An Address

by

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SOME DISCLOSURE PROBLEMS

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SOME PROBLEMS OF DISCLOSURE

I must begin by expressing my appreciation, as a member of the Federal Bar Association, as a member of the Securities and Exchange Commission, and as a long time friend and colleague, for the memorial you are establishing in honor of Ed Rakow. He was a dedicated public servant, a generous, honorable and devoted citizen of Detroit, and a principal architect of the Federal Bar Association in this city. Above all he was a gentleman who served his country and this state for a substantial portion of this 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 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.

Recent years have seen a startling growth in the number of investors, number of securities transactions, volume and

value of securities traded on and off the stock exchanges, as well as a dramatic growth of institutional investors and changing trends in the form and manner of investment management.

. There are now some 24 million investors compared with 17 million in calendar 1962.

. Average daily volume on the New York Exchange has grown from 3 million shares in 1962 to over 10.1 million in 1967. The American Stock Exchange and regional exchanges have also been exceptionally active. On one recent day, the American Stock Exchange volume exceeded 10,000,000 as compared with a daily average of 2,800,000 shares in calendar 1966 and 2,200,000 in 1965. A new record monthly trading high was established in January despite eight shortened trading days. 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 related 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 next 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.

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's stock, it provides management with a keen interest in the price at which the stock is traded and a strong incentive to provide the

There are many ways to create an appearance of earnings and growth when they are not really present. 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. This accounts, in part at least, for the currect rash of acquisitions--hundreds, thousands of acquisitions--and for the growth of the conglomerate company.

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.

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 have 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.

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 responsibilities 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 develppment 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.

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 maintian confidence in our system of public investment in industrial enterprises. An important start has already been made 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.