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CONGLOMERATES AND TAKE-OVERS

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To date our securities markets have functioned well enough to win the admiration of the western world and to become vitally important to our nation. Any adjustments in their operations must therefore be carefully administered, both by the financial community for their entrepreneurial objectives and by the Government for its regulatory responsibilities. Yet none can deny that the enormous changes occurring in the financial world must result in adjustments. The Government's response to the emergence of new business institutions and techniques must be both informed and measured; at the same time the welfare of public investors and the national interest must remain paramount for both the financial community and the Government.

The creation of conglomerates and the acquisition techniques associated with them are among the most visible of the changes. While a number of policy issues in the area of conglomerates and takeovers are outside the scope of the Securities and Exchange Commission, it is a subject of continual exposure, and one in which the financial community has a vital interest.

It is not difficult to establish the subject as being current. There has hardly been a recent edition of a newspaper or magazine in which some member of the financial press has not only reported, but also extensively commented on, conglomerates or corporate takeovers, or, more often than not, both. Most of the alphabet agencies of the Government have recently been faced with this phenomenon: not only the FTC and the SEC, but as conglomeration has reached into the regulated industries, the FCC, CAB and ICC. The Federal Reserve Board, Treasury and the Comptroller are concerning themselves with bank-involved conglomeration, the one-bank holding company,[1] while the Justice Department has taken a renewed look at the development of this merger hyperactivity.[2] Both houses of Con-

* Commissioner, United States Securities and Exchange Commission. The Securities and Exchange Commission, as a matter of policy, disclaims responsibility for any private publication by any of its members. The views expressed herein are those of the author and do not necessarily reflect the views of the Commission. This article was adapted from a speech given before the Central States Group of the Investment Bankers Association of America, Chicago, Illinois, March 19, 1969.

1 On Nov. 5, 1969, the House of Representatives, 91st Cong., 1st Sess., passed H.R. 6778, amending the Bank Holding Company Act of 1956. The bill is now under consideration by the Senate Banking and Currency Committee. *See* H.R. REP. No. 387, 91st Cong., 1st Sess. (1969); 115 CONG. REC. 10,545-75 (daily ed. April 6, 1969).

2 The Antitrust Division of the United States Department of Justice has brought five suits seeking to prevent proposed acquisitions by conglomerate corporations: United States v. Ling-Temco-Vought, Inc., Civil No. 69-438 (W.D. Pa., filed April 16, 1969); United States v. International Tel. & Tel. Co., Civil No. 69-6924 (N.D. Ill., filed April 28, 1969); United States v. Northwest Indus., Inc., 301 F. Supp. 1066 (N.D. Ill., 1969); United States v. International Tel. & Tel. Co., Civil No. 13319 (D. Conn., filed Aug. 1, 1969),

gress have called hearings on various aspects of the conglomerate merger trend.[3]

Nor is it difficult to see why so much attention has been generated by this topic. Since the end of World War II, particularly since the early 1950's, there has been an almost uninterrupted merger movement in our economy — the longest sustained period of economic consolidation in our history. Rather than subsiding, the movement has continued, with 1967 exceeding even 1899 and 1928 for the largest number of recorded mergers in the manufacturing sector.[4] And 1968 saw 68 percent more mergers than in 1967.[5] Although the significance and meaning of the statistics have been questioned, the FTC has stated that in 1968, 90 percent of the assets acquired in all acquisitions of companies with assets of $10 million or more were conglomerate in form.[6]

There is, I believe, a second factor in the arousing of attention to the conglomerate merger — the combined facts that an increasing number of these acquisitions have not been particularly friendly, and that the size of the target companies has become progressively larger. It is unrealistic to think that the management of large target, or potential target, companies who want to resist take-over attempts would fail to point out to all branches and agencies of government the policy issues they see involved in such activity. And in the background, or maybe not in the background, is the fear — some call it real, others call it unreasoning, and yet others say it is inevitable — that the resulting economic concentration will lead to an economy in which this country's productive machinery would be controlled by an elite of super-corporations resembling the Japanese zaibatsus. Clearly the subject is alive and questions are being asked about this intensified conglomeration phenomenon — the popular practice of combining diverse, if not divergent, enterprises into a hopefully viable economic organization.

One might think that by this time everyone would know what a "con-

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prelim. inj. denied (Oct. 21, 1969); United States v. Hartford Fire Ins. Co., Civil No. 13320 (D. Conn., filed Aug. 1, 1969), *prelim. inj. denied* (Oct. 21, 1969).

3 Hearings on the subject of economic concentration were commenced by the Senate Committee on the Judiciary, Subcommittee on Antitrust and Monopoly, during the 88th Cong., 2d Sess., July 1, 1964. Additional hearings are planned during the 91st Cong., 2d Sess. *See Hearings on Economic Concentration before the Subcomm. on Monopoly of the Sen. Comm. on the Judiciary*, 88th Cong., 2d Sess., pts. 1-8A (1964).

The House Committee on the Judiciary, Subcommittee on Antitrust and Monopoly, commenced hearings on July 30, 1969. Hearings were held July 30-31, Aug. 6-8 and Nov. 20, 1969. Additional hearings are planned during the 91st Cong., 2d Sess.

The House Committee on Ways and Means heard testimony March 12, 1969 on conglomerates during its hearings on tax reform. *See Hearings on the Subject of Tax Reform before the House Ways and Means Comm.*, 91st Cong., 1st Sess., pt. 7 (1969).

4 Address by Harrison F. Houghton, Seminar on New Development in Mergers and Acquisitions, Advanced Management Research, Inc., New York City, Sept. 19, 1968, at 6 (mimeo).

5 BUREAU OF ECONOMICS, FTC, STAT. REP. NO. 3, CURRENT TRENDS IN MERGER ACTIVITY, 1968, at 1 (1969).

6 *Id.* at 3.

glomerate" is. Yet, there are hotly contested arguments about that, in no small part because the term has become too pejorative for those who defend the trend or too imprecise for those who seek to be as objective as possible in their analysis of it. This latter motivation led Professor Mautz, in his comprehensive study of financial reporting published in late 1968 by the Financial Executives Institute, to use the term "diversified companies."[7] For purposes of financial reporting, Professor Mautz treated as a "diversified company" one that either is so managerially decentralized, so lacks operational integration, or has such diversified markets that it may experience rates of profitability, degrees of risk, and opportunities for growth which vary within the company to such an extent that an investor requires information about these variations in order to make informed decisions.

With some variation that is essentially the definition the SEC proceeded on in proposing its new rules for disclosure by companies which, in the Commission's words, "are engaged in more than one line of business."[8] The Commission stated that in grouping products or services as lines of business, appropriate consideration should be given to all relevant factors, including rates of profitability of operations, degrees of risk, and opportunity for growth. I shall come back to our requirements later, but one should note that these definitions for purposes of financial reporting do not relate to how the conglomeration or diversification occurred, whether by internal growth or external acquisition.

The FTC, on the other hand, has made use of the word "conglomerate" in defining the type of acquisition or merger that is neither horizontal (between competitors) nor vertical (between supplier and manufacturer or manufacturer and distributor).[9] These two types of mergers, horizontal and vertical, dominated the previous periods of major economic consolidation in American industrial history — the first of which peaked around the turn of the century and the latter in the late 1920's. As the former Acting Director of the FTC Bureau of Economics pointed out, there were some "conglomerate" mergers in the 1920's, but these were of either the product extension or market extension type, unlike the "free form" type that predominates today. Mr. Houghton, who has defined a conglomerate as "a firm which is engaged in a number of industrial activities serving more or less distinct markets,"[10] has stated:

> It's a question of degree. It could be said that the less a firm is dependent

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[7] R. MAUTZ, FINANCIAL REPORTING BY DIVERSIFIED COMPANIES (1968). The term "diversified companies" was also preferred by the Accounting Principles Board of the American Institute of Certified Public Accountants in its release on disclosure of supplemental financial information. AICPA, *Disclosure of Supplemental Financial Information by Diversified Companies*, APB STAT. No. 2 (1967).

[8] *See* SEC Releases, note 25, *infra*.

[9] *Hearings Before the House Ways and Means Comm.*, 91st Cong., 1st Sess., 2410 (1969) (remarks of Dr. Willard Mueller).

[10] Houghton, *supra* note 4, at 8.

> on any one or a few lines of activity for its economic welfare and the longer and wider the number of its products or its geographic markets, the more conglomerated it is.[11]

Thus, for the FTC's purposes of maintaining competition, and of engaging in an in-depth study of the economic efficiency justification for the reduction in the number of independent business units that conglomeration results in, there is again a certain vagueness or flexibility in defining the phenomenon.[12]

Conglomerates have been given yet another suggestive description that bears some pondering. Someone has called them "mutual funds with smokestacks." There is at least an analogy, and perhaps a correlation, between the institutionalization of investors and the conglomeration of corporations. There is certainly a time span coincidence between the concentration of investment decision-making into the hands of managers of larger and larger capital funds, and the concentration of capital allocation decision-making into the hands of managers of larger and larger conglomerates. At the same time that individual investors were purchasing diversification in mutual funds, they, and the institutional investors, were voting their approval of, or accepting tender offers for, diversification in conglomerates. As fund managers are allocators of external equity among a wide range of choices, so in a primary sense are conglomerate managers allocators of internal equity among a now wide range of choices. Both movements are big. In the 8 years since 1960 investment company assets grew by $46 billion[13] while the assets of conglomerate companies grew by about $30 billion.[14]

The almost side-by-side occurrence of institutionalization in the securities markets and conglomeration in industry is some indication that there may be underlying motivations in our society that have produced them both. For example, both funds and conglomerates rely and promote themselves on managerial professionalism and attention to technological innovation. This in turn reflects the unique contribution of this country's business schools to the industrial, or as some call it, post-industrial, system. In inquiring into institutionalization and conglomeration, any thoughtful treatment will have to take account of the immense educational substructure that is creating the new managerial class, and teaching, in effect, that principles of management are not limited to a particular business. Account will also have to be taken of the implications of the computer technology that significantly expands management's capabilities for both internal and external investment. While some commentators have focused on the colorful individuals in charge of some of the more aggressive conglomerates, I am suggesting there is more to the phenomenon than personality.

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11 *Id.* For a critical view of the *Report*, see statement by Harold S. Geneen before the House Antitrust Subcommittee, Nov. 20, 1969, *supra* note 3.

12 The study has since been published: BUREAU OF ECONOMICS, FTC, ECONOMIC REPORT ON CORPORATE MERGERS (1969) [hereinafter cited as FTC REPORT].

13 34 SEC ANN. REP. 115 (1968).

14 FTC REPORT at 356.

Analogy or correlation, such as is suggested here between institutionalization and conglomeration, is not analysis and can be carried too far — there are differences. And so only one other possible connection might be mentioned. The existence of large portfolio positions in some institutional hands may well have facilitated the ability of conglomerates to acquire companies held in those portfolios. The current emphasis by many institutions on short term performance probably results in a special receptivity on the institutions' part to the instant capital appreciation that the public tender offer techniques produce. Indeed, it can become a cause for concern to corporate managements when they see substantial institutional stockholdings develop in their company — a very different reaction from the prior, almost universal satisfaction of managements about "strong" institutional interest in their securities.

There is even an interesting definitional question with which the SEC has been confronted. If a corporation falls within one of the technical definitions of an investment company in the 1940 Act,[15] it becomes subject to all the requirements of that Act, including the rigid and detailed provisions regulating capital structure.[16] Where any corporation owns or proposes to acquire "investment securities"[17] having a value exceeding 40 percent of the value of its total assets, it may fall within the definition of an investment company. The Commission is therefore faced, from time to time, with the question of whether an aspiring conglomerate has become an investment company, particularly when a smaller company acquires securities of a larger company and it is not controlling and directing the affairs of the target company. The question might be framed as whether the conglomerate has lost its smokestacks.

The corporate financial landscape does take on a curious aspect when

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15 54 Stat. 797 (1940), *as amended*, 15 U.S.C. § 80a-3(a) (1964). An "investment company" is defined as any issuer which:

(1) is or holds itself out as being engaged primarily, or proposes to engage primarily, in the business of investing, reinvesting, or trading in securities;

(2) is engaged or proposes to engage in the business of issuing face-amount certificates of the installment type, or has been engaged in such business and has any such certificate outstanding; or

(3) is engaged or proposes to engage in the business of investing, reinvesting, owning, holding, or trading in securities, and owns or proposes to acquire investment securities having a value exceeding 40 per centum the value of such issuer's total assets (exclusive of government securities and cash items) on an unconsolidated basis. *Id.*

For purposes of the Investment Company Act, the term "security" is defined as:

any note, stock, Treasury stock, bond, debenture, evidence of indebtedness, certificate of interest or participation in any profit-sharing agreement, collateral-trust certificate, pre-organization certificate or subscription, transferable share, investment contract, voting-trust certificate, certificate of deposit for a security, fractional undivided interest in oil, gas, or other mineral rights, or, in general, any interest or instrument commonly known as a "security," or any certificate of interest or participation in, temporary or interim certificate for, receipt for, guarantee of, or warrant or right to subscribe to or purchase, any of the foregoing.

54 Stat. 790 (1940), *as amended*, 15 U.S.C. § 80a-2(35) (1964).

16 *See* 54 Stat. 817 (1940), *as amended*, 15 U.S.C. § 80a-18 (1964).

17 *See* note 15 *supra*.

viewed through its tiers of financial intermediation. It serves to show the distance we have traveled from the days when the only non-farming investment opportunity for someone who had saved would either be in his own business or in another single product-local market enterprise, almost always owned and operated by someone he knew. Today, a saver might purchase shares in a mutual fund (or even a financial vehicle that in turn purchases mutual fund shares). The mutual fund, in its turn, in addition to allocating its portfolio through a number of industries, invests a significant portion of its assets in conglomerate companies. They in their turn allocate their capital through a number of industries. Thus, the distance from saver to ultimate investment in real assets is lengthened, and the role and complexity of the intervening financial assets are enlarged. Whether that is the ultimate in economic efficiency or in investment risk aversion I do not know, but it is a profound fact that underlies today's discussions on conglomeration.

The questions are not simple — nor do they suggest simplistic treatment. At least until all the evidence is in, it would seem premature to lump all conglomerates together and classify them as harmful. The SEC's concern, of course, does not reach the broader economic policy questions encompassed in the antitrust and tax laws or in the substantive statutes regulating particular industries.[18] The securities industry may have its version of the conglomerate problem bound up in the questions of institutional membership on the exchanges and public ownership of member firms. But those questions also involve other considerations. In any case, the focus here is on industrial conglomerates and the manner in which they are being assembled.

The Commission's contact with the current conglomerate phenomenon occurs at several junctures: I shall refer to just two. The first occurs when a tender or exchange offer is made. If securities are being offered in exchange for those of a target company, the tenderor must file a registration statement under the Securities Act of 1933,[19] which provides information not only about the tendering company but also the target company. The offer cannot be made until the registration statement becomes effective.

18 There is another statute administered by the Commission that should be kept in mind — the Public Utility Holding Company Act of 1935, 49 Stat. 2393. That statute is the most drastic financial legislation ever enacted by the Congress. The SEC's administration of the 1935 Act involved the simplification of the complex, watered and highly leveraged capital structures of public utility holding companies and integration of the public utility systems. The integration requirements led to the divestment of both geographically dispersed utility properties and of non-utility businesses that were not reasonably incidental or economically necessary or appropriate to the operations of the integrated utility system. While not suggesting that contemporary conglomerates have brought us to this point, the 1935 Act does remind us that if things go far enough, the legislative remedy can be severe.

19 48 Stat. 77 (1933), *as amended*, 15 U.S.C. § 77a (1964). An exchange of shares constitutes a sale for purposes of the 1933 Act. 48 Stat. 74 (1933), *as amended*, 15 U.S.C. § 77b(3) (1964).

When cash is being offered, the tendering company, upon announcing the tender offer, must immediately file with the Commission an information statement under the 1968 take-over legislation.[20] Under either procedure the news of the impending take-over bid is likely to hit stockholders, and investors generally, with trip-hammer suddenness.

The announcement of a tender offer is generally accompanied by a dramatic rise in the price of the target company's securities, considerable market activity by speculators and arbitrageurs, and general confusion on the part of the target company's stockholders and employees. If one of the purposes of the securities legislation is to make the investment decision as rational a one as possible, it is difficult to imagine an atmosphere less conducive to rational thinking than the heat and haste generated by tender offers. Particularly where complex securities packages are being offered, the time generally provided for investors to reach a decision hardly seems sufficient. And the pressure on the management of the target company to present its case in time to offset the impact of surprise is enormous. This hardly seems conducive to rational investor decision on the merits.

Also, there is general concern over the use being made in takeover bids of complex securities, or complex packages of securities. A typical exchange offer might consist of a proposal to issue a package of securities consisting 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 1 share of common stock, at a specified price other than current market, all in exchange for 2 shares of common stock of the target company.

Such a package must be a little difficult to evaluate!

The stockholder of a target company may also experience difficulty in evaluating the relative rights of the securities being offered to him — relative to those of the other outstanding securities of the acquiring company. To cite an example of the type of analytical problem confronting stockholders, a prospectus filed with the Commission by one conglomerate company contains a five page capitalization table, including detailed footnotes.

Securities with a conversion feature have been increasingly used in exchange offers, and such a feature may also prove difficult to evaluate. Of the $11.2 billion worth of securities registered for the purpose of exchange offers in 1968, $4.8 billion represented convertible bonds and convertible preferred stock, compared to $4.6 billion in straight common.[21] The trend

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[20] 82 Stat. 454, 15 U.S.C. § 78m(d)(e) (Supp. IV, 1968); 82 Stat. 456, 15 U.S.C. § 78n (d)(e)(f) (Supp. IV, 1968).

[21] Unpublished data obtained from Securities and Exchange Commission, Office of Policy Research.

is toward the use of convertible bonds. In the last quarter of 1968, securities in the amount of $3.2 billion were registered in connection with exchange offers, of which $1.7 billion, or more than half, represented convertible bonds.[22]

The utilization of convertible debt securities may appear to be the best of all possible worlds, securing for the acquirer the advantages of both debt and equity. But as SEC Chairman Budge has pointed out, it should not be forgotten that convertible debt securities may also have some of the disadvantages of both. If a conglomerate continued to expand via the debt-leverage route, it might impose new classes of senior securities ahead of the current issue and become so heavily leveraged that the security offered by a debt position becomes illusory. The advantage of the conversion privilege may also prove illusory, both because inflated expectations for future growth of the acquiring company may have been created by the current acquisition techniques, and because the security holder may not realize the potential dilution if other convertible security holders convert into shares of the same class.[23] Moreover, in some convertible debt issues it seems impossible that the debt could be paid off as debt.

The increasing use of debt for acquisitions is also true in cash tender offers. In the 72 cash tender offers filed with the SEC between August 1968 and the end of June 1969, more than $1.6 billion of the total $2 billion offered was financed by bank loans.[24]

One consequence of the increase in debt financing is that companies with free liquid assets have become popular as targets for takeover bids. Upon acquisition the liquid assets can be pledged by the acquiring company to secure funds for further acquisitions or to partially liquidate loans made to acquire the target company. While high debt-equity ratios are not necessarily bad, they are legitimate cause for concern if the reason for incurring long-term debt risk is to achieve short-term capital appreciation in a company's stock by structuring a glamorous earnings per share multiple.

This leads to a second point of Commission contact with conglomeration — in the resulting financial statements of the conglomerate company. This concern about the conglomerate's financial statements encompasses both the accounting treatment given to the acquisition or merger, and the disclosure of income information, with respect to the acquired business after the acquisition is consummated.

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22 *Id.*

23 Another practice which has been used to create the illusion of an increase in earnings per share is the failure of some companies to include convertible securities and the other so-called "common stock equivalents" in the computation of earnings per share. The APB has stated that all securities including warrants and options that are substantially equivalent to common stock should be included in a primary earnings per share figure, and a supplemental fully diluted earnings per share figure to show the maximum potential dilution of current earnings by any other securities on a prospective basis must be given. AICPA, *Earnings Per Share*, APB OP. No. 15 (1969).

24 *See* note 21 *supra*.

The accounting treatment problem relates to whether the merged companies are combined for accounting purposes through the "pooling-of-interests" method or the "purchase" method. If the former method is utilized, the accounts of the two companies are, in substance, added together with no reflection of the current fair value of the assets acquired or the full cost of acquisition, even where one of the pooled corporations is 9 or 10 times the size of the other. If the acquiring company has a higher price earnings multiple than the acquired company and the exchange is negotiated on that basis, the mathematical result is that the combined enterprise will show an increase in earnings per share, even though there has been no improvement in real earnings. The Commission and the accounting profession have dealt with this mathematical result of pooling on computation of earnings per share by requiring a restatement of the prior year's per share earnings on the same basis as the present year's, having the mathematical effect of increasing the prior year's also, and thereby flattening out what would otherwise be a sharp upward trend in earnings per share.

Unfortunately, the purchase method is not without its problems either. The amount paid for the target company is nearly always greater than the current fair value of its assets. The excess is treated in the accounts of the acquiring company as goodwill, and the problem becomes what to do with this large intangible item. Accountants argue over whether such goodwill can be left on the books forever, must be written off immediately against surplus, or must be amortized against income over some period of time. The pooling-purchase accounting problem is currently being worked on intensively by the APB and the Commission has a deep interest in a proper result there.

The problem with regard to future disclosure of information about the acquired business was the subject of the Commission's amendments to Forms S-1, S-7 and 10, proposed in September 1968, revised in February 1969 and adopted in July 1969.[25] The revised forms provide investors with financial information about the important components of a conglomerate enterprise. Briefly stated, the amended forms require diversified companies with total revenues over $50 million to disclose for each of a maximum of 5 fiscal years beginning with 1967 the approximate amount or percentage, attributable to each line of business meeting certain size standards, of (i) total sales and operating revenues and (ii) contribution to income before income taxes and extraordinary items. The lines of business that must be so reported are those that contributed, during either of the last two fiscal years, 10 percent or more to (i) total sales and operating revenues or (ii)

[25] The original proposals were contained in SEC Securities Act Release No. 4922 (Sept. 4, 1968), and the revised proposals in SEC Securities Act Release No. 4949 (Feb. 18, 1969). The proposed amendments were adopted by the Commission in SEC Securities Act Release No. 4988 (July 14, 1969).

income before income taxes and extraordinary items. Similar disclosure is also required with respect to any line of business which resulted in a loss of 10 percent or more of such income before deduction of losses. Where the number of lines of business exceeds 10, the disclosure may be limited to the 10 most important lines.

The new forms, which constitute an important advance in corporate disclosure, should help to provide investors with information about conglomerates that is needed to test in part the validity of an often cited reason for their creation, the theory of synergism. In its corporate context this theory implies that the total capabilities of a conglomerate exceed those of the sum of its constituent parts. That sounds impressive, a little mysterious perhaps. The new forms are a step in the direction of removing some of the mystery by providing information about the parts.