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The SEC and Corporate Disclosure: Regulation in Search of a Purpose

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THE SEC AND CORPORATE DISCLOSURE: REGULATION IN SEARCH OF A PURPOSE.* BY *Homer Kripke*. New York: Law and Business, Inc./Harcourt Brace Jovanovich. 1979. Pp. xxii, 368. $29.

Over the last four decades, the Securities and Exchange Commission and its staff have maintained a high level of technical competence, ability, enthusiasm, and integrity. Indeed, the SEC has long been regarded as an excellent training ground for young lawyers. In the last few years, however, the agency has drawn more frequent charges that it is inadequately fulfilling its statutory purpose of facilitating informed investment decisions. Professor Homer Kripke, a close observer of the financial markets for over forty-five years, has led the modern efforts to change basic SEC policies.

Regarded by some as a maverick, Kripke has long argued that the present SEC-mandated disclosure does little to aid the investor in making financial choices. In this, his most recent book, the New York University scholar levels a broadside against the Commission's performance from legal, accounting, and economic perspectives. Although he admires the ability of the Commission and its staff, the author argues that the Commission has failed to meet the challenge of the modern financial marketplace by disregarding the new economic learning about how the securities markets really work.

In Part I of his book, Kripke demonstrates that the SEC acts on the principle that disclosure is an unqualified blessing. This attitude, says Kripke, inhibits the agency from balancing disclosure's costs against its benefits in facilitating informed investment decisions. Professor Kripke paints the picture of an agency so enamored of its own procedures that it never evaluates them critically. He offers, as an example, the Commission's guidelines on disclosing perquisites. The agency acted, laments Kripke, without seriously considering whether such disclosure would really help a prospective investor. Instead, motivated by a sense of moral urgency, it imposed a broad rule without attending to the essential issue of materiality:

> This has all been based on a handful of notorious cases, with no evidence that significant amounts were involved in the majority of issuers or that stockholders would consider the disclosures material. When the novelty was fresh, the staff was apparently imposing cost allocation theories that would extract from many issuers disclosure of a phantom "perk" — an officer getting a benefit that costs the company little or nothing. Trifles like parking spaces were seriously discussed. Such ideological pursuit of details impairs the concept of materiality. These detailed prescriptions are not needed in instances of serious abuse, which the Commission is already handling under the antifraud laws

* This book review was prepared by an Editor of the *Michigan Law Review* — Ed.

> . . . . This "perk" hunt has left behind a residue of worthless, perfunctory "disclosures" that rarely reveal anything material . . . but add new burdens in the disclosure forms. [P. 19.]

Since the Commission rarely assesses the relevance of its disclosure requirements, Kripke is not surprised that disclosures contain little of value to an investor. In Part II, he argues that most of the information relevant to an investor's decision cannot be found in the statutorily-mandated prospectus and registration statement. Kripke maintains that the firm-oriented, historically objective information found in a prospectus inadequately aids an investor in assessing the general movement of the marketplace, the future prospects of the industry in which the firm competes, or even the individual firm's future economic health.

Kripke feels that this results largely from the Commission's failure to adopt an interdisciplinary approach that embraces the new economic knowledge of how the financial markets work:

> Because it did not want to build, or did not know how to build, the competence to function in an economic environment, the SEC has functioned in an environment of dissociated law. A majority of its chairmen, commissioners, and principal staff members have been lawyers. It has had a much smaller group of accountants and only a straggling number of engineers, economists and other specialists.
>
> It is easier to apply verbal formulae to determine materiality than to develop a broad spectrum of skills for the task of defining material and useful disclosure. The Commission's fault is not failure to solve the problem of what is relevant. Its fault is not having tried. [P. 74.]

Kripke points to economic studies indicating that movements in an individual security's price correlate with the market's movement, thus questioning the usefulness of the Commission's firm-oriented disclosure requirements. Further, the "efficient-markets hypothesis" contends that all mandatory disclosure is superfluous. Under this theory, the market rapidly and efficiently "impounds" all public information in the price of securities. If correct, this theory means "there is little likelihood that one can earn abnormal returns by fundamental analysis of securities through public information" (p. 309).

The reader might reasonably ask how investors presently obtain needed information, if not through SEC-mandated documents. Kripke's answer is simple — through the market:

> A disclosure will be supplied voluntarily by issuers interested in the capital markets when there is a consensus among suppliers of capital or other transactors in the capital markets that this information is necessary to them for lending and investment decisions. . . . If, on the other hand, it is material only under SEC conceptions, it will not be supplied unless SEC mandates its disclosure. [P. 119.]

Kripke maintains that such information is adequate, even without an SEC mandate, because the market demands it:

> [T]he stock must have a following of interested investors and the spon-

> sorship of brokers and dealers making recommendations to institutions and individuals after being counseled themselves by financial analysts. Companies must furnish information deemed adequate by analysts . . . or lose their following. . . . Those whose results fall short of what they have given analysts and brokers reason to expect learn that "analysts do not like surprises". [Pp. 123-24.]

Kripke does not ask that the Commission automatically accept the teachings of the new economics of market analysis. He does argue, however, that rather it should recognize developments in nonlegal fields regarding the functioning of the markets and consider changes in its procedures that might respond to those developments. Somewhere between blind acceptance and blind rejection, there lies a happy medium.

In Part III, Kripke "moves from the macroeconomic to the microeconomic." He argues that since financial statements are the heart of disclosure, and since these statements are presented in an accounting context, the Commission's biggest task should be to define accounting conceptually. Financial accounting in the modern world must serve the needs of the serious investor, and not merely report the management's stewardship of the funds entrusted to it by the owners of the business. Yet Kripke finds that the SEC has not sought to direct accounting toward this modern ideal, but has limited its concern to mere surface problems:

> [T]he Commission concerns itself with surface problems that can be forced into the mold of morality. It has not developed a capacity to probe beneath the surface of the hard problems — in the case of accounting, the nature of the financial reality to be abstracted and the kind of reporting that will be useful for the investor. [P. 158.]

Further, he argues, the Commission has abdicated its power to compensate for the accounting profession's natural inertia; it has allowed the accountants themselves to formulate the Generally Accepted Accounting Principles through the Financial Accounting Standards Board. This delegation of power has perpetuated what Kripke considers an unconscionable tradition: the accountants' use of only historical cost in determining asset amounts for financial statements. He maintains that over time the historical cost figure, although objective, becomes irrelevant to investor decisions. Kripke would prefer a "fair value" system, keyed to an asset's replacement cost. "Fair value accounting . . . deals with the problem of prices moving at differential rates. Price level accounting deals with the problem of the change (usually the depreciation) in the unit of currency, and the resulting circumstances that costs incurred in different periods are not homogeneous" (p. 212). Kripke insists that both adjustments are necessary: "Fair value accounting shows price changes without separating the portion that is not a differential change but is merely due to inflation. Price level accounting adjusts all assets alike, concealing differential shifts" (p. 213).

In Part IV, the author attacks the Commission's narrowing of disclosure exemptions to section 5 of the Securities Act. As an example, he picks on rule 146's safe-harbor requirements for private placements. He argues that the rule's complicated and uncertain requirements have encouraged issuers to make costly public offerings rather than private placements of risky venture capital:

> Instead of encouraging securities placements to be private in risky venture capital situations, the SEC's attitude tends to push these very enterprises toward public offerings: the rigid requirements of Rule 146 create the fear that the Commission will contend that the § 4(2) exemption is not available. The cost-saving of private placement as against a public registration has been severely reduced (if it exists at all) because of the agency's requirement that the information be the same as in a registration statement. . . . The private placee is disadvantaged if he wants to sell because he becomes subject to the resale limitations of Rule 144 . . . while the ordinary purchaser in a public offering is free of these restrictions. Thus the balance of considerations steers the issuer toward a public offering and improvidently facilitates purchases by unsophisticated members of the public who would not have been invited to be private placees. [Pp. 240-41.]

Part V concludes the book by suggesting that "the key to righting the agency's course is to commit determination of policy to persons with broad vision and the interdisciplinary capability contemplated when agencies like the SEC were created in the heyday of the New Deal" (p. 276). Kripke thinks the present commissioners have this ability, but are shackled by three groups of technicians: the public accountants, the SEC's examining and interpretative staff, and its enforcement staff.

The public accountant, bemoans Kripke, has become a fourth party in "the trilateral disclosure system of issuer, investor and SEC" (p. 277). The author repeats his earlier arguments that the SEC, not the accounting profession, should determine accounting principles. The profession's influence should be cut back to areas where its financial sophistication would prove most valuable. For example, Kripke would value accountants' judgments on the inclusion of "soft information," such as projections of earnings and asset valuations in financial statements. But Krikpe doubts whether accountants will ever assume such a role until the SEC rids itself of its obsession with liability and discipline — an obsession that requires accountants to be policemen.

The SEC's examining and interpretative staffs could also unchain the commissioners' abilities, according to Kripke, by becoming more receptive to the inclusion of estimates and valuations in the disclosure documents:

> [The SEC's examining and interpretive staffs] support the tendencies of

the public accountants toward objectivity and reliability and for similar reasons — not liability, but protection against criticism, by their own supervisors or by Congress and the public. They recognize that one cannot be criticized for permitting verifiable statements to be made; but one could be criticized for having let "soft" information be published, if it later proved to be inaccurate, no matter how reasonable it might have originally appeared to be. [P. 282.]

Finally Kripke prescribes that the SEC should curb its enforcement staff. He attributes the current lack of meaningful disclosure largely to the staff's "infatuation with liability." This litigious atmosphere, he says, discourages innovation in disclosure devices. Further, the frequency of fraud does not justify the SEC's enforcement orientation:

I am not a Pollyanna who believes that there are no security frauds. There are plenty of them and — be it noted — they were there in the heyday of enforcement, before the Supreme Court started limiting Rule 10b-5. The volume of situations calling for enforcement against fraud or serious nondisclosure has been substantial and it is not suggested that the Commission's concern has not been justified. Yet those cases have been insignificant compared to the volume of legitimate and proper disclosure consistent with what people understood was required of them. The Commission has been wrong in letting the needs of enforcement and the enforcement mentality color its dealings with the law-abiding sector of society. It has loaded disclosure for everyone, e.g., the notices of Rules 144 and 146, management compensation, and so on, in the hope of hampering a few abuses. Its creativeness has been almost entirely in the area of enforcement. [P. 284.]

In the book's appendix, Kripke dismisses as a failure the report of the Advisory Committee on Corporate Disclosure, which the SEC appointed in 1976 to evaluate the present disclosure system. The Committee (of which the author was a member) failed because it ignored the possible impact of the new learning in the economics and accounting of the disclosure process. It did not rethink the fundamental premises and goals of the disclosure system. It thus shirked its principal mission.

The SEC and Corporate Disclosure poses a reasoned challenge to the fundamental concepts of the present system of corporate disclosure. The author's sweeping recommendations are sure to provoke lively criticism. For example, it may appear incongruous that Kripke should advocate greater SEC control over accounting principles, given his displeasure with the proliferation of SEC-mandated disclosure rules and procedures. Kripke explains the apparent inconsistency by arguing that, by wresting control of security disclosure from technicians like the public accountant, the Commission could take a fresh approach to the meaning and purpose of disclosure. But if the Commission has been narrow-minded in the past, how can anyone guarantee that it will broaden its view in the future merely because the role of the technicians is changed?

Any book that freshly analyzes a system long dominated by vested interests is bound to draw critical pot-shots. Fortunately, the criticism itself should stimulate reconsideration of the meaning of disclosure. As Professor Kripke has been telling us for years, such a rethinking is badly needed.