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IMPROVEMENTS IN CORPORATE DISCLOSURE

An Address By

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IMPROVEMENTS IN CORPORATE DISCLOSURE

Before opening the meeting up to questions, I do have a few remarks to make about a familiar topic, disclosure – the production of dissemination of information about issuers of securities. Disclosure, seemingly so innocuous, serves three vital functions: it enables investors to make informed investment decisions; it may serve to decrease the temptation of those who manage other people's money to sin, since the would-be sinner knows that his activity will have to be fully disclosed; and, it serves an enforcement function. As the officers often primarily responsible for relations with shareholders and who must deal directly with the Commission over disclosure matters, you have been exposed to these several facets of disclosure. You are aware, of course, that, although the principle itself is relatively noncontroversial, the practicalities are not always free from controversy. Tough decisions must be made, and great care must be taken. You serve as the nexus between the corporation and its shareholders, so that the successful implementation of our disclosure program is, to a significant extent, in your hands. The Commission can encourage you and prod you, or can offer guidelines and requirements, but it cannot perform your job.

I imagine that most of you have heard as much as you care to about how the principle of disclosure is the foundation of our federal securities laws. Rather than repeat that message, tonight, I would like to speak about the specific implementation of that principle in several areas that are particularly relevant to your work and that have been centers of recent Commission activity: improved financial disclosure, annual reports to shareholders, and projections.

In the past year or so, the Commission has taken a number of significant steps to increase the amount of financial information available to investors. Early in 1973, we required the filing of timely information regarding unusual charges and credits to income. Under the new rules, a Form 8-K must be timely filed, setting forth the details associated with the charge and including a letter from the registrant's independent public accountant indicating that the accounting principles followed are in conformity with generally accepted accounting principles.

Later in 1973, we took three significant steps to increase disclosure of the significance of various methods of financing, all of which were effective in time for 1973 financial statements. These related to financing leases, income tax expense discrepancies, and short-term borrowing. The thrust of our proposals was that there be disclosure of the consequences of certain kinds of financing, so that the results shown in corporate income statements could be analyzed and compared with the financial statements of other companies.

In addition to these adopted requirements, a number of significant proposals are still outstanding, proposals upon which I expect Commission action in the year ahead. First, is our proposal for improved disclosure of the effect of accounting alternatives on reported results. We have been working with this proposal for over a year, and we have already published it twice for comment. We have received extensive comments, and we recognize that the area is a difficult one. It is likely that we will put yet another proposal out for comment before adopting final rules, but, ultimately, we do hope to adopt rules applicable to 1974 financial statements.

We have also published a proposal for the amendment of Guide 22 to the preparation of registration statements, which will provide for an improved analytical summary of material changes in corporate results, supplementing the summary of earnings. We believe this to be an important step in requiring management to take some responsibility in pointing to the most important aspects of corporate results and indicating the extent to which past results may not be indicative of what can be anticipated in the future.

In connection with the proposal and adoption of these increased financial disclosure requirements, the Commission articulated, for the first time, an approach to disclosure which emphasizes the varying needs of different groups of investors. This approach, which we call "differential disclosure," reflects our recognition of the fact that the data needs of the average investor may be different from those of the professional analyst and, accordingly, that different levels of summarization in the presentation of financial results are desirable.

Under this approach, we recognize that certain detailed data may be of interest primarily to the professional analyst who has the responsibility for developing an understanding in depth of corporate activity. Such an analyst would expect to devote substantial time to the study of corporate information and would have the professional training and skills to understand and use it. It is our view that, if analysts do use this information effectively, the results will be reflected in the marketplace and improve the capital allocation mechanism.

While our recent emphasis on disclosures aimed more at analysts has received the most publicity, I believe that an equally important part of the differential disclosure

concept is that part which identifies the responsibility of the corporation to present meaningful analytical summaries in terms that the average investor can understand. It is apparent that many investors do not have the time, or the training, to analyze a set of financial statements and footnotes carefully, to extract those elements which are most important in appraising corporate results. Management, on the other hand, is in an excellent position to do this, and it seems to us an important part of their responsibility that they do so. Guide 22, which I mentioned earlier, is therefore, a vital part of our differential disclosure approach.

We expect this approach to promote the interests of individual investors because they will receive more comprehensible data, because nothing is or ever will be furnished to professional analysts pursuant to our rules that will not be available to any investor, and because the whole philosophy of the ’33 Act has relied heavily on the proposition that ordinary investors benefit from the information available to brokers and brokers’ analysts, and we think this is still true.

Our concern that analysts and other professionals receive detailed and sophisticated disclosures is matched by our concern that the individual investor receive at least basic information about the registrant. We have, over the last few years, significantly improved the disclosure required in documents filed with the Commission, but we recognize that much of this information may never reach the investor. The Form 10-K annual report, for example, contains substantial and vital information, but is not directly available to most shareholders and investors. We are trying to improve our own dissemination system, but, while we are in the process of doing so, we must look to management’s annual report to shareholders as the model of a successful disseminated

disclosure document. This being so, we have turned our attention toward improving the disclosures made in management's annual report.

Anyone familiar with our financial markets will agree that the single document providing information with respect to an issuer that, by far, is most widely disseminated and is most likely to be available to anybody faced with an investment decision, is management's annual report to shareholders. More people get it, more people retain it, and more people know where to find it than any other single document in the whole process of financial disclosure, and it is perhaps ironic that this is the one document that our present system of federal securities regulation neither requires nor governs in any direct respect, except, of course, through our fraud and proxy rules. Nevertheless, we know that it exists, and we have long taken at least partial advantage of it.

It may seem curious that the Commission does not have any express authority to regulate such reports or communications to shareholders by ordinary '34 Act-registered companies. We have such authority under the Investment Company Act of 1940 and the Public Utility Holding Company Act of 1935, but not with respect to the Securities Exchange Act. However, the '34 Act does give us authority to regulate the solicitation of proxies by companies registered under that Act and, for over thirty years, we have used this jurisdictional "hook" to intrude somewhat upon the annual report to shareholders. Our initial requirement was simply that an earnings statement for the last year and a balance sheet be sent to all shareholders prior to, or concurrently with, the solicitation of proxies, and it was well understood that this would probably be done by means of the annual report to shareholders. In 1964, we added the requirement that any discrepancies in accounting principles and procedures between the financials supplied in the annual

report to shareholders and in the Form 10-K filed with us be reconciled by a narrative in the annual report.

In December 1972, the Report of our Industrial Issuer's Advisory Committee recommended that we adopt substantive amendments to our proxy rules to improve disclosure in annual reports to shareholders.

On the basis of these recommendations, and our own belief that improved dissemination of information through the annual report was both feasible and desirable, we proposed last January that the proxy and information statement rules be amended to do three things:

First, standardize to some extent, and improve in some instances, the content of the annual reports to shareholders;

Second, improve the dissemination of Form 10-K, by making it available to shareholders on request; and

Third, improve dissemination of the annual report and proxy material to the beneficial owners of the securities.

With regard to the first of these suggestions, the proposals would require that the annual reports to shareholders include the following information: the general nature and scope of the issuer's business; the contribution of a company's various lines of business to the company's sales and earnings; a five year summary of earnings; the nature and scope of the liquidity and working capital requirements of the issuer; at a minimum, the name and principal occupation or employment of each director and executive officer; and the principal market in which the company's securities are traded as well as the high and low prices for each quarter over the most recent two years, together with information as

to dividends paid and a statement of the company's dividend policy. In addition, we have proposed that financial information and data or financial highlights, in the form of charts, graphs, figures and the like, should not present the results of operations or other financial information in a light more or less favorable than that presented by the actual financial statements included in the annual report to shareholders.

In our release, we have tried to adhere, to the extent possible, to our traditional policy of not interfering with management's annual communication with its shareholders. We have not tried to restrict so-called free writing, except to point out that charts and graphs and pictures and whatnot should not be significantly different in the financial results and conditions that they portray from what appears in the financial data included in the Form 10-K. If the proposals are adopted, the annual report would retain its status as a nonfiled document and would still not be subject to staff review prior to use.

Management sometimes has to be reminded that the annual report, while not a filed document, and thus not subject to liability under Section 18 of the '34 Act, is nevertheless a document subject o Rule 10b-5. Management's annual report to shareholders is free writing in the sense that it neither has to be filed in advance nor subjected to processing or comment by the staff, but it is not free, as you all know, in the sense that anything goes.

Turning now to some of our specific proposals, the first is that the annual report contain information describing the general nature and scope of the issuer's business.

The proposal is not to require a full statutory prospectus description of the business with anything like the same detail appearing in a Form S-1 registration statement or in the Form 10-K, but only the information which management, "in its

opinion," believes adequately describes the company's business. Closely related to this, of course, is the requirement that there be disclosure, similar to that in the Form 10-K, of the contribution of a company's various lines of business to its total sales and earnings.

Line of business information is already required to be included in reports on Form 10-K and is voluntarily reported in substantially the same manner today in annual reports distributed by many companies to their shareholders. Back in 1969, when the Commission first proposed that '33 Act registrants be required to disclose the contribution of various lines of business to their operations, the Commission was met with the argument that the fast developing trend was to provide line of business information voluntarily in reports to shareholders and that, therefore, there was no need for the Commission to adopt a requirement along those lines.

It is now more than four years later, and various studies indicate that the trend has not developed to the point where all, or even substantially all, publicly-owned companies are reporting this information. Our proposed requirement would provide for more uniformity, which is in the interest of those companies which presently recognize their obligation to provide meaningful information to their shareholders.

The requirement for a five-year summary of earnings to be included in annual reports was recommended by our advisory committee and was one of the recommendations in the recent New York Stock Exchange White Paper on Corporate Disclosure. '34 Act reporting companies are presently required to provide such a summary of earnings in annual reports filed with us on Form 10-K, so there should be little burden in providing similar information in annual reports to shareholders. It appears from the comments we have received that there may be some details to work out

concerning the extent to which exhibits or schedules have to be included. If the Commission adopts its proposed guidelines to require a textual analysis of material changes in the summary of earnings to be included in reports on Form 10-K, those guidelines would also apply to the summary of earnings in annual reports to shareholders. Our advisory committee had recommended a similar approach.

If adopted, these proposals also would require textual information which, in the opinion of the management, indicates the nature and scope of the liquidity and working capital requirements of the issuer. The New York Stock Exchange White Paper suggested similar disclosures, and information relating to liquidity is presently required to be disclosed in reports filed with us on Form 10-K.

Some commentators have objected to this proposal on the ground that it would require the disclosure of some forward-looking information concerning the company's future prospects. This may be so, but it is not inconsistent with other steps we have taken recently with respect to the disclosure of a company's future prospects. I might also note, parenthetically, that at least one company has provided estimates of sales and earnings in its annual report. While we may not agree with the method of presentation in all respects, we do not object to reasonably-based estimates of future performance appearing in annual reports, and our recent proposals would not change this position.

We have also proposed that, at a minimum, the name and principal occupation or employment of each director and executive officer be set forth in the annual report to shareholders. It is reasonable to assume that investors want to know the identities of the persons who are managing this company. Moreover, this is substantially less information

concerning management than is presently required in report filed with us on Form 10-K, and, thus, does not appear to us to be a burdensome requirement.

The final substantive requirement which would be imposed, if our proposals are adopted, provides for identification of the principal market in which the company's securities are traded and the high and low prices for each quarter over the most recent two years, together with information as to dividends paid and a statement of the company's dividend policy. Similar information is presently required to be disclosed in registration statements under the '33 and '34 Acts. The New York Stock Exchange White Paper suggested that a much more comprehensive set of market data be included in annual reports, but we are not prepared to go that far at this time.

Since we recognize that the annual report is management's vehicle for communicating with security holders, we do not intend to require that an annual report look like a report on Form 10-K. Our proposals would permit management to present the required information in any form it deems suitable, including placing the new information in an appendix. I cannot emphasize too much the flexibility as to presentation we fully intent to leave up to management.

Our second objective is the wider dissemination of annual reports on Form 10-K. This obviously could most easily be achieved by requiring that companies send copies of their annual reports on Form 10-K to all shareholders and other interested persons. Popular opinion to the contrary notwithstanding, we are conscious of the cost and trouble that our requirements may impose upon issuers, and we are reluctant to go this far. Instead, we have proposed, in our recent release, that the company's proxy statement

indicate that the company will send a copy of the annual report on Form 10-K to shareholders upon request.

Although commentators have suggested that this might be an expensive proposition, we do receive many complaints from shareholders, indicating that they cannot obtain information from their companies and that they would like to obtain copies of their 10-K's. Of course, they can obtain a copy from the Commission, or one of the companies providing such services, but this is apparently awkward and time-consuming and difficult for many ordinary investors.

As you know, some issuers already provide copies of the 10-K to all security holders, sometimes charging a fee calculated to be something less than the copying charge for the same document ordered from the Commission, and in some instances the 10-K actually serves as the substantive portion of the annual report.

Our third objective in our proposed proxy rule amendments is to provide a means by which the improved disclosure we have proposed can effectively and expeditiously be communicated to shareholders. Therefore, we have proposed that a company, when it solicits proxies, be required to determine from the recordholders of its securities the numer of beneficial owners and to provide sufficient copies of its report to its recordholders upon request, to permit recordholders to provide a copy to each beneficial owner. Our proposal also would require the company to pay the reasonable expenses incurred by the recordholder in transmitting the reports to beneficial owners. This requirement now exists with regard to information statements.

This is perhaps the most controversial of our proposals, and the one that presents the most practical difficulties for issuers and others. I assure you that we will give this

proposal and the comments on it careful attention. However, as you may be aware, the entire question of record and beneficial ownership has been receiving considerable attention, both in Congress and from our staff. Our staff is presently considering whether certain of our disclosure requirements relating to the acquisition or ownership of securities should be modified to require the disclosure of those persons who have the power to vote securities rather than simply the record or beneficial owners, and whether the threshhold reporting level, which is generally ten percent, should be lowered to five percent. Resolution of those questions might have some effect on the proposal in question. I also recognize that this new proposal will not change things much for the listed company or the over-the-counter company whose nonbeneficial record owners are primarily members of national securities exchanges, where the practice and the obligation of forwarding material after having received information as to quantities required and the undertaking of the company to pay reasonable expenses is well-established. Our proposal would extend beyond that group of companies.

The comment period on our proposed proxy rule amendments ended on March 15. We received about a hundred and fifty letters of comment – about a hundred from registered companies, and the rest from lawyers, accountants, public relations firms, various professional organizations, and investors. Almost everyone had something to say, and I imagine that the staff will take a while to analyze, summarize, and prepare internal responses to all of these comments. Many were generally favorable, but almost all contained criticism of one sort or another. Considerable unhappiness was expressed about providing Form 10-K's to stockholders – mostly on the question of expense and bulk. The provisions relating to supplying information to beneficial owners also did not

meet with wholehearted enthusiasm. Of the substantive requirements for disclosure of information, it appears that the working capital and liquidity disclosure is most unpopular, apparently because of the difficulty of defining what those terms mean, and of determining what the company's position actually is. We did get a letter from the securities committee of the American Society of Corporate Secretaries. They expressed general support for our proposals, specifically objecting only to the requirement for a description of dividend policy and of working capital and liquidity position. In both instances, their fear was that meaningful statements could not be made. In addition, they wanted it made clear that the exhibits to a Form 10-K need not be provided to shareholders on request. As I have indicated, the extensive comments on the proposals, and their importance, suggest that we will not act hastily on this matter.

I would like to devote the remainder of my time to one other area that involves both the disclosure of information and the dissemination of that disclosure. As you know, we have indicated that we intend to adopt standards governing the filing of forecasts with us. The standards promised in our release on projections, issued in February, 1973, are long overdue, and we hope to get them out by the Fall. I believe that the guidelines set forth in our statement of February, 1973, still represent a sound approach for the Commission to take on the subject of forecasts and projections, and I expect us to move forward in this area, along those lines.

The present Commissioners have not addressed themselves to this topic in a collective way so, adhering to the policy of our earlier statement, any forecast or projection made here by me with respect to future actions of the Commission on the subject of forecasts and projections is subject to the possibility that a majority of the

Commission may have, at the time of action, a contrary view, and, indeed, that I may be persuaded by the staff or other Commissioners to join in a contrary view.

With this careful hedging, I expect the Commission to do what it said it wanted to in February, 1973. We were a little discouraged by the recent federal district court decision concerning Douglas Aircraft Corp.* The court in that case seems to have applied a standard of accuracy to a forecast that supports the worst expectations of those that argue that forecasts are too dangerous legally. On the other hand, we were encouraged by the earlier court decision in the Monsanto case,** which seemed to apply reasonable tests, as we were by the recent exposure draft of the AICPA Management Services committee, which indicates increasing interest in the ideas.

On the whole, I am about where the Commission was in February 1973. Most investing is based on estimates of future earnings. We should, at least, experiment on a voluntary basis with permitting the investor to get this information from management in a formal and regulated way, rather than only, and always, from salesmen, base don God knows what.

As to liability, we hope that we can include statements that will give courage to counsel for registrants who want to engage in the bold experiment, by making clear our view of the law—namely, that a projection or forecast is not actionable merely because it turns out to be wrong, provided only that it was based on a reasonable and good faith effort on the basis of information available at the time.

All of the developments I have mentioned today reflect the influence of two concepts at work—improving the dissemination of meaningful information to investors,

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* Beecher v. Able, 66 Civ. 3471, 3382, 3775 (S.D.N.Y. 3/22/74).

** Dolgow v. Anderson, 53 F.R.D. 664 (E.D.N.Y. 1971)

represented by our proposals with regard to annual reports to stockholders, projections and certain financial disclosure, such as proposed Guide 22, and improving the quality and sophistication of financial disclosure for use by professionals, represented by much of our recent activity concerning financial disclosures. All of them directly affect you, since you are in the position of dealing with both the security holders and the professionals, as well as with the Commission.

I know you must have some questions, so I propose to stop here and see where I can expand upon particular matters that may be on your mind.