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CONGLOMERATES AND SECURITIES REGULATION: AN INTRODUCTION

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Commissioner Richard B. Smith of the Securities and Exchange Commission (SEC) suggests that conglomerates may be "mutual funds with smokestacks." The thought is a pregnant one for securities regulators. Smith refers to the growth of a class of professional money managers, trained in management principles that are not confined to a particular business. The thinking of these professionals tends to similar objectives, whether the men are part of mutual fund management or of conglomerate management. Their concern for diversification tends to make large corporations look increasingly like mutual funds; their concern for development of special situations tends to make mutual funds look increasingly like conglomerates.

In 1932, just before the first federal securities laws were enacted, Berle and Means, in *The Modern Corporation and Private Property*, pressed home a recognition of the divisions that had emerged between most corporate stockholders and corporate insiders. Such institutional concepts permeate the assumptions of the securities laws. The newly emerging institutions also present distinctive concepts and pose new problems; viable regulation requires recognition of these.

One basic consideration stems from the fact that conglomerate corporations are investors in securities which also, like mutual funds, usually sell their own shares to public investors. Unlike the average investor, the conglomerate may often pay for the securities which it buys, not in cash or property of a fixed value, but in its own securities, which can fluctuate in value according to public assessment of the profitability of conglomerate investment decisions. This introduces a complex form of leveraging into conglomerate investment. In addition, the investor (or his security analyst) buying shares in a conglomerate is presented with difficult problems in his efforts to make informed investment decisions.

In his article below, Jerome S. Katzin characterizes one form of conglomerate investment activity as the purchase of increased earnings per share. An increase in earnings boosts the price of the conglomerate's own shares. The process is made possible if the conglomerate is the beneficiary of popular expectations that it will grow, and therefore is awarded a high price-earnings multiple in the market. In this way it can use its securities to acquire companies with a lower earnings multiple, and can often pay a premium, for the combined results will show an increase in earnings for the conglomerate. The increase of course further tends to boost the price

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of the conglomerate's shares. This all works, so long as investors in the conglomerate's shares maintain their confidence.

It would seem that such purchases of increased earnings per share by conglomerates are not conducive to enlightened investment decisions, particularly when the investor must also cope with other flexible accounting practices. Such practices also threaten to create market instabilities because the leveraging is based on short-term increases in profitability of conglomerate shares which will last only so long as popular expectations keep up the price of the conglomerate's own shares. This point was perhaps driven home by the market decline of conglomerates during 1969. Such results run afoul of traditional securities law objectives.

The Commission's response to this problem thus far seems to have been principally in the accounting field. Commissioner Smith states that the Commission and the accounting profession have been requiring "pooling back" accounting treatment to reduce (but not eliminate) the distorting effect of pooled earnings per share. No one accounting method has yet managed to solve the distortion problem altogether, though the accounting profession is now considering methods that may have a substantial effect on the practice of purchasing earnings.

Considerable attention has also been given to the question of reporting divisional earnings, so as to minimize the masking of results in divisions through the pooling of reported earnings for the entire conglomerate. A. A. Sommer traces the history of efforts to this end, while David Norr, a financial analyst, notes the analyst's need for such data. Phillip E. Fess points out the opposition to divisional reporting within the accounting profession, which was overridden by the SEC regulations, and Mr. Sommer points to the opposition of management, which has expressed concern that data disclosed can be made available to competitors or unions, and also that it will make it harder for them to carry a losing division which is doing substantial research and development work. Though these objections may have substance, they are not dissimilar to historical objections to compulsory disclosure, and the SEC can be expected to press ahead despite them.

The recently enacted Williams Bill represents a response to a more general problem, the use of cash tender offers as a technique for the acquisitions and mergers by which conglomerates grow. Robert W. Haack, President of the New York Stock Exchange, outlines problems which the Williams Bill has not solved, to which the Exchange is now devoting attention. For example, when a takeover is being accomplished by an offer of securities rather than cash, the Williams Bill does not apply. While the investor may still receive information from the acquiring company in the form of a prospectus, a good many of the Williams Bill rules of fairness are not available. Mr. Haack gives examples of how the Exchange is trying to deal with this problem for corporations subject to its jurisdiction.

Acquisitions and mergers have presented another and increasingly troublesome problem in dealings between the professionals and the public, the issuance of complex packages of securities which public investors often find unintelligible. Mr. Haack refers to certain of these as "funny money" securities. There is no doubt that investors have trouble evaluating what Commissioner Smith calls a typical package of:

> (1) $45 principal amount of subordinated debentures, often bearing a curious rate of interest;
> (2) 3/5ths of one share of preferred stock, that has no public market; and
> (3) 3/10ths of a five-year warrant to purchase one share of common stock, at a specified price other than current market, all in exchange for two shares of common stock of the target company.

Mr. Haack says that the New York Stock Exchange will not list nonvoting common stock, and will review other securities carefully before listing them. But neither he nor Commissioner Smith set forth comprehensive solutions, and the problem will undoubtedly continue pending further study. It becomes increasingly difficult here to confine regulation on the theory that the seller has made disclosure.

There are a host of other questions which might be raised, beyond the scope of the present discussion. If conglomerates have increasingly become like mutual funds, to what extent should the policies of the Investment Company Act be applied to them through new legislation? If professional money managers are more alert to the true value of securities which the public has a hard time evaluating — such as the complex securities peculiarly leveraged by distorted earnings statements that accountants cannot correct — to what extent are the present restrictions on insider trading adequate to prevent the managers from taking undue personal or institutional advantage of the situation? Finally, and not least, how far should the money managers be permitted to expand their activities directly within the securities industry, as through the purchase of stock in member firms whose stock may be offered to the public.

These emergent institutions, conglomerates and analogous mutual funds, will keep legal planners and securities regulators busy for many years to come.