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FINANCIAL REPORTING IN A TROUBLED INDUSTRY

REMARKS BY

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COMMISSIONER

SECURITIES AND EXCHANGE COMMISSION

NATIONAL ASSOCIATION OF REAL ESTATE
INVESTMENT TRUST'S ANNUAL ACCOUNTING
AND TAX CONFERENCE
BERMUDA
June 5, 1975

FINANCIAL REPORTING IN A TROUBLED INDUSTRY

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Securities and Exchange Commission

Perhaps no industry has demonstrated as dramatically the incredible speed at which fortunes in our economy may change, prosperity switch into deep depression, and troubles mount and multiply. While the roots of your industry go back to 1960 when Congress enacted Sections 856 – 858 of the Internal Revenue Code, which provided for tax treatment of real estate investment trusts on a basis similar to that accorded mutual funds, nonetheless the most explosive growth of your industry occurred between 1968 and 1973. In 1968 the assets of the real estate investment trusts in this country aggregated about $700 million; by 1973 this amount had skyrocketed to more than $21 billion. In 1971 over $1.6 billion of REIT securities were publicly offered; during 1974 this figure had dropped to less than $200 million. Where once sources of credit and money seemed virtually unlimited, both in amount and variety, by 1974 most of these sources had dried up and the scramble for funds was desperate and usually unavailing.

Rarely has an industry in this country blossomed as fully as the REIT industry and then run into such tremendous peril and trouble in so short a period of time. Your troubles have had impacts in many quarters. As a consequence of the significant commitments of banks to REITs, the Commission has had to question, when bank holding companies have sought to register securities with it, the extent to which the finances and prospects of the holding companies may be adversely affected by credit

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extended by their bank subsidiaries to REITs. As you know this has created substantial controversy which now hopefully is on the way to resolution. Two weeks ago the Commission cleared and declared effective the registration statement of the Manufacturers Hanover's holding company which included extensive disclosure with respect to the status of loans to REITs. Among the information included in that registration statement, which was comparable to the information that had been contained in the Chemical Bank holding company prospectus a few weeks earlier (that offering aborted for various reasons), was data concerning the extent to which credit had been extended to REITs, the status of the loans, the extent to which interest was being accrued, and so on. While everyone is quite aware that the disclosures in the Manufacturers Hanover prospectus are not intended to be definitive or necessarily a pattern for the future, I think it is significant that a mode of disclosure was worked out in this case which was satisfactory to all parties. The Manufacturers Hanover offering has been postponed because of market conditions, but there is no evidence that this information was over-dramatized, or misinterpreted, or given a weight evidencing misunderstanding on the part of analysts.

One of the most difficult problems that we all experience with regard to the disclosure system we have in this country is the adaptation of it to new and changed circumstances. Unfortunately – perhaps from a different perspective, fortunately – all of the answers to our problems are not contained in the statutory mandates under which we operate.

That mandate itself has only been fulfilled gradually. For reasons that are somewhat obscure in history, despite evidence that there had been significant abuses in the trading markets and on the exchanges during the years prior to 1933, Congress addressed itself first to the problem of disclosure in connection with distributions of securities and left until 1934 action with regard to a continuing system of disclosure. Notwithstanding Congress' intention that there be a continuous reporting system, it was not until the mid and late sixties that the problem was addressed in depth. As a consequence of the Wheat Report, the Commission has steadily sought to devote increasing amounts of its resources to the examination of the periodic filings, with the hope that in time they may rival in quality and integrity the ’33 Act filings which are customarily prepared with the precision of a diamond cutter and mulled by our staff with the care of a Talmudic scholar.

And yet, all of these efforts would in my estimation fall short of the mark were it not for a most fortuitous development in 1942, a development that has made the process of disclosure and integrity in the marketplace a greater reality than it would otherwise have been. This development was the adoption of Rule 10b-5.

Section 10(b) of the 1934 Act provides simply that “it shall be unlawful for any person directly or indirectly by the use of any means of instrumentality of interstate commerce or of the mails, or any facility of any national securities exchange…to use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.”

Little use was made of this section until 1942; during the years preceding that, three rules were adopted under it and all of them were relatively narrow in scope and impact. However in 1942, in an effort to deal with a particular situation that had developed involving fraud in connection with the purchase of securities, the Commission quickly incorporated in a rule under this section the substantive provisions contained in Section 17(a) of the 1933 Act and extended them to fraudulent or manipulative conduct in connection with the purchases as well as the sale of securities.

Rule 10b-5 provides the basis for assaulting all sorts of deceptions in the marketplace, efforts to move the market with false or misleading information, and the massive varieties of chicanery that constantly imperil investors. Most important perhaps, it has provided the seed from which there is springing a disclosure system that is truly current, one that keeps the market constantly and fully informed.

No matter how timely a report is filed with the Commission, it still may only convey information that has become relatively old even before the filing and millions of dollars of securities may have been traded between the time of the event and its disclosure in the filing. The most timely report filed with the Commission is the Form 8-K which must be filed within 10 days after the end of the month in which an event has occurred that requires such filing. If the event in question occurred early in the month then as many as 35 or 40 days might pass before the disclosure is made in the files of the Commission – and of course then it may be some period of time before that information is picked up and widely disseminated. Furthermore the Form 8-K does not make mandatory the release of all material information; rather it describes in twelve items specific information which must be disclosed on the form and then it provides a catch-all permitting, but not mandating, the disclosure of any other material events that have occurred during the month.

If the disclosure system that we had developed in this country were bounded in its entirety by the formalities of the system calling for filing at the Commission, I would feel that we had fallen considerably short of developing an adequate system. The constant goal of any disclosure system must be the development of a truly efficient market, that is, a market in which all material information is available promptly to all participants so that the market, at any given moment, will reflect all of the material facts concerning the issuer. This can hardly be the case when information trickles into the market at varying intervals after the event, is only sporadically disseminated, is questionable as to adequacy and completeness. A satisfactory disclosure system must assure that information is complete, accurate, and perhaps above all, timely.

While the Commission has not articulated rules that mandate immediate disclosure of all material information, the exchanges have been demanding in this regard. The exchanges, notably, the New York Stock Exchange and the American Stock Exchange, have elaborated standards with regard to the kind of information which should be promptly disclosed and the manner in which disclosures should be made. Particularly noteworthy in my estimation is the publication by the American Stock Exchange in which this matter was discussed with great sophistication and particularity.

From a strictly legal standpoint there is not flat requirement that a corporation make a prompt announcement of all material developments in its affairs. It has been explicitly recognized by the courts, principally in the Texas Gulf Sulphur case and in Financial Industrial Fund v. McDonnell Douglas Corp., that there may be good business reasons for non-disclosure. In the Texas Gulf Sulphur case the court said in a dictum, that such a reason was present when the corporation was engaged in buying up properties and leases near a major mineral discovery, an effort that might have been frustrated or at least become considerably more costly had it been disclosed that the discovery had been made. In the McDonnell Douglas case, the court held that a short delay in disclosing adverse earnings information was justified because of the necessity of checking to ascertain the accuracy of the information. Implicit in this dictum and this opinion, obviously, is the thought that absent a sufficient business reason a corporation may not withhold information from the marketplace and that the failure to make prompt disclosure of material information, absent good reason, may constitute a violation of the federal securities laws.

It is not difficult to develop both an economic and legal theory to sustain this approach. From an economic standpoint, investment decisions are made constantly day-by-day; they are not postponed to await the disclosure of information that might be in a 10-K or 10-Q or an 8-K. Rather they are made on the basis of the information that is available at the moment in the marketplace, and quite obviously, those decisions are going to be better informed, more economically relevant if all material information is available to the one making the decision. Any departure from standards of accuracy, completeness and timeliness lessens the efficiency of the marketplace, distorts the integrity of the forces established there, and creates leads to uneconomic decision-making. In addition it creates the opportunities for such abuses as misuse of inside information.

From a legal standpoint, it is not difficult to determine that a failure by a corporation to make a material disclosure with regard to any matter has the effect of making other disclosures previously made misleading, and thus violative of Rule 10b-5, clause two, which states that it is unlawful "to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading". A court might also easily find a violation of other clauses, e.g., that the failure to disclose operated or would operate as a fraud or deceit. If previously a corporation has reported a favorable earnings trend and that trend is suddenly reversed, or is damaged by an event, it is not an undue stretch of the law to determine that the failure to make that disclosure renders statements previously made misleading or that such a failure is fraudulent or deceptive. Thus I would have to say that any corporation which fails to make prompt disclosure of adverse information concerning its affairs – and for that matter a corporation which fails to make favorable disclosure as well – may be incurring considerable risk of violating Rule 10b-5.

Obviously the difficulty in deciding to disclose adverse information is much greater than deciding to disclose favorable information. There are circumstances, I'm sure, in which a corporation is reluctant to make disclosure of favorable information – for instance, reporting sharply increased earnings at a time when labor negotiations are going on can obviously make that process somewhat more difficult. However generally when there is hesitancy to make disclosures, it is at a time when there are adverse developments. Very often the rationales that are relied upon to justify postponement of adverse disclosure seem eminently reasonable. Perhaps the adversity is temporary and may be quickly overcome; for instance, a corporation finds itself in default under a loan agreement, it is engaged in negotiations for a waiver, but has no certainty that the waiver is going to be granted on satisfactory terms. Should the disclosure be made at the time of default or when it becomes evident that a waiver is not going to be available? Similarly it may be hoped that a quarter's dip in earnings will be made up during subsequent periods, with the results for the year showing an increase over the previous year. If this is a reasonable hope why should not the issuer be permitted to forego disclosure of the adverse earnings (putting aside for one moment legal requirements relating to disclosing interim results), especially when frequently the market treats momentary lapses of that sort very harshly and over-reacts to them? When a corporation is experiencing a liquidity crunch and is extending the period for payment of bills, a disclosure of this fact will simply exacerbate the plight in which it finds itself and may hasten the ultimate demise of the firm.

Unquestionably the results of the disclosure system may be harsh with respect to a particular enterprise. However, a judgment to defer disclosure of adverse information because "things will get better" or because perhaps the bad can be packaged with the good is a dangerous course. All of us know the unpredictability of the business world and there can be little if any assurance that adverse information today will turn into good news tomorrow. And even if an adverse trend does correct itself, still there will have been investors who before the upturn made investments who would be able to contend, and with some justification, that had the information been in the marketplace they would not have paid as much for securities as they did and consequently were harmed even though the adversity may have been of a transitory nature.

The danger, of course, is not confined to private litigation. The Commission has extensive power to initiate enforcement proceedings to remedy disclosure shortcomings.

It can bring an action for an injunction in the federal court and upon appropriate proof the court will in most cases place the erring issuer under an injunction again future violations. As you undoubtedly recall, the Commission brought such an action against an REIT which had failed to file its Form 10-K at the time required. The court in that action issued an injunction ordering the trust to file its reports in timely fashion for a period of twenty-five years. A failure to abide by that order could result in a finding of contempt of court, not a pleasant prospect.

In addition to the possibilities of civil litigation in the event a corporation or trust fails without sufficient reason to disclose material information, the Commission has the power pursuant to section 12(k) of the 1934 Act to suspend trading for ten days if "…in its opinion the public interest and the protection of investors so require…" The Commission can exercise this power summarily, without notice and without hearing; furthermore, it can, and often does, renew the ten-day suspension if the reason for the original suspension continues.

The Commission has frequently invoked this power if it had information indicating that there is a trading market for a security and that there is a deficiency of information in the marketplace – either material information has not been disclosed or the information circulating in the marketplace is incorrect.

Obviously this is a considerable power and one that the Commission can and should use only when there is a high degree of certainty about the facts upon which it proposes to act. During my time at the Commission this power has been exercised responsibly and cautiously. It is, as I imagine is apparent, a potent means of bringing about prompt disclosure, although I suspect most issuers are not aware that it can be used, and has been used, to force into the marketplace information that had been previously undisclosed.

If the Commission were to interpret its mandate to require prompt and full disclosure, which in turn serves its broader mandate to assure fair and efficient markets, in a manner that involved delicate balancings of the interests of those who might be harmed and those who might be helped by requiring a given disclosure, in my estimation the system would soon weaken and become bogged down in intolerable delays and confusion. It is never pleasant to require a disclosure that you know is going to adversely affect the market price of stock, drop the values of institutional portfolios, disillusion and perhaps harm seriously the financial fortunes of countless individuals. And yet the risks of such happenings are inherent in the investment process. I do not think the Commission, or issuers for that matter, should gamble on expectations of recovery somewhere down the road, or on the hope that good information will balance the impact of bad, or engage in nice philosophical debates over whether information is really material or not. Companies whose shares are traded in the public marketplace – and shareholders of such companies – must recognize that any business disadvantages that may exist in making such disclosures are simply one of the costs of being a public company. The commitments involved in public reporting were equally to the interests of potential shareholders as to current shareholders.

Materiality, of course, is the core problem: when is something material? There is no simple or easy test, though, of course, the Commission and the courts have of necessity sought to articulate standards. The one most commonly referred to today is that stated in the <u>Affiliated Ute</u> case decided in 1972 by the United States Supreme Court. The court there said,

> "All that is necessary is that the facts withheld be material in the sense that a reasonable investor might have considered them important in the making of this decision."

Another that is frequently spoken is this: a fact is material which upon disclosure may be reasonably expected to result in a significant impact on the market price of the security.

The <u>Affiliated Ute</u> test, given the authority of its source, is likely to be followed by other courts when confronting these problems. Several aspects of the definition should be noted. First, it is stated in the subjunctive: information is "material" if it might be important to a reasonable investor. This, of course, in a sense makes the task easier and demands erring on the side of disclosure. Second, the test is the reasonable investor, and he, of course, was defined in the Texas Gulf Sulphur case as including the speculator as well as the long-term investor. Obviously these are not always easy determinations to make. They are not mathematically precise, though in some contexts various statistical or mathematical ratios have been developed in an effort to provide benchmarks, e.g., a less than 5% variation in how income statement items may not be material.

However, much disclosure is not susceptible to that sort of measurement; then it is only the informed judgment of the financial officer, the auditor and the attorney which can make a meaningful determination of materiality. Perhaps a simplistic way of looking at the matter is this: Suppose you were offered two investments, each of which has identical characteristics with a single adverse exception, and all characteristics, including the differentiating factor, are disclosed. Which investment would you find preferable? Would you pay the same price for them? If your tilt is toward the one about which there does not exist the awkward fact, then I would suggest you have decided the question of materiality.

Obviously as the problems of the REITs have multiplied the Commission's staff has sought to develop patterns of more meaningful disclosure to reflect the business uncertainties which they face. Among such – and I would emphasize that additional or different requirements may be designed if unusual or new problems appear – are these:

1. The balance sheet captions for investments should state separately the amounts of non-income producing properties or loans on which interest is not being accrued currently because of questions of ultimate collectibility.

2. The policy for classifying loans as non-income producing should be described in notes to the financial statements.

3. Investments in properties acquired by foreclosure or in lieu of foreclosure should be set out separately on the face of the balance sheet.

4. Notes to the financial statements should explain the components of the carrying value of properties acquired by (or in lieu of) foreclosure (i.e., amounts of the original loans, any accrued interest not collected but carried as part of cost of foreclosed property, payments to prior lien holders, legal fees).

5. The basis for determining the provision for loan losses should be explained for each period for which an income statement is required, and the reasons for changes in percentages or in methods used to provide for losses should be explained.

6. A note should state the amount of interest earned but not accrued and the amount accrued but not collected on problem loans during the period.

7. Trusts experiencing problems relating to declining occupancy rates or having vacant properties, are requested to discuss the extent of such problems.

As you confront these problems of disclosure, I would urge the use of imagination, and hopefully, if your imagination does not run riot, our staff will cooperate in permitting such approaches. For instance, it may be necessary to utilize more forward looking information, with perhaps two or more estimates of future consequences based upon different assumptions concerning interest rates, the shape of the economy in general. Thus, now, at a time when the future course of short term rates is uncertain, it may be well to spell out the consequences of rates at a 7% level, at a 9% level, at an 11% level and possibly a 13% level. Similarly, it may be well to express some information in terms of ranges rather than in absolute figures, thereby alerting the user of the information to the uncertainties inherent in the industry today. Generally it is more important to express economic reality with some reference to quantitative estimates than simply reiterate legal phrases. Where reality indicates substantial uncertainty, this should be an important part of the disclosure package. The Commission addressed this issue and offered some specific guidelines and examples in Accounting Series Release No. 166 –

"Disclosure of Unusual Risks and Uncertainties in Financial Reporting" – issued in December 1974. In these times there is little use to an investor and little insulation from liability in the stock phrases or the conventionalities that continue to persist under the caption, "Introductory Statement". The goal should be to give the investor the viewpoint that management enjoys to the fullest extent that can be done within reasonable limits of print and paper. The discussion now required in '33 Act and '34 Act filings and annual reports to shareholders concerning the income statement, which must identify and explain significant differences in line items from period to period, can be an excellent medium for making meaningful disclosures to investors and affording them the benefits of management's analyses of where the trust is, where it has been, where it is going.

You are undoubtedly by now weary of the constant reiteration of the need for honest and candid disclosure. Believe me, the Commission's insistence upon such is not born of a desire to embarrass you and make the rehabilitations of your enterprises, to the extent they need it, more difficult. The Commission's sole purpose is to carry out the mandate given it by Congress over forty years ago: to assure the existence of fair and efficient markets, markets in which investors may participate with confidence that no one is advantaged over them because of superior sources of information, markets which are awash with pertinent, relevant, timely information concerning those who issue securities. In addition, we believe that candid disclosure is very much in your own interests since a reputation for candor will be a major asset to a company both in good times and bad.

Hopefully the time will come when disclosure, instead of being a burden to you, will become a means of portraying to the public the fruits of good management and rising prosperity. I hope when that day comes I may have the chance to exult with you over that happy event.