FINANCIAL DISCLOSURE—A TOOL FOR PUBLIC ANALYSIS

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"Once ample and reliable data is publicly available, investors and the general financial community are better able than any governmental agency to assess the inherent investment merits of securities. In addition to assuring an honest market place, public disclosure is an effective governor of the conduct of corporate managements in many of their activities; it is the best bulwark against reckless corporate publicity and irresponsible recommendations and sale of securities. The potential exposure of corporate management, securities salesmen and others to personal financial liabilities and to civil and criminal penalties effectively encourages compliance with the Federal Securities Law."[1]

This statement is from a recent House Committee Staff Report. The cardinal purpose of Federal securities legislation has always been full and fair disclosure to the public. The Interstate Commerce Commission is in the process of assuring that this purpose is upheld with regard to surface transportation industry security devices. The vehicles for this assurance are the Commission's recent decisions in *Ex Parte No. 275, Expanded Definition of Term "Securities"*[2] and *Ex Parte No. 279, Securities Regulation—Public Offerings (Form of Offering Circular Required for Public Sales of Securities Authorized Under Section 20a or 214 of the Interstate Commerce Act)*[3]—neither of which is administratively final. To understand the issues involved in these two proceedings, some background is probably called for.

The *first* annual report of the Commission issued back in 1887 referred to the manner in which corporate stocks were manipulated for the benefit of managers and to the destruction of the interest of the owners, and it added that this was often a great scandal resulting sometimes in bank-

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1. *Inadequacies of Protections for Investors in Penn Central and Other ICC-Regulated Companies*, Staff Study for the Special Subcommittee on Investigations of the Committee on Interstate and Foreign Commerce, House of Representatives, July 27, 1971.

2. 344 ICC 114.

3. 344 ICC 168.

ruptcy and practical destruction of roads which could have been avoided.[4]

In 1894, the Commission pointed out that one reason for this condition was undoubtedly over-capitalization. "It is a notorious fact", the Commission said, "that many of the lines then in the hands of receivers were capitalized out of all reasonable proportion to the actual cost of the property. Until there is some practical restriction upon the capitalization of railway properties at fictitious values there must still continue to be non-dividend paying stock, defaulted interest on bonds, receiverships, etc."[5]

In 1908, and every year thereafter, to and including 1919, with the sole exception of the year 1918, the Commission repeated its recommendation that some adequate method of Federal control over railway capitalization ought to be adopted.[6]

Finally, on February 28, 1920, the Transportation Act of 1920, section 20a[7], gave the Commission "control" of capitalization by making it unlawful for railway carriers to issue securities or assume obligations on securities of others except upon application to and investigation and approval by the Commission.

In 1936, the Congress passed Section 214[8] of the Act which in effect placed motor carriers under section 20a.

The pertinent part of section 20a is paragraph (2). Under paragraph (2), common carriers by railroad (and motor carrier) must first obtain this Commission's authorization before issuing any share of capital stock or any bond or other evidence of interests in or indebtedness of the carrier (collectively termed securities) or before assuming any obligation or liability as lessor, lessee, guarantor, endorser, surety, or otherwise in respect of the securities of any other person, natural or artificial, even though permitted by the authority creating the carrier corporation. The Commission may then issue an order granting the authority requested only if it finds that such proposal (a) is for some lawful object within the applicant's corporate purposes and compatible with the public interest which is necessary or appropriate for or consistent with the proper performance by the carrier of service to the public as a common carrier and which will not impair its ability to perform such service and (b) is reasonably necessary and appropriate for such purpose.

That authority is broad. It applies not only to protecting the public and

4. First Annual Report of the Interstate Commerce Commission, December 1, 1887.

5. Eighth Annual Report of the Interstate Commerce Commission, December 1, 1894.

6. Twenty-second through Thirty-third Annual Reports of the Interstate Commerce Commission with the exception of the Thirty-second Annual Report.

7. 49 U.S.C. § 20a.

8. 49 U.S.C. § 314.

the investor, which is also the function of the Securities and Exchange Commission, with respect to most securities, by requiring full disclosure, but it permits the Commission to go beyond that and determine whether a transaction would be financially sound for the carrier and in the public interest. This is consistent with the fact that carriers perform a vitally important public service. They are in many ways considered to be a utility, or are at least considered to be affected with the public interest, requiring adequate regulation.[9]

The whole question of the scope of the regulation of carrier financing was broadened as new methods of financing evolved. As pointed out in the report of the Commission in the *Watt* Case,[10] the question as to what constitutes an evidence of interest in or indebtedness of a carrier is one which merits detailed analysis in the light of present day practices. Indeed, the Commission's previous limited view of its own jurisdiction under section 20a probably contributed to a loss of effective control over carrier financing.[11] And as the recent report by the ICC states, the narrow construction of section 20a was largely self-imposed. This was widely recognized as was the fact that at least partly as a result of restrictive administrative interpretation of section 20a the Commission simply did not have effective control of carriers' capital transactions.

The Commission, in recognition of the situation and changing times, instituted the proceeding in *Ex Parte No. 275*. In instituting the proceeding it referred to "the present day situation where a substantial amount of financing by carriers is represented by instruments other than capital stock, bonds, or notes, the traditional forms of securities."[12] This represents an effort to give maximum effect to the statute's objectives. The action taken is supported by the Commission's underlying power essential to the effective discharge of the Commission's responsibilities—in this case the National Transportation Policy's admonition to foster sound economic conditions in transportation and among the several carriers[13] as well as the accounting and reporting provisions of the Act.[14]

Specifically, the decision in *Ex Parte No. 275* expanded the definition of the term "security" recognized by the Commission. In the past, the Commission had interpreted the term "securities" as extending only to stocks, bonds, notes and other agreements having similar attributes.

9. See for example 6 CFR § 150.

10. *Watt Transport, Inc.—Investigation of Practices*, 338 ICC 338 (1971).

11. *The Penn Central and Other Railroads*, A Report to the Senate Committee on Commerce, Committee on Commerce, United States Senate, December, 1972.

12. Notice and Order of the Commission in *Ex Parte No. 275*, issued March 17, 1971.

13. See 49 U.S.C. preceding §§ 1, 301, 901, and 1001.

14. See 49 U.S.C. § 304 (a)(1) and (2) and 49 U.S.C. § 320.

"Noteless" borrowing was held beyond the reach of the Interstate Commerce Act. With regard to an evolving economic life style within the surface transportation industry, the commission has re-evaluated its position and determined that "securities" will now be construed to include all agreements which create a present or future interest in, or indebtedness of a carrier or in property owned, leased or otherwise employed by all regulated carriers. Included would be loan agreements, credit agreements, mortgages, chattel mortgages, advances, deeds of trust, equipment trusts, and security agreements whose terms provide for other than full payment at the time of consummation.

What does it mean to the public, the surface transportation industry, and the financial community generally?

Carrier fiscal policy will be given more scrutiny. It will be more difficult—hopefully impossible—for carriers to subordinate operating requirements including plant improvement to the wholly illusory goal of unjustifiably improving the company's credit standing. It will be more difficult for carriers to use methods of financing which give the appearance of a reduction in long term debt and fixed charges where no such reduction has occurred. It will be more difficult for carriers to construct irresponsible techniques of earnings maximization or earnings inflation. It will be more difficult for carriers to employ an unjustified dividend policy set up solely to inflate the price of the company's stock and give the carrier a better credit standing. It will also be more difficult for carriers to indiscriminately utilize and expand a program of diversification investments at the expense of meeting their statutory obligations.

The Penn Central collapse unveiled for public scrutiny a whole series of unsavory practices. New ground was broken by a management anxious to put the best possible face on its financial condition. Earnings inflation was employed by the Penn Central and its predecessor, the Pennsylvania Railroad, with great forcefulness. This technique was not concerned with realities of income or cash flow but was an effort to pretend that earnings were larger than they really were by inflating them. Earnings maximization, a practice in many deteriorating companies, was thus pushed to extremes by the management in this case.[15]

As the practice of earnings inflation continued throughout the sixties, there developed less and less relation between cash flow and reported income. Devices used included requiring subsidiaries to inflate reported earnings and declare large dividends, reporting as much income as possible as ordinary income rather than extraordinary; restricting maintenance and capital expenditure budgets; capitalizing equipment refurbishing (a

15. See *The Penn Central and Other Railroads*, Note 11.

practice which the ICC Bureau of Accounts has considered to be improper, requiring that costs should be written off as maintenance expenses in the year of rebuilding); and treating as many ordinary expenses as possible as "extraordinary expenses". These practices did not generate any new cash; they only seemed to. Although the Penn Central was an illiquid company where cash management would seem to be a major area of management concern, the generation of cash according to the Senate Commerce Committee Staff Report "was secondary to the attempt to inflate and thus distort reported net. Accounting theory which stresses conservatism and consistency, was either ignored or adhered to solely when consistent with the principal objective of delusion."[16]

It is not possible here to go into all of the practices of the Penn Central that have been pretty widely described in various places including the Staff Report of the Senate Commerce Committee. We know by the self-admitted statements of the Penn Central Management that cash flow had very little relation to the reported net income of the corporation. The result may have been that the Penn Central stayed out of bankruptcy longer than it would have otherwise, but the real question is whether this deferral of bankruptcy was in the public interest or in the interest of the transportation company involved. The company policy served to keep the impending financial collapse from the public generally and even from many financial analysts. Although it is perhaps impossible to prevent such misrepresentation and deception, nevertheless, improved knowledge about the sources and uses of funds by the Penn Central would have highlighted its precarious position several years before the event. It is thus appropriate and advisable that the Interstate Commerce Commission should develop the necessary procedures for spotting problems well before a crisis develops and before hurried, poorly reasoned temporary expedience is forced by events.

In addition to the proceeding in *Ex Parte No. 275* and *Ex Parte No. 279*, the Commission is reviewing the entire railroad accounting system. A precise accounting policy is inseparable from a policy which advocates adequate financial disclosure.

The Commission's interests in obtaining additional or more meaningful information is not for harrassment purposes. Adjustments in accounting techniques and disclosure improvements can have a direct impact on the performance of a transportation company. It may affect management's decision on how much effort to apply to various transportation purposes of the carrier. Perhaps the Penn Central for example would have spent more money on rail maintenance if the accounting practices had

16. See *The Penn Central and Other Railroads*, Note 11.

been somewhat different than as prescribed by the ICC rules. The Penn Central advised the Federal Rail Administration on October 16, 1973, that some 6,900 miles of its track would not meet the minimum safety requirements, i.e., trains could not safely travel 10 miles per hour. It is difficult to comprehend how such incredible deterioration could occur. It is conceivable that adjustments in accounting practices a few years ago would have helped prevent such deterioration.

The purposes of disclosing information accurately are many. First, the public and user knowledge of such information may be assumed to be a helpful corrective element in itself. It would enable the public to take action to protect itself against a sudden loss of rail service or the unacceptable deterioration of service while at the same time providing an objective signal for public opinion influence to be felt by private decision makers. Second, such information would be of vital assistance to government in formulation of policy and identification of specific problems. It is quite possible, for example, that if the federal government had been completely aware of the condition of the railroads in the Northeast during the 1960's it might not be faced with the kind of crisis situation which now confronts the Nation. This increased financial information would be very useful to present and prospective investors and would provide some useful protection for them.[17]

The key goal of an accounting system and of disclosure should be understandability. As one well known accountant has put it:

> "The confounding and confusion of tongues has evoked strong criticism even from persons who are sophisticated in the accounting idiom.
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> If financial statements were 'understandable', could Penn Central have disposed of its commercial paper to some of the most astute and prestigious banks, insurance companies, and other professional investors? Could there have been the psychedelic conglomerate craze of the 1960's?. . . ."[18]

Management, the Commission and the public must be better able to acquire the most accurate and extensive information possible about carriers and the transportation industry.

With regard to a securities application, it should be kept in mind that principal concern of this Commission under section 20a is the effect of a security device upon the soundness of the carriers' credit and financial

17. See *The Penn Central and Other Railroads*, Note 11.

18. Briloff, Abraham J., *Unaccountable Accounting*, (New York, N.Y.: Harper and Row Publishers, Inc., 1972).

structure. The Commission thus considers whether the proceeds are to be used for a proper carrier purpose, whether the terms are unreasonable, whether the financing will result in overcapitalization, etc. There are certain things the Commission must have in order to process security applications. The Commission needs to know what the parties want. It is surprising how frequently an application fails to present clearly what it asks for. The Commission needs all relevant financial data including a balance sheet to see if the carrier can afford what it proposes. The Commission has to know what the carrier is going to use the money for in specific terms. The carrier should state what the cost of employing the security device will be.

There has been consistent use of the term "carrier". However, in a situation where a person who is not a carrier, for example a holding company, which is authorized under section 5(2)[19] of the Act to acquire control of any carrier or two or more carriers, the Commission may provide, pursuant to section 5(3)[20] of the Act, that such person will be considered a carrier and may subject it to the provisions of section 20a and 214. In such cases, the Commission will authorize the use of a security only if it finds that such use is consistent with the proper performance of service to the public by each carrier which is under the control of such person, that it will not impair the ability of any such carrier to perform such service, and that it is otherwise consistent with the public interest.

There are two basic conflicts here. One is that the Commission should do everything it can to prevent the carrier from being exploited, i.e., to prevent the destruction of the carrier's capability to provide transportation services as required by the public. On the other hand, there has been some thought that holding companies may be beneficial to a carrier in the sense that they have a broader base for attracting money at better rates. Such money could be advanced to the carrier and this would be particularly valuable where the carrier would have difficulty in raising money:

This Commission does not in the abstract want to pass on whether an investment in any non-carrier is good. Yet, if it should appear that an investment would endanger a carrier, the Commission should be able to focus on the non-carrier investment to make a determination consistent with the purposes of the Act. This does not mean that the Commission would insert itself into the everyday decision-making process of the management of regulated carriers; nor does the Commission in any way intend to usurp management prerogatives. But carrier management will

19. 49 U.S.C. § 5 (2).
20. 49 U.S.C. § 5 (3).

be made more aware that its prerogatives are not unlimited but subject to review and publicity. Hopefully, this awareness will spark a reaction of more thought, better planning, improved management action, and greater disclosure to safeguard the carrier's financial well being—and benefit the public as users and investors.

Section 20a also confers upon the Commission the authority to require not only the filing of a prospectus, but its dissemination to all prospective purchasers. Indeed, the Commission already requires a prospectus to be submitted for approval if securities are to be issued to general public. However, there have been no guidelines or requirements established for the content of that prospectus. The Commission's ultimate decision in *Ex Parte No. 279,* whatever its specific requirements, should correct this deficiency.

The provisions of *Ex Parte No. 279* require that a new prospectus or offering circular be filed by carriers seeking public financing through the Commission. The form involved is similar to the form of the SEC—namely, the S-1 form—but would require additional information relevant to the transportation industry. This includes such information as carrier investment in non-transporation areas, carrier investment in corporate conglomerates, and the relationship of a carrier as to subsidiaries and/or corporate parent. In particular, the financial data would show a carrier's relative operation in transportation and non-transportation areas.

This complete disclosure form would be required primarily in connection with general stock issues. There would also be a new abbreviated form for use with stock offered solely to a carrier's employees. Several exemptions to using the new form are contemplated. Moreover, the form would not be required in connection with securities issued to knowledgeable individuals or businesses who do not propose to make further offering to the general public. These would include stock dividends and splits since they are issued only to current shareholders.

In concluding, it is evident that the public, the financial community and the surface transportation industry should recognize that the Commission's actions in *Ex Parte No. 275* and *Ex Parte No. 279* were guided by the hope that such disasters as those that befell the Penn Central and other bankrupt carriers will not occur again. Ths public and the financial community generally should have greater confidence in future carrier securities, because many devices employed to circumvent Commission surveillance will no longer be available to chip away at financially healthy carriers. The Commission is determined to reassert and broaden its control over carrier financing. The two recent decisions in *Ex Parte No. 275* and *Ex Parte No. 279,* with whatever modifications that may appear

appropriate in those proceedings before they become final, will help the Commission do this—not only to the benefit of the public but to futher financial disclosure as a tool for analysis by the public and particularly the financial community most concerned with carrier investment, debt, and security practices.