

MEMORANDUM REGARDING SECURITIES BILL—H R 4314

I am in favor of a substantial extension through the medium of a Federal statute of the protection afforded to investors in securities. I, however, recognize great practical difficulties and I am not disposed to rate too highly the results that will be immediately attained.

It is in the general social interest that new enterprises should be undertaken and it is not, therefore, in the public interest to make the provision of capital for such new enterprises unduly difficult.

It is an inevitable result of competition and the progress of invention that many enterprises new and old should become unsuccessful. Indeed, if an attempt were made to preserve the values of enterprises whose products have been superseded and at the same time the new and superseding enterprises were earning a fair return, the result would be that the burden on the fruits of industry of the contribution paid to those whose claims rest on past savings and investment would become greater than the community would be willing to bear. For either the total burden on consumers would become too great or the share of the fruits left for those making a current contribution to production in the form of labor, etc., would become inadequate.

The Congress must face the fact that a substantial percentage of industrial investment will in any event be lost. This seems to me (1) to make it the more incumbent on the Congress to see that investors have the opportunity to make their investments on the basis of reasonable information, but at the same time (2) to make it in the highest degree undesirable for the Congress to assume the responsibility of requiring any governmental agency to decide either what is the true value of any investment security or even that the information available to the investor is all that is necessary to enable him to make a wise decision.

Indeed, while it is desirable that such protection as is practicable shall be given to those who invest in securities whose value is dependent on the profits earned by the maker thereof, it is in my judgment even more important to facilitate and encourage investment of small savings in Government securities and other forms of holdings fraught with less risks and requiring less financial knowledge and less constant watchfulness than are necessary to even moderately successful commercial investments.

As I have indicated, I do not think the immediate practical results of the proposed legislation will be very considerable. A large proportion of the buyers of industrial securities are not investors, though they may think they are. They are not greatly swayed by the information given them, but are, I think, more generally influenced either by salesmanship or by general reputation either of the maker of the security or of the banking house issuing it. I am, however, hopeful that gradually the dissemination of better information will bring about an improvement in investment practice.

The problems to be solved in formulating legislation seem to me to be:

First, to determine the scope of the legislation;

Second, so to define the liability of directors and others as to impose penalties for fraud or culpable negligence without making the burdens so heavy that responsible persons will refuse to assume them and the business will pass into the hands of less responsible persons;

Third, to formulate requirements for proper disclosure by distributors of securities in respect of their compensation for and interests in the issue;

Fourth, to devise adequate but not unduly burdensome provisions for the disclosure of information relative to enterprises upon which securities are based.

With regard to the scope of legislation, I strongly favor limiting it, at least in the first instance, to original offerings of securities, though I see no objection to including in the provisions regarding such new securities requirements for proper periodical reports subsequent to the issue. I believe that the Act should contain exemptions so as to exclude from it transactions which are not offerings to the public. Such exemptions require very careful study and I do not feel that I have any special competence for recommending what they should be.

The formulation of provisions which will impose proper penalties on directors and others responsible for an issue without deterring responsible persons from accepting directorships is a delicate one. It seems to me to be clear that provisions such as those contained in the original House Bill under which directors would be responsible for errors in statements of fact of which they had no knowledge nor any reasonable means of knowledge would defeat the ultimate purpose of the law.

The problem of proper disclosure of interest does not seem to offer very great difficulty, but this, again, is a feature in regard to which I do not feel competent to make specific suggestions.

The disclosure of information is a problem, however, which presents very great practical difficulties. Among the most important information is that which is of an accounting nature, and it is particularly with this branch of the question that I feel my experience gives me some qualification to express opinions as to what is essential and practicable and what is not.

The first difficulty that I see in the problem of formulating requirements for information is the impossibility of determining what facts are most essential in each case. The second is, that much which is loosely regarded as matters of fact is in reality matters of opinion. The third is, that the inferences drawn from facts and the opinions based on them are usually more important than the bare facts themselves.

In so far as accounting information is concerned, it seems to me fundamentally important to recognize that the accounts of a modern business are not entirely statements of fact, but are, to a large extent, expressions of opinion based partly on accounting conventions, partly on assumptions, explicit or implicit, and partly on judgment. As an English judge said many years ago when business was far less complex than it is today. "The ascertainment of profit is in every case necessarily matter of estimate and opinion."

The most vitally important single factor in the value of a business enterprise is usually its future earning capacity. Such earning capacity may be estimated if someone is willing to prophesy, but usually the experience of the past is accepted as the best guide. What income is to be attributed to an accounting period of the past depends partly on accounting methods and partly on estimates. There is no escape from the use of conventions, because the income attributed to any period is not the fruit solely of actions and transactions within that period, but is affected by actions and transactions of the period prior thereto and the probabilities in respect of transactions in later periods. It is equally clear that estimates must be made and that they may prove incorrect even though made in the best of faith by the most competent persons. For instance, in order to arrive at the income for a given year it is necessary to estimate how long machinery in use will last and to place a value on unsold merchandise. But machinery capable of use for years may be rendered obsolete by new inventions perfected by others, the sale price of merchandise may be suddenly and vitally affected by a change in fashion, a revision of tariffs, development of cheaper methods of production, excessive production, distress selling by others, etc.

I would, therefore, stress the paramount importance of avoiding in the law anything likely to perpetuate the common misunderstanding that balance sheets and income accounts are statements of fact and of doing whatever is possible to bring home to the investor that in formulating all such accounts conventions and opinions necessarily play an important part, and that their value depends on the competence and integrity of those exercising the necessary judgment. To this end I should like to see either in the report accompanying the bill or in the bill itself a declaration of the purpose of the bill in so far as accounts are concerned which should be to insure (1) that, in balance sheets, the assets and liabilities shall be fairly classified; that the bases* on which the values are determined at which the assets are carried shall be fairly disclosed, and that a responsible person or persons shall have expressed an informed opinion that the balance sheet is fairly presented on the bases indicated and in accordance with acceptable accounting practice; and (2) that any statement of income shall be so framed, as in the opinion of competent and responsible persons, to constitute the best reflection reasonably obtainable of the earning capacity of the business under the conditions existing during the period to which it relates.

Since past earnings are significant to the investor only in so far as they are a guide to the future, it is desirable to do what can be done to safeguard the investor against statements of past earnings being put forward, as evidence of the value of a security, unless those putting them forward disclose all knowledge which they may have of changes of conditions which have already taken place that would make such past earnings wholly unreliable as a guide to the prospective future earnings. It is perhaps impossible to provide complete safeguards on this point, but I believe that something can be done in this direction.

The accounting information which should be required by the statute should, I suggest, include:

(1) A brief description of the general principles or methods of accounting regularly employed by the issuer in keeping its books and accounts and determining its income and financial position.

(2) A balance sheet or statement of assets and liabilities and capital of the issuer of the securities.

(3) A statement of income covering not less than three years, if the issuer has been so long in business.

(4) A declaration by the chief accounting officer of the issuer, or by an independent public accountant, that the balance sheet and statement of income are in his opinion, properly prepared on the basis of a fair and consistent application of the methods of accounting regularly employed by the company as described under subdivision (1).

(5) Special provisions to cover the case of companies operating through subsidiary corporations.

Such requirements would be substantially in accord with the recommendations of a committee of the American Institute of Accountants to the New York Stock Exchange which was favorably regarded by the Exchange and put in evidence by the chairman of the Committee on Stock List in the course of his testimony before the Senate Committee on Banking and Currency on January 12, 1933. They would constitute a distinct advance in practice.

Specific suggestions for provisions to be inserted in the bill in order to meet these requirements, which I had prepared, came to the attention of the Investment Bankers Association

* E.g. cost, reproductive cost less depreciation, estimated going concern value, cost or market whichever is lower, or liquidating value as of a specified date, etc.

of America and have, I am advised, been embodied, substantially as proposed, in amendments which have already been suggested to the Committees of Congress considering the bill, as follows (the notes are mine):

SUGGESTED SUBDIVISIONS OF SECTION 5 COVERING ACCOUNTING REQUIREMENTS

(5) A brief statement of the general principles or methods of accounting regularly employed by the issuer in keeping its books and determining its financial position and income.

NOTE:

This requirement contemplates not a detailed explanation of the technical accounting methods, such as is embodied in what is commonly known as a "classification" or "card of accounts," but a statement of the broad accounting principles followed by the issuer.

In the absence of some such statement of principles there is nothing to which a declaration such as is contemplated in the fourth suggestion regarding the correctness of the accounts submitted can be related.

The revenue acts since 1918 have uniformly laid down as the general basis for determining income that it shall be computed "in accordance with the method of accounting regularly employed in keeping the books of such taxpayer."

The general nature of the information to be given under this head is indicated in Exhibit II of the report of the committee of the American Institute of Accountants to the New York Stock Exchange previously mentioned. Some of the more important points to be covered are the following:

- (a) Upon what classes of property, on what basis and at what rates provision is made for, or in lieu of, depreciation;
- (b) Upon what basis inventories are valued—whether at cost or market whichever is lower, or on some other basis;
- (c) What classes of expenditures are deferred instead of being charged directly to income account and what procedure is followed in regard to the gradual amortization thereof; etc., etc.

(6) A balance sheet showing a classified statement of the assets, liabilities and capital of the issuer at the latest practicable date prior to the filing of the registration statement, showing on what basis of valuation the several classes of assets are stated. If the balance sheet is not in accordance with the general books of the issuer, or with any previously published balance sheet of the issuer, as of the same date, information shall be given showing in what respects it differs from said books or such previously published balance sheet.

NOTE:

While the basis of valuation of assets will be ascertainable from the statement of accounting methods, it seems desirable that the basis of valuation should be indicated on the face of the balance sheet so that the information will be as readily available to investors as possible.

No reference is made in this subdivision to contingent liabilities and obligations which may in effect constitute a liability which seriously affects the financial position. I have not found it possible to draw a specific provision which would meet all the possible situations satisfactorily, and I think it preferable to leave the point to be covered by the declaration that

the balance sheet fairly presents the financial position, which declaration could not properly be given unless items of this kind were adequately disclosed in the balance sheet.

(7) A statement with respect to the income of the issuer for the latest fiscal year for which such statement shall be available and for the two preceding fiscal years, or, if the issuer has been in business for a lesser number of fiscal years, then for the longest practicable period during which the issuer has been in business; and, if the date of filing of the registration statement shall be more than six months after the close of the last fiscal year for which such statement shall be available, a statement of the income from such closing date to the latest practicable date.

Such statement with respect to the income of the issuer shall show the income fairly attributable to each fiscal period covered thereby. The following items shall be shown separately: operating income; non-operating income; interest charges; income taxes, and other fixed charges. Items of income or expense which are of an exceptional character and are not likely to recur shall if they affect the net income reported to a material extent, be shown separately.

If the statement of income has not been prepared in accordance with the general books of accounts of the issuer, or with any previously published statement of income of the issuer for the same period or periods, information shall be given showing in what respects the statement of income differs from such books of accounts or such previously published statement of income.

NOTE:

This subdivision and the succeeding one require, I think, to be amplified to cover the case in which the business to be carried on by the issuer was, during a part of the preceding three years, carried on by a predecessor organization or organizations. In such cases, statements of income and changes of surplus of the predecessor organization or organizations should be required.

(8) A statement showing the changes in the surplus of the issuer during the period covered by the statement of income required under subdivision (7).

(9) A declaration by the Treasurer or one of the principal accounting officers of the issuer or by an independent public accountant or by independent public accountants that the balance sheet and the statement of income are in his or their opinion, correctly prepared on the basis of a fair and consistent application of the methods of accounting regularly employed by the issuer in keeping its books, and fairly reflect its financial position as of the date of said balance sheet and its income for the respective periods covered by said statements of income, except as may be stated in said declaration, and a declaration similarly signed, dated not more than ten days before the date of the filing of the registration statement that, as of such date, the signer had no knowledge of any change since the date of said balance sheet, except in the ordinary and regular course of business, in the character of the assets or the financial condition of the issuer which might adversely affect the securities proposed to be issued, except as may be stated in said declaration.

(10) Whenever the value of the security is dependent to a material extent upon the financial position or income of a corporation or corporations in which the issuer has a controlling interest, through stock ownership or otherwise, the registration statement shall include the same information regarding the assets, liabilities, capital and income of such controlled corporation or corporations (either separately or collectively) as is required in respect of the issuer by this

subsection, or in lieu of or in addition to such information in respect of the issuer, consolidated statements (containing like information) of the assets, liabilities, capital and income of the issuer and of any or all such controlled corporations as may be proper in the circumstances of the case.

NOTE:

This provision is made flexible so as to meet all the varied conditions that are encountered, including the cases not only of controlled companies that are substantially wholly owned, but controlled companies in which there are substantial outside minority interests.

As I have already indicated, I think the bill might well contain provisions for periodical accounting reports subsequent to the issue. I suggest the following:

1. Whenever, while an issue of securities to which this Act applies shall be outstanding, the issuer shall change the general principles of accounting employed by it or shall change in any material way the manner in which practical application is given to such principles, a full statement of the change shall be filed with the Commission within sixty days of the date on which such change becomes effective.

2. Any issuer of securities to which this Act applies shall so long as the securities shall be outstanding file annually with the Commission within ninety days from the close of its fiscal year statements in respect of its financial position at the close of such fiscal year and its income for the year, in such detail and form as the Commission shall prescribe, provided that the Commission may in its discretion extend the time for filing such statements in any case in which it shall be satisfied that it is not reasonably practicable for the issuer to file the required statements within the time prescribed by this Act; and provided, also, that the Commission shall not be empowered to require under this section any information which it would not be empowered to require in respect of a new offering of securities under Section 5 of this Act.

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The adoption of provisions such as I have suggested would, I believe, bring the requirements into accord with the best current practice, and all that would be necessary to meet the varied conditions that will arise would be to provide for the making of such detailed rules and regulations as might be necessary to give full effect to these provisions.

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