all</u> they do.

SROs have no prescribed standards of due process that involve public comment on rules developed for Commission review and approval. In contrast, the FASB follows extensive due process procedures that are at least as stringent as the requirements of the APA and in many ways more so. And the Commission oversees the FASB's procedures.

Finally, the FASB and its predecessors have spoken with authority on accounting standards applicable to both public and private issuers. Having one set of standards applicable to all business enterprises, whether or not touched by SEC regulation, makes sense. The Commission's approach to accounting standards developed by the private sector makes this result possible.

3. SEC Oversight -- How it Works

It is through continuous oversight of the private sector that the Commission exerts its major influence on the principles developed by the FASB.

The Chief Accountant of the Commission, as the principal advisor to the Commission on accounting and auditing matters, has primary responsibility for oversight. Through a constant exchange of views with the FASB, the Chief Accountant, and through him, the Commission, are kept current on all significant accounting developments.

This informal process of oversight creates numerous opportunities for the Commission to affect not only the approach to be taken by the FASB with respect to various issues but the agenda of issues to be considered.

The Commission's accounting releases often establish standards of accounting or disclosure for registrants. In many cases these releases have been followed by related pronouncements from the private sector, which in turn are followed by rescission of the Commission release.

Notable among the Commission releases that spurred private sector action were its rules on lease disclosure (ASR 147-October 1973), disclosure of replacement cost data (ASR 190-March 1976), and the moratorium on capitalization of interest (ASR 164-November 1974). The replacement cost disclosures, of course, precipitated the FASB's standard requiring the disclosure of inflation-adjusted data (FAS 33-September 1979). The Board also subsequently issued standards requiring lease capitalization (FAS 13-November 1976) and providing for limited circumstances in which interest could be capitalized (FAS 34-October 1979).

More recently, our staff's insistence that a major registrant accrue a liability for unpaid vacation pay in its financial statements included in a Securities Act filing influenced the FASB's decision to subsequently issue FAS No. 43 "Compensated Absences" in 1980. This standard requires the accrual of any unpaid vacation pay or sick pay at the end of a period. Our staff issued an accounting bulletin to announce its position. That SAB was rescinded when FAS 43 was issued.

Another example of Commission influence was its recent decision to propose a moratorium on internal software cost capitalization. This action has already accelerated the efforts of an AICPA task force addressing the issue. The moratorium was proposed because accounting guidance today is inadequate, creating incomparability among financial statements and confusion among the investing public. It would freeze current practice until adequate rules are developed.

Although such action has been rare, the Commission has not hesitated to override private sector initiatives when it was found necessary. In Accounting Principles Board Opinion No. 2, issued in 1962, the APB concluded that investment tax credit benefits should be reflected in income over the life of the acquired property (the deferred method) and not in the year the property was placed in service (the flow-thru method). After careful study, the Commission decided in January 1963 to accept either the flow-thru method or the deferred method prescribed by the APB.

In December 1977, after studying the two basic historical cost accounting methods for the oil and gas industry (full cost and successful efforts methods), the FASB issued Statement 19 mandating successful efforts. The SEC decided that neither method adequately considered the valuation of oil and gas reserves, which is the critical variable in assessing the economic success of an oil and gas producing company. Accordingly, the Commission instituted an experimental project to develop an accounting method based on the valuation of proved oil and gas reserves. In the interim period, the Commission required certain value-based disclosures as supplemental information. The Commission stated in ASR 253 (August 1978) that companies could continue to use either the full cost or successful efforts method. The cost of requiring a change to one of them could not be justified, in the Commission's view, since neither was considered adequate. It also established uniform standards for applying the full cost method. The fact that the SEC was not ultimately successful in its quest for a new method of value based reporting does not negate the fact that it acted when it felt action was required.

The Board's project on how to account for receivables "sold" with recourse offers a very current example of how the joint process works. The Board has proposed that, since the receivables are no longer assets of the seller, in that the benefits are now controlled by the buyer, they should be replaced on the seller's balance sheet with the cash paid for them, without any recorded liability attributable to the recourse feature. Our staff is inclined to believe there is no substantive difference between receivables "sold" and those pledged against borrowing. Informal discussions are continuing, with our staff attempting to understand the rationale which supports the Board's proposal. There is a productive tension here. But it is important to understand that the Commission does not insist that the Board adopt exactly the same standard that the Commission would if it were directly dealing with the issue. In the final analysis, the question will be, does the Board's solution fall within a range of solutions acceptable to the Commission.

The Commission's oversight efforts involve an additional feature worth mentioning. Effective oversight requires a credible enforcement presence. The Commission must be willing to compel issuers and accountants to comply with Commission rules and private sector standards.

Although questions have been raised by some, recent Commission actions evidence its continuing resolve to ensure full and fair disclosure to investors. For example, Bank of America revised downward its earlier reported operating earnings for the fourth quarter after the SEC staff indicated that a $30.8 million tax-free gain from a swap of equity for debt should be counted as extraordinary income rather than part of operating income. After we objected, Aetna Life & Casualty recently stopped its practice of reporting future tax benefits as current earnings. And, after the SEC staff challenged Alexander & Alexander's accounting for its acquisition of a British insurer, A&A charged off $40 million in acquisition costs immediately instead of reporting them as an intangible asset to be expensed over 40 years.

Nor has the Commission ignored the accounting profession. A Fall 1982 Wall Street Journal article headlined "SEC Goes Easier on Accountants" suggested that the Commission was displaying a less aggressive regulatory stance with respect to accounting firms -- not "riding herd" too closely. These conclusions appear to be based, in part, on perceptions that the Commission's toughness towards accountants can be fairly measured by the level of enforcement division cases publicly announced against accountants.

All of this is nonsense! The statistics were not taken over a long enough period to be meaningful. Moreover, as is so often the case, statistics fail to tell the whole story. Lengthy incubation periods are often required to evaluate apparent audit failures. In addition, there is an ebb and flow to accounting failures that tends to follow the ebb and flow of the Nation's economy. Subsequent to the Wall Street Journal article, the Commission has concluded several actions against independent accountants. Moreover, indications are that the level of such actions may significantly increase in the current year.

4. Some Comments on the Future

In the 1970s, there was a need for the Commission to be highly visible and active in prodding the private sector to act or in acting itself. The FASB was in its formative stages, the profession was under siege in the wake of highly publicized bankruptcies and corporate scandals (Penn Central, Equity Funding, Four Seasons Nursing Homes), and Congress was exerting considerable pressure on the profession and the Commission through its Congressional oversight committees. Today, the FASB enters its second decade of existence in a different environment. Many see the Board as a mature standard setting body with strong ties to both the SEC and the community it serves.

For the FASB to remain effective, and for the Commission to maintain its posture of reliance, the Board must preserve and enhance its credibility. That credibility may be impaired by the Board's apparent inability to complete the major phases of the conceptual framework, a project that has consumed major resources of its staff since 1973. Remarkably, the Board has yet to make a single hard decision. This project is too important in terms of dedicated resources and expected benefits to be allowed to languish further. In particular, resolution of the recognition and measurement issues would be highly beneficial to the development of future accounting standards.

Now, a few concluding thoughts. In carrying out its statutory responsibility to ensure full and fair disclosure, the SEC has attempted to strike a balance between establishing accounting standards itself and leveraging its efforts with private sector groups.

I am satisfied that on balance the decision to place reliance on the private sector has not been improper, and that the system is reasonably effective. However, it can be made to work better. One positive step to increase the Commission's effectiveness would be for the President to appoint a distinguished independent accountant to the Commission when my term ends next year or thereafter when another opening occurs.

There has been much written and said about the need to get good CPAs more involved in the workings of our government. The appointment of Roscoe Egger as Commissioner of the IRS and Chuck Bowsher as head of the GAO indicate that some progress is being made here. Accounting is the keystone to financial disclosure and thus central to the work of the Commission. Ours is a logical agency in which to continue the trend.

I am surprised that on only one occasion in fifty years has an accountant been selected as a Commissioner of the Securities and Exchange Commission. That Commissioner was Jim Needham, who served from 1969 to 1972. Given the increasing complexity of accounting issues and the frequency with which they are presented to the Commission, such an appointment would strengthen the Commission's ability to make sound decisions in this area.

It would enhance our oversight program in various ways. For example, it would serve as a link between the Chief Accountant and the Commission. It would also improve communication between the Commission and the private sector, because such a Commissioner would be a logical spokesman for the Commission in accounting, auditing and financial reporting matters.