Statement on Financial Disclosures about Acquired and Disposed Businesses

Commissioner Robert J. Jackson Jr.

May 3, 2019

Let me begin by thanking the Staff in the Division of Corporation Finance, including Division Director Bill Hinman, for their hard work in developing today's release and for helpful briefings throughout this process.

Today's proposal governs the financial information firms give investors relating to mergers and acquisitions, among other things. The proposal provides several necessary updates to our rules. But I'm concerned that the proposal treats mergers as an unalloyed good—ignoring decades of data showing that not all acquisitions make sense for investors. Thus, while I vote to open this proposal for public comment, I urge investors to help us engage more carefully and critically with longstanding evidence that corporate insiders use mergers as a means to advance their private interests over the long-term interests of investors.

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Mergers and acquisitions offer substantial benefits for public companies and investors, creating economies of scale and scope that make firms more efficient.[1] But research has long shown that they can also be used by executives to build empires, even if giving management more domain is not in investor interests.[2] Our disclosure rules should balance these benefits and costs, requiring information after mergers close that allows investors to hold management accountable for their mistakes. The prospect of that accountability makes management more likely to pursue only those mergers that make long-term sense for investors.

In two ways, today's proposal ignores evidence on how corporate insiders use mergers to extract private benefits at investor expense. First, our rules historically have required certain disclosure related to the acquisition of "significant" businesses—that is, those with sufficiently large implications for the firm's financial future to make more detailed disclosure necessary.[3] For decades, we have determined the "significance" of the merger by reference to the audited value of the acquirer's assets according to its last-filed annual financial statements. Today's proposal would, among other things, determine a deal's significance based upon the market value of the acquirer's equity.[4]

The problem with this change is that it could result in less disclosure about acquisitions made by companies whose market value is significantly different from their book value. The evidence shows that those are the mergers that are more likely to be bad deals—precisely the type of mergers for which we should require the *most* transparency.[5] That's especially true in light of evidence suggesting that managers prefer to hide information about underperforming mergers in order to avoid accountability to investors.[6] So it's not clear to me why we should change our rules to give investors less information about these deals, since doing so risks giving executives more freedom to pursue mergers that harm the long-term health of the company.

Second, the economic analysis in the release reflects a troubling trend of one-sided thinking in our rulemakings.[7] To justify today's changes, the economic analysis goes on at length about the benefits of rolling back certain disclosures. But it says nothing about the foundational theory or evidence showing that mergers also come with substantial agency costs.[8] The failure to grapple with these costs suggests that our regulatory choices reflect one-sided advocacy rather than sound economic analysis.

For example, the release describes the obvious fact that target companies receive a substantial premium when they're acquired.[9] But the release ignores the other half of this well-known equation: that acquiring companies' stocks tend to take a hit upon the announcement of a merger.[10] Looking at the performance of the *combined* company, which is more logically—and economically—sound, shows that many mergers are not in investors' long-term interests.[11]

Equally troubling is the release's reliance on decades-old research, failing to engage with more recent evidence that tends to undermine to the proposal's premise. Many of the older papers cited in today's release suffer from well-known methodological problems.[12] Those studies also exclude evidence from the merger waves of the 1980s and 1990s—evidence that shows that many of those mergers harmed investors over the long run.[13] Ignoring that history puts investors at unnecessary risk of the harm that would come from repeating it.[14]

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Contrary to the ideological intuition evident in today's release, mergers come with both benefits *and* costs. Some acquisitions create important efficiencies; others allow managers to build empires and extract value from investors. Our disclosure rules should give investors the tools to tell the difference. That's why it's so important that commenters come forward with detailed ideas about how this proposal can be improved in ways that will empower investors to hold executives accountable—particularly for those mergers that harm investors over the long run.

I am grateful to the Staff for their hard work on this proposal. And I look forward to hearing from commenters about how it can be improved in ways that would reflect a more balanced perspective about the implications of mergers and acquisitions for ordinary investors.

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[1]*See, e.g.*, Michael C. Jensen & Richard S. Ruback, *The Market for Corporate Control: The Scientific Evidence*, 11 J. Fin. Econ. 5 (1983) (famously noting that an active takeover market can create efficiencies by transferring inefficiently managed assets to more efficient management—or by creating synergies through economies of scale or scope).

[2]For the foundational citations, *see* Michael C. Jensen & William H. Meckling, *Theory of the Firm: Managerial Behavior, Agency Costs, and Ownership Structure*, 3 J. Fin. Econ. 305 (1976) (explaining that managers have private incentives to conduct mergers and acquisitions to increase the size of the firm in order to extract more pay or perquisites at shareholder expense); George Lucas, dir., Star Wars, Episode IV: A New Hope (1976) (providing a contemporaneous interpretation of the costs of empire-building). For empirical evidence, *see* Sandra B. Betton, Espen Eckbo & Karin S. Thornburn, *Corporate Takeovers*, *in* Handbook of Empirical Corporate Governance 291 (2008) (surveying the empirical literature on mergers and acquisitions, including the "stylized fact" of economically and statistically meaningful long-term stock-price underperformance after mergers—suggesting that mergers are not, on average, value-creating for investors); *see also* Ole-Kristian Hope & Wayne B. Thomas, *Managerial Empire-Building and Firm Disclosure*, 46 J. Acct. Rsrch. 591 (2008).

[3]*Instructions for the Presentation and Preparation of Pro Forma Financial Information and Requirements for Financial Statements of Businesses Acquired or To Be Acquired*, Release No. 33-6413 (Jun. 24, 1982); 17 CFR 210.3-05.

[4]Securities & Exchange Commission, *Amendments to Financial Disclosures about Acquired and Disposed Businesses*, Release No. 33-10635 (May 3, 2019) (hereinafter, "Release").

[5]*See, e.g.*, Fangjian Fu, Leming Lin & Micah S. Officer, *Acquisitions Driven by Stock Overvaluation: Are They Good Deals?*, 109 J. Fin. Econ. 24 (2013) ("[O]vervalued acquirers significantly overpay for their targets. These acquisitions do not, in turn, lead to synergy gains. Moreover, these acquisitions seem to be concentrated among acquirers with the largest governance problems. CEO compensation, not shareholder value creation, appears to be the main motive behind acquisitions by overvalued acquirers.").

[6]*See, e.g.*, Ron Shalev, *The Information Content of Business Combination Disclosure Level*, 84 The Acctng. Rev. 239 (2009) (showing that acquirers who disclose more financial information have better subsequent firm and stock-price performance, consistent with the theoretical argument that managers attempt to hide financial information about merger mistakes).

[7]*See, e.g.*, Statement of Commissioner Robert J. Jackson, Jr. on Final Rules Implementing FAST Act (March 26, 2019) (noting the Commission's recent tendency to "ignor[e] facts in favor of belief that the SEC can deliver a free lunch in finance").

[8]For compelling proof of this possibility that evaded even the basic literature review in today's proposal, *see* Hope & Thomas, *supra* note 2 (showing that, after the adoption of new accounting rules eliminating mandatory disclosure of financials for geographic segments of public, multinational companies, "nondisclosing firms, relative to firms that continue to disclose geographic earnings, experience greater expansion of foreign sales, produce lower foreign profit margins, and have lower firm value").

[9]*See* Release, at n. 282; *see also* Gershon Mandelker, *Risk and Return: The Case of Merging Firms*, 1 J. Fin. Econ. 303 (1974).

[10]*See* Gregor Andrade, Mark Mitchell & Erik Stafford, *New Evidence and Perspectives on Mergers*, 15 J. Econ. Persp. 2 (2001) (survey paper showing that between 1973 and 1998 the stock price reactions for the acquirer firm was minus 3 or 4 percent and that the joint value shows no clear pattern).

[11]*See id*.

[12] For thoughtful and important reasons for caution about studies of exactly the type relied upon in today's release, *see* S.P. Kothari & Jerold B. Warner, *Measuring Long-Horizon Security Price Performance*, 43 J. Fin. Econ. 301 (1997) ("Conclusions from [earlier] long-run horizon studies require extreme caution.").

[13] Ran Duchin & Breno Schmidt, *Riding the Merger Wave: Uncertainty, Reduced Monitoring, and Bad Acquisitions*, 107 J. Fin. Econ. 69 (2013) (showing that the "average long-term performance of acquisitions initiated during merger waves is significantly worse," and providing evidence that firms conducting mergers during waves feature corporate-governance arrangements that give managers more discretion in choosing merger targets).

[14]*Cf.* George Santayana, The Life of Reason 14 (1905) ("Those who cannot remember the past are doomed to repeat it.").