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THE SEC AND THE PRESS: PARTNERS IN FERRETING OUT FRAUD

An Address By

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Securities and Exchange Commission

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It is a very distinct pleasure and privilege for me to be present with you and have the opportunity to speak to you today when you are honoring the winners of the Gerald Loeb Award. It is heartening to participate in ceremonies that recognize the art of journalism at its best, particularly in the financial field with which I am principally concerned. Through such awards, not only are those who receive them recognized, but they constitute an encouragement to everyone who practices the art to emulate the performance which has merited the award for these recipients. By reporting that merits the award, and by the recognition that follows it, the entire journalistic profession is, in my estimation, elevated, its standards improved and its achievements increased.

The temptation on an occasion like this is to give a speech about the abstract merits of the free press, the responsibility of those who control the the press and those who express themselves through it. Such an address would hark back to colonial days, describe the often mounted assaults on the principles incorporated in our Constitution and glory in evil defeated. All of this would make for patriotic, lofty and perhaps elevating oratory.

I would rather speak of something more specific than that, even though such an address would indeed be appropriate on this occasion. I would like to talk about the

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press, and more particularly financial reporting, as one of the means by which corporate conduct and corporate responsibility are being steadily improved in this country.

Our staff works closely with members of the press. Frequently a reporter will get a sniff, a smell that something is wrong in a corporation. They may not have enough hard facts to print a story, but they nevertheless feel that there is something that should be pursued. Many cases have been developed from such a hunch. Sometimes the reporter provides more than just a hunch. He provides leads and facts that give our staff a running start in their investigations.

One need not reach very far into the past to identify instances in which the financial press has done a remarkable job in identifying corporate depravity, irresponsibility and outright larceny. A couple of instances come quickly to mind. While the first intimations of trouble at Equity Funding were imparted by a dissatisfied former official to a security analyst, the first public display of the whole story was contained in an outstanding article which was published in The Wall Street Journal. This article reflected meticulous backup research, incisive analysis of truly incredible events, as well as considerable style in the writing. Without this piece of journalistic enterprise I am sure that eventually all of the facts concerning Equity Funding would have found their way into the public consciousness. However, this happened more quickly, more efficiently and certainly more interestingly than if other means had been used to accomplish that. Let me read to you the text of a letter that was sent to the Executive Editor of The Wall Street Journal by Irving Pollack, now a Commissioner but then the Director of the Commission’s Division of Enforcement:

> “I want to bring to your attention our deep appreciation for the assistance given to us recently in the Equity Funding

> matter by Mr. Blundell, Bureau Chief of your Los Angeles Office. Mr. Blundell, after receiving information concerning serious problems at Equity Funding, immediately made that information known to both our Los Angeles Office and to Stan Sporkin of this office. While I am sure he was interested in breaking a good story he was also particularly concerned over the need to protect the investing public and accordingly he determined to share his information with the appropriate regulatory authorities. This was done at the clear risk of possibly missing out on a very exclusive and important news story. Although it is not always possible for the system to work as well as it did in this case, I am obliged to express our sincere gratitude where in fact there had been appropriate accommodation of our respective interests all for the benefit of the investing public.
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> "Again, we express our deep thanks to Mr. Blundell (by the way, Mr. Blundell's stories were extremely well done)."

Similarly, the work of one of the award winners we are here to honor today brought the Commission's attention to the first intimations that the San Diego empire of C. Arnholt Smith, Westgate-California, was in trouble. Let me read from another letter from Irving Pollack, this time to the Bureau Chief of The Los Angeles Times:

> "As you are aware, we have just completed a major civil action against Westgate-California, Inc. and C. Arnholt Smith. We believe that this action represents an important and necessary step for the protection of investors. Our inquiry in this matter was commenced as a result of the fine work of Paul Steiger of your staff. His 1971 article on Westgate's annual report was the spark that generated our interest into certain of the company's financial activities. We think that Mr. Steiger's efforts represent investigative financial reporting at its constructive best. It is not often that a reporter is able to witness important public interest benefits as the byproduct of his reporting efforts. Mr. Steiger and The Los Angeles Times can certainly take great pride in its fine reporting work.
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> "On behalf of the Commission, I want to express our thanks for all Mr. Steiger has done to protect the interests

> of investors and wish him continued success in his superb financial and investigative reporting."

In another instance, an alert middle west reporter brought to the Commission information concerning the activities of two promoters of a geriatrics center to be financed through the issuance of municipal securities. With insight worthy of our Enforcement Division, he sensed the presence of actionable conduct despite the fact that municipal securities are exempt from the registration requirements of the 1933 Act. Our staff investigated and an action was commenced.

Similarly, and I say somewhat bashfully, despite extensive reporting requirements that the Commission has developed over the last 40 years, nonetheless frequently the first information that is available to us, as well as to the public, concerning abuses of the inside trading process comes out because of the suspicions, followed by the diligence, of newspaper reporters. Not infrequently this is a result of highly developed skepticism of the human race which results in the diligent digging out of particle after particle from sharply resistant raw material until finally the moment comes when these particles fit into the coherent pattern displaying the frailties of human nature. Let me give you one example. Following some unusual market activity in the stock of Avis, there appeared an article in The Wall Street Journal describing a meeting held with a small group of analysts. That article prompted a Commission investigation which resulted in the filing of a Commission law suit. This is not an isolated example; there have been many others. Clearly the spotlighting accomplished by the reporting of insider trading and the misuse of material non-public information has proved to be as much of a deterrent as have the Commission's actions in this area.

Not only do I acclaim the initiatives of the press in digging out the sordid details about the manner in which some corporate enterprises have been conducted, but I also sing the praises of the press in publicizing the work of others, like the Commission and state regulatory agencies. Often, but for the attention given to our work by the press, the public would be shrouded in ignorance and barely aware of the abuses inflicted upon their money by some to whom they have entrusted it. Frequently these reporters go well beyond the charges that are made in our complaints and seek out additional facts that highlight and dramatize better than we can do in the formalistic confines of legal documents the true dimensions of the misdeed. More than that, reporters often warn the public of emerging areas of fraud. The west coast seems to provide many examples, so let me use another one. In the past few years we have seen great abuse in the trading of so-called commodity options. The operations of such outfits as Goldstein, Samuelson were publicized by the press and the dangers in such operations as this -- and others like the Glenn Turner operations -- have been brought to the public's attention in a manner that left little doubt about the real motives of the people involved.

The extraordinary thing about these remarkable journalistic feats is that frequently they are accomplished by persons who have not been specially trained in the law or accounting, but who have, because of the necessities of their job and their dedication to the ideals of their profession, indeed become expert in legal and financial concepts. Also these investigations are done without the power of subpoena which the Commission finds indispensable in ferreting out fraud and other kinds of misconduct. The job of a financial reporter tracking down the truth about complicated corporate matters must often be a frustrating one and I would imagine that frequently he wishes he could literally, with the backing of subpoenaes, reach into the files of a reluctant interviewee, or put him under oath so that misstatements expose him to prosecution. The reporter has substituted for these deficiencies quick intelligence, healthy skepticism, interviewing skill, imagination and resourcefulness to such an extent that frequently it appears that he has not been impeded at all in pulling out the truth because his weapons were limited.

When reporters do this job, they are often charged with undermining American confidence in American business. The charge runs like this: if you tell people about the peccadilloes and faults of some American businessmen they will think that all businessmen act like this. They will then refuse to invest in American corporations, the productive capital resources of the nation will wither and die, the entire structure of American capitalism will topple and all of us will be the poorer for it. These are the same charges leveled at the Commission whenever it brings an action against corporations and their officers, their accountants and their lawyers.

Such an argument, in my estimation, is unfair to the American people and unfair to American business. The overwhelming majority of American businessmen run their businesses honestly and with an abiding sense of integrity -- and the American people know it. The overwhelming majority of businessmen deplore as do you and I the conduct of the Billy Sol Estes, Lowell Birrells, the Cortes Randells, and the Robert Vescos.

I think it is instructive to contemplate the alternative to the process by which misdeeds become public property. Do we really want the stark facts in National

Student Marketing, Four Seasons, Equity Funding, Home-Stake and in countless other schemes to be buried and kept out of the consciousness of the American people? In every one of the debacles that we have experienced, public money was the fuel for the engine and when the engine disintegrated it was the public money that was lost. In far too many instances we have witnessed the evil-doers leaving the wreckage they have created with carefully preserved fortunes and very limited retribution, while their victims, the public investors, have experienced tragic wipeouts. Do we really want all this kept under cover in the name of preserving confidence in corporate enterprise?

I would suggest to you that the American public is fully able to distinguish between honest businessmen and dishonest businessmen. Thank Heaven the number of dishonest businessmen has been few in number, despite the vast carnage that a few of them have created. Businessmen who operate their enterprises on the public's money have accountability to the public and in order for that accountability to mean anything at all, the public must know the manner in which corporate executives carry out those responsibilities. I doubt if anyone could successfully argue that public disclosure of conflicts of interest, personal avarice and corporate mismanagement has not raised the standards of corporate conduct without, in my estimation, exacting an oppressive price in waning public confidence.

But it is hard to deny that public confidence is fragile. We have witnessed repeatedly in the last few years instances in which a single newspaper article containing perhaps only a hint of corporate trouble has sent a corporation's stock plummeting, with immense losses, both directly and indirectly, to numerous individuals. Perhaps there is no more immediate and clearer witness to the power of the press than in those instances. This is not to suggest that adverse information about a corporation should be covered up lest its shareholders suffer losses; after all the very concept of an efficient market assumes that all information is fully and immediately disseminated in the market place. It does suggest, however, the overriding necessity for care, temperance, and skill in reporting corporate news. The article based upon inadequate understanding of intricate corporate transactions can create vast havoc and inflict upon investors losses they shouldn't suffer.

While the record of financial journalists in identifying, publicizing and bringing to the Commission's and public's attention fraudulent conduct involving corporations, and in telling us after the orgy that we ate and drank too much, has been most commendable, in another particular, however, I think many in the profession have been found wanting. I level this criticism at the journalism profession with some diffidence because the blindness to which they were subject was shared by a large number of people who should have known better -- financial analysts, lawyers, accountants, even regulators. During those incredible years that John Brooks has called the "go-go years" it seems to me many financial journalists lost some of their native skepticism and in many cases were as caught up in the unrealities of the times as anyone. Perhaps it is unjust and unfair to attribute this shortcoming to financial journalism when so many others were guilty of the same fault. If there is a justice in it, it is because we expect financial journalists to be more perceptive than many, to approach the financial affairs and the self-serving publications of corporations with a skeptical eye and to avoid running with the herd. When these expectations are disappointed than many suffer. As I have reviewed the period from, say, 1965 to 1972, I am dismayed at the extent to which we all kidded ourselves into the belief that somehow we had moved onto new, permanent plateaus of excellence and affluence. Did we really believe that the old standards for judging investments were forever gone, that new standards were appropriate; that sales per share instead of earnings per share counted; that paper earnings were the same as operating earnings; that accounting techniques created real wealth; that large numbers of corporations were so well managed that quarter by quarter their earnings would forever go in only one direction? We made folk heroes out of the most articulate purveyors of these notions and we accepted unquestionably these subtle delusions.

I attribute to most of these entrepreneurs no evil motives for they were the victims of the same sort of euphoria as the rest of us. Today many are paying the price for having accepted these questionable concepts. The accounting profession is fighting its way out from an inundation of Commission and privately instigated litigation, much of it because they lent themselves to practices which preserved the myth. Some in the legal profession find themselves the subject of litigation much for the same reason. Seemingly solid corporate empires have been severely shaken and in many instances have completely collapsed. In one recent case the head of a company which the market once valued at hundreds of millions of dollars and which was built on the appealing notion that the founder of the company had found a means of tapping the vast youth market has admitted the use of all kinds of devices to shore up the facade which he had created and which so many who should have known better helped him embellish.

The journalism profession has been great in ferreting out fraud and in describing fully those that have surfaced because of other initiatives. The question I ask now concerns not so much fraud or similarly overt criminal or serious non-criminal misconduct. Rather, I am concerned with the ability and the willingness of financial journalists to stand back from the passing parade and see it for what it is while it's happening. As we look back on that turbulent period at the end of the 60's and the first part of the 70's I think all of us realize that what was passing before our eyes should have been clear to us for what it was: unreal, economically unsound, destined for collapse. It would have been well if courageous and perceptive journalists had done more to tell the public that indeed the emperor had no clothes, that you do not make wealth out of accounting tricks, that nothing goes up forever, that the past is sated with instances of similar self-delusion, and that abuses like those which abounded inevitably create collapses. And yet few, very few, articles warning of these abuses and their ultimate consequences found their way into the popular press or into business publications. Instead, during that period the prophets of the new order were lionized, praised for their genius and imagination and given free rein to express their convictions without critical comment.

The record, I hasten to add, is not all dark. I recall articles in many publications which saw through all the glittering promises and warned that perhaps all was not well and the future was studded with the threat of disaster. One particular instance occurs to me. In 1968 one journalist wrote in this fashion:

> "Almost every day you pick up the newspaper, some company is merging with another company. The average person has no idea what is happening, but it could eventually affect everybody in the U. S. What it boils down to is that if you merge an apple company with another apple company, you're violating the antitrust laws. But if you merge an apple company with a banana company, then you're building a conglomerate; and

whether you know it or not, conglomerates are the ‘in’ thing to own.

“This is how conglomerates work.

“Let us say that Dalinsky’s Drugstore in Georgetown decides to merge with Fischetti’s Meat Market in Bethesda, Md. Since neither Dalinsky nor Fischetti can agree on whose name to use, they call the company the Great American Drug and Meat Co. They issue stock and it is immediately sold out, because any company that has the words ‘great,’ ‘American,’ ‘drug’ and ‘meat’ in it must have potential. Now, with the stock from their company, they make a bid to take over the Aetna Curtain Co., offering Aetna stockholders one share of GADAM for every two shares of Aetna.

“Once the deal is completed they go to the bank and borrow $500,000 on the Aetna Curtain Co. to buy the Markay Life Insurance Co.

“Then, using the money in the Markay Life Insurance Co., they make a bid on the Mary Smith Pie and Bakery Co., offering 1 1/2 shares of Markay for 1 2/3 shares of Mary Smith.

“It turns out that Mary Smith Pie and Bakery has a $3 million surplus cash flow, so Dalinsky and Fischetti use this cash flow to buy the Carey Winston Life Preserver Co., which in spite of its name specializes in the building of Nike missiles.

“With government contracts from the Carey Winston Life Preserver Co. as collateral, GADAM buys the Washington Green Sox baseball team, which it merges with the Norfolk Warriors, a basketball team that loses money but can come in handy to write off the profits of a TV station that GADAM is bidding on in Winnipeg.

“With these companies as a nucleus, Dalinsky and Fischetti decide to make more acquisitons, because, as Dalinsky tells a Time magazine reporter who is doing a cover story on him titled the ‘Boy Wonder of Georgetown,’ ‘If you stand still you die.’

> "The next step for GADAM is to go to the First Citizens Bank of Wesley Heights and borrow $20 million against the stock. With the money Dalinsky and Fischetti buy the Second Citizens Bank of Culpepper, and then use the stock to purchase the First Citizens Bank of Wesley Heights.
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> "From there it is only a matter of time before GADAM starts a mutual fund, a fried chicken franchise company, a Puerto Rican rum plant and a senior citizens' apartment complex in Fairbanks, Alaska.
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> "In less than three years, Dalinsky, who put up $30, and Fischetti, who put up $25, control $3 billion worth of businesses and are each worth on paper $50 million. The only danger is that if either Dalinsky's Drugstore or Fischetti's Meat Market loses the lease on its store the whole conglomerate pyramid could fall down. When you get right down to it, that's the only part of their business that Dalinsksy and Fischetti understand."

Remember this was written in 1968 -- and not by a financial journalist but by that old friend, Art Buchwald. During the next two or three years, before the bubble burst, many pieces appeared in financial journals which continued to build the myth that somehow Dalinsky's Drugstore and Fischetti's Meat Market could constitute the foundations of vast enterprises into which the public -- and for that matter, highly sophisticated institutional investors -- should pour untold millions of dollars. I would ask how it was that a humorist could see the lurking disaster so clearly when those of us far better equipped could not?

To do the sort of job that I suggest -- to stand back from events and appraise them in their totality, as well as with particularity -- requires more than the ability, not too abundant to begin with, to write intelligent English. It requires a knowledge of the way the securities markets are organized, the manner in which they function and the role of corporations in American life, and a deep awareness of the ethical standards by which corporate enterprise should be conducted. This means that a good financial reporter must have among his skills and knowledge a keen awareness of economics, some notion of history and an ability to reflect and ponder the broad trends of which the pieces constitute parts. I am not suggesting, of course, that all financial reporters need ph.D's in economics, or that they be lawyers or accountants. Rather, I suggest only that they have among their equipment a thorough knowledge of that about which they write, as well as an ability to communicate that effectively to the public they serve.

My criticisms of journalists for not better alerting their readers to the extravagances of the late 60's and early 70's, like those concerning the press's prowess in detecting and exposing fraud, and like most generalizations, are clearly not applicable universally. Those who receive the awards being given today, and those who have received them in the past, are glittering evidences of the perils of generalization, for they and many of their colleagues often were, indeed, modern St. Johns crying in the desert, with their readers too intent on speculative profits to either read their warnings or take them to heart.

I think there is evidence that more journalists than ever before, chastened like the rest of us by embarrassed recollections of that period just past, are approaching their tasks with renewed skepticism and with renewed awareness of their responsibility. Their example should inspire their comrades.

There will come other times when it will be tempting to put aside native skepticism and help in creating a new time of euphoric optimism, boundless faith in the future, a conviction that we have found the ultimate solutions to corporate and economic problems. I would hope that all of us who have been through the experience of the last half dozen years will be able to pull in the reins and look askance. But I suggest that there is a peculiarly important role for the financial journalist. Because he has a forum, because he has an audience, because he has in many instances the confidence of so many, because he has skills, because part of his professional makeup is skepticism, because the vast bulk of people look to periodicals for their notions of the world outside their experience, it seems to me that it is peculiarly incumbent upon him to step back from the passing parade with its colorful uniforms and the lively beat and look beneath the fluff and the colors to the hard reality -- and report it. He will pay a price for this candor. Many of his best sources will clam up, he will be accused of being anti-business, his publisher may complain about declining advertising revenues and innumerable other charges may be made against him. But if he does this job with integrity, and with fairness, and with dedication to the truth, and with a sound understanding of corporate and financial complexities, he will have served the public well, he will deserve the honor of his profession and he will sleep soundly at night.