SOME THOUGHTS ON THE DISCLOSURE APPROACH TO SECURITIES REGULATION

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As we all know, in 1933 it became accepted in the United States that the widest possible disclosure of corporate affairs would encourage savers to buy shares and obligations issued by companies seeking public funds. To this end, extensive legislation, both detailed and complex, was enacted in the U.S. in 1933 and 1934.

Also wishing to attract savers to investment in securities, France followed the U.S. example in 1967 and enacted legislation requiring public stock companies to furnish information to the public and to their shareholders. ‘Ordonnance’ No. 67-833 (28 September 1967), which created a commission on stock exchange operations (Commission des Opérations de Bourse or COB), specified that it was a question of “encouraging long-term savings, especially as regards new categories of savers, and of encouraging greater investment in stocks and shares”.

More recently, Brazil has followed suit by creating a stocks and shares commission. Meanwhile, other countries, especially Germany and Great Britain, have begun a debate on the suitability of introducing similar legislative regulations of their own.¹

Two main arguments are put forward to justify these legislative undertakings. First, the better the shareholder is informed, it is claimed, the more likely he will be to entrust his money to companies seeking his investment; he will thus be acting according to reason and not intuition. Second, disclosure enables the saver to be warned against fraudulent or specious requests for his investment, and may reduce the frequency with which these phenomena occur.

What is the value of these two arguments in the light of financial market evolution?

The moralizing effect of U.S. and French legislation is beyond question. Since they are now under close supervision, companies are induced to provide accurate information to investors and to avoid behavior harmful to them. This appears so obvious that it is scarcely worth proving. One need only mention by way of example the judgments rendered in both the U.S. and France against ‘insiders’ who turn to

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their own advantage information concerning the company and its business that they obtain by virtue of their position.

But what about the impact of disclosure policy on the behavior of the financial market and the behavior of savers? Does the obligation to disclose information reach its economic objective of stimulating the financial market and of attracting individual savers? Such questions are embarrassing, since the criteria for evaluation are uncertain. This essay is an attempt to consider various critical elements in the operation of financial markets and the behavior of individual investors. It asks whether required disclosure of corporate information is indeed one such critical element. It would be well to take into account the following before passing judgment on the merits of a disclosure regimen: (1) the state of investments in shares, (2) the behavior of market prices and (3) the way in which companies subject to disclosure regulation operate. One must indeed be careful before claiming that required disclosure of corporate data has a significant effect on these matters.

1. The state of investments

It is pointless to underline the almost total failure of French companies in their request for public money for investment. The situation concerning the issuance of shares is desperate. The COB's latest report reveals that for 1976 the number of issues of shares was extremely low. This discouraging state of affairs is further aggravated by a marked lack of interest on the part of shareholders. In recent years, French families have been net sellers of shares and obligations.\(^2\)

This same lack of interest on the part of individual shareholders is making itself felt in the U.S. As Professor Tunc puts it:\(^3\)

For a long time collective and individual savings went hand in hand. But the individual saver was stung by the losses in 1969, 1970, 1973 (down 18%) and 1974 (down 30%). The number of people holding shares or participating in mutual benefit societies fell from 30.8 million in mid-1970 to 25.2 million in mid-1975 (down 18.3%). The really serious aspect is that the average age of the shareholder has gone from 48 to 53 — there is an almost total absence of new younger shareholders.

In every country, the percentage of collective saving (institutional investment) is very much on the increase. Thus, in the U.S.\(^4\) it represents almost 50% of securities listed on the New York Stock Exchange and often seems to account for 75% of the trading there.

Collective saving is perhaps even stronger than these figures suggest. Retirement funds at present hold more than a third of all shares in U.S. publicly-held companies. In ten years the proportions may well be one-half. At this moment, they are said to own the majority of shares in over half the one thousand largest companies.\(^5\) It may be added that in France, as well, companies investing in stocks and shares have, for two years, been experiencing renewed public interest.
2. Behavior of market prices

Analysis of the behavior of market prices on the stock exchange shows how difficult it is to identify with any certainty the factors that determine share prices. Neither the economic environment in the country in which the company is doing its principal business nor the value of the company appear to be of prime importance. The shareholder's lack of knowledge has, however, been denounced as a major source of imperfection in the determination of market prices. And a survey has revealed that the more familiar analysts are with a company, the less risky they think it is to invest in that company. However, numerous facts tend to limit the practical value of these judgments.

In the first place, disclosure does not appear to play a definite role in the determination of market prices. For example, reduced or insufficient disclosure does not necessarily lead to systematic under-valuation of companies. It has been noted that for the last sixteen years the best investment records have been achieved in the Brazilian, South African, Singapore, Hong Kong and Japanese markets. Yet not only does the disclosure provided to investors vary in intensity from one of these markets to another, but for a considerable part of this period the practice of disclosure has been unknown in some of these markets.

Moreover, it is well nigh impossible to state with authority that detailed disclosures definitely have a beneficial effect on the determination of market prices. In the first issue of this Journal, Professor Mendelson indicated that economists have not been able to establish conclusively that the U.S. disclosure system has had an impact on share prices in that country, and that economists are reduced to judging it on the basis of ethical or political attitudes. Others have noted that the shareholder seems to distrust accounting assessments generally, and that he particularly has doubts about the accuracy of the determination of profits by accounting methods. He especially distrusts forecasts of the future; his specific motivation is the dividend he will actually receive.

In the second place, disclosure does not appear to guarantee predictable behavior in market prices. The U.S. disclosure system, which is the most highly developed in the world, does not prevent U.S. stock exchanges from registering sudden variations in market prices. Professor Tunc provides several illustrations. For example, the market prices of numerous U.S. companies (some of them very reliable) went up or down two or three times in value over a 5-year period: thus between 1971 and 1975, General Electric fluctuated between 30 and 75, General Motors between 28 and 91, I.B.M. between 150 and 375, I.T.T. between 12 and 67. In January of 1975 alone, the Dow Jones Index rose nearly 15%. When Wall Street was told on October 23, 1973 at 2:28 P.M. that President Nixon was going to hand over his tapes, the Dow Jones Index, which had dropped 7 points since the beginning of the day's trading, because of the fear of impeachment, jumped 19 points in 25 minutes, only to fall back 6 points in the next half-hour. Professor Tunc ends his examination of prices on the U.S. market as follows: "It is at present held that market tendency is basi-
cally influenced by some 50 market analysts. Market prices are therefore scarcely the result of investors' deliberating and ruminating on information which companies are obliged to supply. 14

A third factor tends to minimize still further the importance of disclosure on the behavior of market prices. The practice of diversifying risks, which is highly recommended by stock market experts, leads investors not to take an interest in all types of investments (especially if there is the possibility of insufficient disclosure) since some risks can be eliminated through diversification.15 Therefore, it is by no means certain that a rational investor will attach extra value to a share simply because his uncertainty about it has been reduced by fuller disclosure. This is borne out by a comparison of market prices in different world markets. As has already been noted, over the last sixteen years the five best investment records have been registered in Brazil, South Africa, Singapore, Hong Kong and Japan, where disclosure was non-existent or incomplete. On the other hand, over the same period, despite the volume of disclosure, U.S. markets figured among those with the worst records.16

3. The way companies operate

It is by no means obvious that the relationship of shareholders with their companies has been improved by the availability of extensive disclosure. It had been hoped that the shareholder, when he had been better informed about company affairs, would feel safer and more involved. It was thought that the informed investor, rather than selling at the first sign of difficulty, would try to defend his position within the company, especially by challenging management. The observable facts give the lie to this forecast. It is common knowledge that shareholders do not attend annual meetings. In France, in particular, the COB regards it as a triumph if there is one shareholder out of a thousand present for public stock companies.17 Only once to our knowledge have shareholders of such a company challenged its directors in the courts (the case of the Pont-à-Mousson).

Moreover, shareholders practically never use the information disclosed to them. According to studies carried out in the U.S., 40% of shareholders spend less than five minutes reading their company's annual report.18 In 1970, the COB confirmed this same passive attitude in France. It has noted that in most cases the annual shareholders meeting is of little interest. The tedious reading of documents goes on in front of a thinly scattered audience made up mostly of the company's bankers. No important question is brought up and no discussion develops, unless there are present in the hall some of those wranglers who are to be found year in and year out at the meetings of some companies.19

Despite these unconvincing results, the company must bear the costs of disclosure, which are considerable. See, for example, the Securities and Exchange Commission's release of December 10, 197620 in which the SEC revealed its intention to require foreign companies issuing securities in the U.S. market to make disclosures
similar to those required of U.S. companies. The SEC justified this step in part by the necessity of bringing foreign companies (which at present enjoy simplified disclosure requirements) into line with U.S. companies as far as expenses are concerned, and of making sure that this cost difference gives them no advantage.

It seems, however, that the operating cost of a disclosure system has never been accurately calculated. Professor Mendelson, in the article mentioned earlier, can say no more than "the [regulatory] pattern is certainly not costless".21 One can but regret this state of affairs and thus urge research which would permit the quantification of the different factors in the cost of a disclosure system: company expenses (drafting of documents, operation of the department in charge of disclosure, time spent in finding the exact solution in the maze of uncertain and ever-increasing rules, obtaining expert advice, and so forth), the expenses of supervisory bodies, the inflationary effect of the bulk of these expenses, etc. Failing such a study, how is one to make a scientific assessment based on a balancing of the value of a disclosure system with its costs?

4. Conclusion

The preceding observations lead to two conclusions. The first is that one should be modest and moderate in assessing the value of disclosure and its potential effects. Any doubt we may have about the effects of disclosure does not allow us to question the requirement that, in general, investors should be informed. However, there is sufficient doubt to justify the exercise of great care before creating an endless maze of rules. Further, there remains sufficient doubt to justify not recommending the systematic importation of a given disclosure pattern unless its feasibility is taken into account. Judicial sociology22 teaches that if the law is not a bad thing in itself, it is not always a good thing either, and that one should mistrust the legislative appetite for smooth-running administration.

The second conclusion is that the comparative development of individual and collective securities investment calls for a readjustment of disclosure requirements. Perhaps disclosure about companies should be focused primarily on the needs of institutional investors and experts, since direct individual investment in securities is less and less significant, and since the structures of a modern economy are reinforcing this tendency. Indeed, if disclosures are to be required for the benefit of individual savers, the requirements should be imposed on investment institutions that seek public funds. More savings from the public are furnished directly to those institutions than to operating companies. If there is need for protection of the public investor through the disclosure process, it is at the level of the investment institution.
Notes

1 As far as Germany is concerned, see Kolloquien-Beiträge, Transparenzprobleme des Kapitalmarktes (1976). As far as England is concerned, see Evidences to the Committee to Review the Functioning of Financial Institutions (so-called ‘Wilson Committee’) (1977).

2 Les facteurs de variation des cours de bourse 75, 1er Colloque de la COB (1976).

3 Tunc, Le Droit des Sociétés Anonymes aux Etats-Unis, 11 (1976).

4 Id. at 10.

5 Id. at 11.


7 Sigalla, La diversification internationale des portefeuilles, Analyse Financière 14 (1976).

8 Salmon, Les facteurs de variation liés à la stratégie de l’entreprise, in Les facteurs de variation des cours de bourse, cited supra n. 2, at 80.


10 Sigalla, op. cit. supra n. 7, at 14.


12 Salmon, op. cit. supra n. 8, at 80.

13 Tunc, op. cit. supra n. 3, at 7 et seq.

14 Tunc, op. cit. supra n. 3, at 12.

15 Salmon, op. cit. supra n. 8, at 81.

16 Sigalla, op. cit. supra n. 7, at 15.

17 COB, Rapport Annuel (1977), at 94.


19 COB, Rapport Annuel (1970), at 63.


21 Mendelson, op. cit. supra n. 11, at 62.


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