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REPORT

OF THE

ADVISORY COMMITTEE ON CORPORATE DISCLOSURE

TO THE

SECURITIES AND EXCHANGE COMMISSION

NOVEMBER 3, 1977

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ADVISORY COMMITTEE ON CORPORATE DISCLOSURE

TO THE

SECURITIES AND EXCHANGE COMMISSION

NOVEMBER 3, 1977

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

ADVISORY COMMITTEE ON CORPORATE DISCLOSURE

November 3, 1977

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Commissioner Philip A. Loomis, Jr.
Commissioner John R. Evans
Commissioner Irving M. Pollack
Commissioner Roberta S. Karmel
Securities and Exchange Commission
Washington, D.C. 20549

Dear Mr. Chairman and Commissioners:

It is our deep pleasure and privilege to present to you, on behalf of your Advisory Committee on Corporate Disclosure, its Report.

This Report is the fruit of twenty-one months of intensive effort by 17 Committee members (later 16, upon the appointment of Committee member Williams to the Chairmanship of the SEC) and variously eight to ten members of the Commission's staff. In addition to that, the work of the Committee was greatly assisted by the American Institute of Certified Public Accountants, the Financial Analysts Federation, the Financial Executives Institute, the New York Stock Exchange and the Securities Industry Association, all of whom contributed generously in advising the Committee and, in some cases, in developing extensive surveys and reports that were of great help. The Committee wishes to thank Dr. Paul A. Griffin of Stanford University and William Van Valkenberg, formerly

of the Commission's staff and currently associated with Mess'rs. Bogle and Gates in Seattle, Washington for the papers they prepared for the Committee. Finally, the Committee wishes to thank all the organizations and individuals who participated in the Committee's case study or responded to the Committee's request for comments on certain issues set forth in Securities Act Release No. 5707, for their valuable advice and assistance.

Although not all members agreed unreservedly, the Report concludes that the disclosure system established by the Congress in the Securities Act of 1933 and the Securities Exchange Act of 1934, as implemented and developed by the Securities and Exchange Commission since its creation in 1934, is sound and does not need radical reform or renovation. However, this conclusion does not dictate that the Commission should be indifferent to research which some would suggest has already or may in the future suggest a radical modification of this disclosure system. Further, as is evident from the contents of the Report, it does not suggest that there is no need for significant changes in the Commission's procedures, rules, emphases and approaches to disclosure problems.

We would like to commend the Commission for its initiative in creating the Committee, in shaping its broad charter and in supporting its labors. You were generous in furnishing staff and financial resources; we hope that our product is worthy of the support and resources which you gave.

This Report should not reach you without recognizing expressly the members of the Committee's staff, some recruited expressly to work on this Report, others taken from their ongoing activities at the Commission to work on the Report. These fine people were Bruce Baggaley, Paul A. Belvin, Hugh Haworth, Robert P. Lienesch, Edythe B. Macchiavello, Eugene Pillot, Jon C. Richards, Michael P. Rogan, S. James Rosenfeld, Patricia C. Rubini, Charles C. Tuck and Charles R. Wenner. All of these people worked unstintingly, enthusiastically, uncomplainingly and creatively and the Report bears a significant imprint of each of them.

The most resounding gratitude and recognition must belong to Mary E.T. Beach. Mrs. Beach, as nearly as any one

person, has been the central, couldn't-have-done-without, ingredient in the work of the Advisory Committee and the preparation of its Report. She has led the staff brilliantly. She has borne with the members of the Committee with unlimited patience, she has contributed her vast experience to the achievement of our work product. A large portion of the good of the Report is to be attributed to her; none of its shortcomings should be.

All of us are appreciative to the Commission for the pleasure of this experience and the opportunity to contribute to the ongoing work of the Commission which has earned a remarkable reputation as a responsible and responsive agency. All of us stand ready to lend whatever further assistance we may be able to render in carrying out the recommendations of this Report.

Respectfully submitted,

W. A. Sommer, Jr.

Arthur Fleischer, Jr.

William H. Beaver

Ray J. Groves

Warren E. Buffett

Deborah E. Kelly

John C. Burton

Alan B. Levenson

Victor H. Brown

Martin Lipton

David Norr*

Robert A. Malin*

Elliott J. Weiss*

Roger Murray*

Frank T. Weston*

*These members have prepared separate statements expressing their views on certain issues examined by the Committee. Their statements are included in the Digest of the Report.

Committee member Homer Kripke dissents from this Report for the reasons set forth in his statement which begins at page D-49 of the Digest of the Report.

DIGEST OF THE REPORT

This digest summarizes a full report consisting of an Introduction and four parts.

The Digest states the Advisory Committee's charge and its response to that charge. It includes a summary of the Committee's observations and conclusions, and a list of its recommendations. It also includes a dissent from this report signed by Committee member Kripke and separate statements by Committee members Malin, Murray, Norr, Weiss and Weston expressing their views on certain issues examined by the Committee.

The Introduction considers whether there are presently economic and public policy justifications for the existence of a disclosure system that, at least with respect to company-originated information, is characterized by a mandatory dimension administered by the SEC.

Part One, "Participants in the Disclosure Process," is comprised of six chapters describing the roles of the principal participants in the corporate disclosure system: companies, financial analysts, portfolio managers, information disseminators, registered representatives, and individual investors. These chapters were written by the Advisory Committee staff based upon its questionnaire and interview study and supplemented through studies by the Financial Analysts Federation and the Securities Industry Association.

Part Two, "Recommendations Concerning Commission Procedures in Developing Disclosure Requirements and Standards," and Part Three, "Recommendations Regarding Substantive Disclosure Requirements," together contain twelve chapters. These chapters, also prepared by the Committee staff, are based principally upon the proceedings of Advisory Committee meetings, discussions with the Committee members and responses to the request for public comments made in Commission Release No. 33-5707. These chapters reflect the Committee's observations and the underlying philosophy and rationale for the Advisory Committee's recommendations. The views expressed in these twelve chapters are not uniformly supported by Advisory Committee members, and therefore should not be considered as official Committee statements.

Part Four, "The Disclosure Environment," consists of four chapters discussing the evolution of the present system, current economic theories on disclosure, the liability provisions of the securities acts and the impact of disclosure of questionable foreign payments by certain companies on the market price and trading volume of their securities. These chapters are papers prepared at the request of the Advisory Committee.

THE ADVISORY COMMITTEE'S CHARTER

The charge to the Advisory Committee on Corporate Disclosure is:

(1) to identify the characteristics and functions of the present system of corporate disclosure and the role of the Securities and Exchange Commission within that system;

(2) to assess the costs of the present system of corporate disclosure and to weigh those costs against the benefits it produces;

(3) to articulate the objectives of a system of corporate disclosure and to measure the Commission's present disclosure policies against those objectives;

(4) if necessary, to formulate recommendations to the Commission for adjustments to Commission policies to better effectuate those objectives.

The Advisory Committee met for a total of 18 days during its 11 meetings between February 1976 and September 1977, conducted a comprehensive questionnaire and interview study of the primary participants in the corporate disclosure system, consulted with experts and examined pertinent studies and research reports, some prepared especially for the Committee. The Advisory Committee believes that it has accomplished its charge to the extent that it is presently practicable to do so, and hopes that its research results, analyses, observations, conclusions and recommendations will be of assistance to the Commission.

Interpreted broadly, the Committee's charter could encompass all types of corporate disclosures regardless of purpose. However, the Advisory Committee believes that the role of the Securities and Exchange Commission in

the corporate disclosure system is oriented by statute primarily to the investor and security-holder. Therefore, since the Committee was created by the Commission for the purpose of advising it, the Committee determined that it should focus on the disclosure system as it pertains to investment and corporate suffrage decision-making.

The Present System

The present disclosure system is complex and involves many persons and organizations who perform various roles. These include companies, analysts, portfolio managers, disseminators, registered representatives, and individual investors having varying degrees of sophistication and access to information.

Companies, as the principal source of firm-oriented information, are at the center of the corporate disclosure system. Their willingness (as opposed to their obligation) to provide information is a function of management's perception of the utility of the disclosure to the company and the user, the hard and soft dollar costs associated with the disclosure and the feasibility of communicating the information.

Analysts combine the information provided by companies with industry and macroeconomic data. They provide an interpretation of the information and frequently conclude with a buy-sell-hold recommendation directed to specific portfolio objectives. The interest of analysts

and disseminators in particular companies is influenced by the company's market capitalization or the potential for unusual return on investment.

Portfolio managers in large structured organizations select industries which will benefit from an assumed economic scenario and utilize analysts' recommendations for individual company selection appropriate to the characteristics of specific portfolios.

Information disseminators condense, summarize and disseminate available information and thereby assist analysts and investors in obtaining investment decision-making information in forms suitable to their respective needs and abilities to use it.

Individual investors use various methods in making investment decisions, ranging from fundamental analysis and replication of the activities of portfolio managers, to total reliance on the advice of registered representatives.

The Securities and Exchange Commission administers a mandatory disclosure system intended to assure that reliable firm-oriented information is available to the public. It does not purport to administer a system designed to produce all information used in investment decision-making. Further, information filed with the Commission has often been widely disseminated before filing.

The Committee considered the significant studies concerning the functioning of securities markets, theories concerning capital asset pricing and portfolio

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organization and belief in some quarters that market forces may adequately provide sufficient reliable firm-oriented information, and determined that the basics of the present system should be continued and that major change in the federal securities laws or their administration is not needed. The Committee concluded, with some dissent, that:

(1) The "efficient market hypothesis" -- which asserts that the current price of a security reflects all publicly available information -- even if valid, does not negate the necessity of a mandatory disclosure system. This theory is concerned with how the market reacts to disclosed information and is silent as to the optimum amount of information required or whether that optimum should be achieved on a mandatory or voluntary basis;

(2) Market forces alone are insufficient to cause all material information to be disclosed;

(3) Commission-filed documents often confirm information available from other sources. The Commission's filing requirements, while often not a source of new information to investors, assure that information disclosed by publicly held companies through many means is reliable and is broadly accessible by the public.

Cost/Benefit Considerations

An effort to analyze costs and benefits was a part of the charge to the Committee. While reducing costs and benefits to objectively measurable terms would be highly desirable, the Committee was generally unable to do so. The Committee's

staff successfully isolated only a few costs, principally legal and audit fees associated with registration statements and periodic reports. Efforts to go deeper were frustrated because methods of allocating internal costs are so varied that gathering comparable cost data from even a small sample of companies would have required far more time and resources than were available, and the data might still have been of doubtful reliability. Further, the Committee was unable to quantify such costs as competitive disadvantage and management disincentive to innovate and such benefits as confidence in the markets and efficient security pricing. The difficulties of evaluating costs and benefits, however, have not caused the Committee to reject the desirability of the Commission continuing its efforts to measure them more definitively. Further, inexact though they may be, perceptions about cost/benefit tradeoffs do underlie many of the recommendations found in this report.

SEC Objectives in the Investor Oriented Corporate Disclosure System (Chapter VII)

The Committee's charge includes the articulation of a statement of objectives to guide the Commission in its administration of the investor oriented corporate disclosure system. A statement of objectives is essential as a guide to rational, consistent problem-solving and policy-making, and as a standard for evaluating whether the Commission's programs are effective and appropriate to its jurisdiction. Such a statement also may reduce the number of inappropriate

demands made of the Commission by those who misunderstand its function.

The Advisory Committee recommends that the Commission adopt the following statement of objectives:

> The Commission's function in the corporate disclosure system is to assure the public availability in an efficient and reasonable manner and on a timely basis of reliable, firm-oriented information material to informed investment, and corporate suffrage decision-making. The Commission should not adopt disclosure requirements which have as their principal objective the regulation of corporate conduct.

This statement reflects the Committee's belief that the Commission's present statutory mandate extends only to information material to informed investment and corporate suffrage decision-making. The Committee recognizes that many constituencies look to the corporation for a variety of information, but believes attempts to serve groups other than investors would exceed the Commission's statutory authority.

Further, some argue that if information oriented to audiences other than investors or shareholders were required to be included in filings with the Commission, investors and shareholders would be compelled to sift out that which is relevant to their views, thereby hampering investment and corporate suffrage decision-making. This approach would lower the materiality threshhold and "simply . . . bury the shareholders in an avalanche of trivial information--a result that is hardly conducive to informed decision making." TSC Industries, Inc. v. Northway Inc. 426 U.S. 438, 448-49 (1976).

The phrase "firm-oriented information" is an acknowledgement by the Committee that although general macro-economic information is critical in investment decision-making, the Commission should not prescribe it as a part of the mandatory component of the corporate disclosure system it administers. Reporting companies should not be held responsible for information which is not within their expertise. The "firm-specific" language is intended, however, to emcompass disclosure of macro-economic factors to the extent they have a special or unique impact on the company.

The proposed statement recognizes that corporate filings need not be, and are unlikely to be, readily understandable in total by uninformed investors. The Commission should emphasize disclosure of information useful to reasonably knowledgeable investors willing to make the effort needed to study the disclosures, leaving to disseminators the development of simplified formats and summaries usable by less experienced and less knowledgeable investors.

Finally, the proposed statement reflects the Committee's belief that the Commission should not mandate disclosure requirements which result in non-material information and which have as their principal objective the regulation of management conduct. If the Commission perceives a need to regulate directly corporate conduct, it should request from Congress the authority to do so.

Materiality (Chapter VIII)

The materiality concept serves a variety of functions,

operating both as a principle for inclusion and exclusion of information in investor and shareholder disclosure documents and as a standard for determining whether a communication omits or misstates a fact of sufficient significance that legal consequences should result.

Although there may be some uncertainty associated with the application of the materiality concept because its current formulations are not readily translatable into objective criteria, the Committee is of the view that it is not possible to develop an objective definition of materiality that will have general applicability to all fact situations. The materiality of a particular fact must be determined after considering the importance of that fact in the context of the present and future business and financial circumstances of the company. Because the information necessary to make this evaluation is available to management, it has the major responsiblity for making this determination.

To the extent that uncertainty among users and preparers of disclosure documents concerning the application of the materiality concept in an area is present and widespread, the Commission should promptly amend its disclosure requirements to reduce uncertainty. This may be done by specifying a new type of information which is considered material or through the establishment of numerical benchmarks for materiality of certain categories of information.

RECOMMENDATIONS AND SUMMARY OF OBSERVATIONS AND CONCLUSIONS

This summary of observations and conclusions and the list of recommendations which follows reflect the consensus of the Advisory Committee as to modifications in Commission policies which would improve the operation of the corporate disclosure system and enable the Commission to more fully and effectively achieve its objectives. The nature of the issues, the Committee's observations and recommendations, and the rationale for and intention of those recommendations are explained. Comprehensive discussion of these matters can be found in Parts Two and Three of this report. Since several of the recommendations call for increased or improved review of information filed with the Commission additional staff may be necessary.

Rule-Making and Monitoring Practices (Chapter IX)

The Advisory Committee believes that the effectiveness of the Commission's disclosure programs can be increased if disclosure problems are more promptly identified, public input into the solution of these problems is maximized and a program for monitoring the effectiveness of new rules is implemented.

The Advisory Committee's recommendations include the following points:

(1) after identifying a disclosure problem of general significance, the Commission should initiate rule-making procedures and not rely for unduly prolonged periods on such ad hoc procedures as commenting on filings

and enforcement actions;

(2) prior to proposing a specific rule to deal with a major conceptual issue, the Commission should publish a concept release discussing the problems it perceives, the reason it proposes to proceed to rule-making, possible alternatives and should request public comments;

(3) the Commission should withdraw promptly proposals not adopted;

(4) as a part of its release announcing adoption of a disclosure rule, the Commission should state that after a specified period it will review the extent to which the rule has yielded the benefits expected and the manner in which and the standards by which such a determination will be made;

(5) academic research should be encouraged to aid in the monitoring efforts; and

(6) results of the monitoring process should be described in the Commission's Annual Report to Congress so that necessary remedial action can be taken if undesirable consequences are revealed.

The Committee believes that several benefits will result from these proposals. First, public input secured at the earliest possible time increases the likelihood that the resulting rule will be effective. Further, by acknowledging a monitoring obligation, major requirements which become unnecessary, ineffective, or have outlived their usefulness can be eliminated; and those which are not being complied with can receive added attention through

the Commission's enforcement program. Finally, if monitoring reveals possibly undesirable consequences not amenable to remedy by exercise of the Commission's powers, legislators will have a means of being alerted and may respond if necessary.

This set of recommendations is not intended to suggest that the Commission should initiate rule-making before it has sufficient experience with or understanding of the issue before it, and it does not suggest that the Commission should be unconcerned with or should not assist registrants in dealing with individual disclosure problems on a case-by-case basis.

Industry Guides (Chapter IX)

The Committee recommends that the Commission cooperate with preparers and users of information in developing disclosure guides for specific industries, with the goal of tailoring disclosure requirements to differing industry characteristics. When accomplished, this approach would have these advantages:

(1) disclosure requirements not meaningful in a particular industry situation would be minimized;

(2) vital disclosures in a particular industry would be obtained, and not obscured by detail irrelevant to that industry; and

(3) the Commission's staff would have a ready reference for a particular industry, and thereby be better able to apply uniform disclosure requirements to all registrants in that industry.

The Committee recommends that the Commission experiment with a few industries and monitor the effectiveness of the approach before embarking on a program for development of guides for all industries.

Forward-Looking and Analytical Information (Chapter X)

The traditional policy of the Commission has been to permit disclosure of virtually only "hard" information in filings (i.e., objectively verifiable historical facts) as distinguished from "soft" information (e.g., opinions, predictions, analyses, and other subjective evaluations). In recent times the Commission has departed from this constricting practice. The Advisory Committee endorses this departure and recommends that the Commission actively and generally encourage the publication of forward-looking and analytical information in company reports to shareholders and in Commission filings. It believes that the SEC staff should encourage responsible experimentation with disclosure of soft information and that the experimentation should be monitored to determine the usefulness of the information which results and the cost of producing it. To further encourage disclosure, a safe harbor rule is proposed for adoption. The rule would provide protection from liability for forward-looking and analytical information, unless it is proved that the disclosure was without a reasonable basis or was made other than in good faith.

In addition to recommending that the Commission

generally encourage disclosure of soft information, the Committee identifies several categories of information for special Commission attention. Management forecasts of sales and earnings seem to be of special interest to investors and analysts. The Committee's case study shows that there exists a widespread, informal system for communicating information about management projections. Although most managements have mixed emotions about discussing their projections, mainly because of credibility and liability concerns, some will, at least indirectly, convey their expectations to analysts. If the publication of projections becomes more widely accepted, communication among management, analysts and investors regarding management's expectations about the future can be more direct. Furthermore when companies formally publish projections they are likely to exercise greater care in preparing the information, and this would be a benefit to investors.

Thus, the Committee recommends that the Commission develop an experimental program to encourage the disclosure of information concerning future company economic performance. A public statement should be issued encouraging public companies to disclose projections in filings with the Commission subject only to the conditions that the projections be prepared on a reasonable basis, be disclosed in good faith, and be accompanied by an appropriate cautionary statement.

The Committee recommends that the Commission encourage but not require, registrants to publish major assumptions

underlying projections, comparisons of previous projections with actual results, and management analysis of the variances. The items of information to be forecasted, the time period to be covered by the forecast, and the decision to discontinue forecasting would also be discretionary with management. Third party review would be permitted but not required. The Commission should, however, require that previously issued projections still current at the time a registration statement is filed be included in the registration statement with appropriate updating if necessary.

A voluntary projections disclosure program is more appropriate than a mandatory program for the following reasons:

1. A mandatory system would necessitate the formulation of specific disclosure rules and regulations. The Committee is of the opinion that the Commission does not now have an appropriate basis for formulation of such rules and regulations, and that a period of experimentation is warranted.

2. All public companies should not be required to sustain the expense and other burdens that may be associated with a program for the public disclosure of projections. In some instances, companies might reasonably find that the burdens of projection disclosure would outweigh any corresponding benefits.

3. Public companies should not be compelled to expose themselves to the potential risks of liability and litigation for inaccurate projections.

4. Many companies would find it difficult, if not impossible, to prepare reasonable projections due to a lack of operating history, general economic factors or industry conditions.

The Advisory Committee also gave considerable attention to management analysis of financial information. In its case study, the Committee found that management analysis of the summary of earnings (Guide 22 under the 1933 Act, Guide 1 under the 1934 Act) is regarded by many investors and analysts as one of the best disclosure concepts ever adopted by the Commission. In some cases, however, the resulting discussion has not been meaningful. In part this may be because the numeric materiality standards included in the guides encourage mechanical compliance.

The Advisory Committee believes that the most effective management analysis results when management explains the events behind the financial statements rather than complies mechanisticly with the detailed items included in the present guide. Therefore, the Committee recommends that the guides be modified to delete the numeric tests and to emphasize that broader latitude will be given to registrants in implementing the analysis requested.

An important feature of the management analysis is the identification of significant facts which have affected reported results and are not expected to have a significant impact in the future and significant facts which have not affected results in the past and are expected to have a significant impact in the future. Accordingly, the Committee has drafted an instruction indicating that the analysis should focus on facts and contingencies

known to management which would cause reported financial statements to be not indicative of future operating results or of future financial condition." In connection with the recommendation to revise Form 10-K discussed below, the Committee recommends that the management analysis become Item 9 of Form 10-K. Accordingly, the revised text appears in the new Form 10-K which is included in the recommendation section of the Digest.

In a further effort to improve the quality of the management analysis the Committee recommends that the guides be amended to require the submission of a letter signed by the chief financial or accounting officer with each appropriate filing stating that due regard was given to all aspects of the requirement. The requirement for a letter should be terminated three years after its promulgation unless expressly extended by the Commission.

Other voluntary disclosures recommended are (1) planned capital expenditures and financing; (2) management plans and objectives; (3) dividend policies; and (4) capital structure policies.

Segment Reporting (Chapter XI)

Statement of Financial Accounting Standards No. 14 requires the inclusion of specified segment information in the financial statements, but there may exist a continuing problem with regard to these disclosures. A possibly significant gap remains between the level of segmentation some managements are willing to provide and the information

which users assert is needed for investment decision-making.

After dialogue with both analysts and management the Advisory Committee concluded that in some cases past levels of segmentation need improvement. Thus, the Committee endorses SFAS No. 14, with the hope that improvement will result from its application.

In addition, the Committee recommends that the Commission attempt to develop on an industry by industry basis a standardized product line classification for presentation of both dollar and, where appropriate, unit sales of each product line (within a segment) whose total sales comprised a certain percentage of consolidated sales in the previous fiscal year. This should be done in the process of developing industry guides so that the advice of both users and management of registrants can be considered.

The Committee believes this approach is beneficial in several respects. First, the problem of standardization will be approached on an industry-by-industry basis so that Commission action is limited to those industries where product line standardization is desirable and possible. Also, rather than imposing an arbitrary classification system, the development of standard product line reporting requirements could be accomplished by analysts and managements of registrants familiar with the particular industry.

Because the evaluation of a company consists of the

analysis of each segment and, the relationship of those segments to the whole, the Committee recommends that the narrative discussions in reports and registration statements filed with the Commission be presented on a segment basis, thus organizing the information according to the way it is used.

Finally, the Committee recommends that the Commission require unaudited segmented financial statement disclosures in Form 10-Q quarterly reports. The Committee believes that timely segment information assists users in evaluating earnings statements and forecasts.

Disclosure of Social and Environmental Information (Chapter XII)

Recently, controversy has arisen about the extent to which the Commission should require disclosure of company activities and policies regarding environmental matters and other aspects of corporate social performance.

A part of that controversy involves the kinds of information which are material to investment and corporate suffrage decision-making. Some argue that investors are primarily concerned with information that will help them evaluate the future financial performance of the company and that social and environmental performance is material only when it may affect that performance in a significant way. Others argue that shareholders may use this information in exercising their corporate suffrage rights even if it does not appear that the information reflects on future financial performance,

because it assists in evaluating the performance and qualifications of management and candidates for election to the board of directors, and the social responsibility of the corporate entity.

The Committee recommends that the Commission require disclosure of social and environmental information only when the information in question is material to informed investment or corporate suffrage decision-making or required by laws other than the securities laws. Generally information is material to investors only when it relates significantly to future financial performance or when a corporation's activities in these areas reflects a management engaged in a consistent pattern of violation of law.

The Advisory Committee also endorses the Commission's conclusion reached after its hearings on this issue that there are no broad categories of social and environmental information not now covered by mandatory disclosure requirements that should be made the subject of new requirements.

The Committee believes that the shareholder proposal rules provide an appropriate means for shareholders who are interested in social and environmental matters to influence management to disclose it.

Proxy Statement Requirements (Chapter XIII)

Deliberations about the proxy process brought out marked

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differences of opinion among the members of the Advisory Committee. The Commission has broad authority in the proxy process, but this process is so interwoven with corporate governance procedures -- historically within the jurisdiction of the states -- that there are difficult questions about the extent to which the Commission should exercise its authority.

There also are difficult questions about the purpose of proxy statement disclosures as they relate to corporate governance. On one side are those who believe that proxy disclosures should focus on matters directly related to economic performance. Others argue that since boards of directors serve as monitors of management, information should be furnished about the organization and role of the board so that shareholders may evaluate the effectiveness with which the board carries out this function.

The Committee recommends, by a slim majority, that the Commission should develop disclosure requirements that, taken as a whole, will strengthen the ability of directors -- as the representatives of shareholders -- to serve as the independent, effective monitors of management. This focusing on the monitoring role is not intended to imply that management should not serve on the board of directors. The minority with respect to this proposition agree with the desirability of reform in the corporate governance process, but question the effectiveness of disclosure as a means of achieving it.

Because of the substantial differences of opinion

on the Advisory Committee as to the need for new disclosure requirements or exactly what their substance should be, only the two disclosures discussed in the paragraph below are specifically recommended to the Commission for adoption. However, certain additional proposals, illustrative of the general approach to the area that the Committee believes the Commission should consider after the completion of its proposed public hearings on corporate suffrage and proxy disclosure issues, are included in Chapter XIII.

The Committee recommends that shareholders be given information about the nominating committee (if any) of the board of directors, and that companies be required to file with the Commission a director's letter of resignation if the director so requests.

The Advisory Committee believes that the disclosures in proxy statements about management proposals, particularly those where management may have a conflict of interest, such as option and other similar type plans, anti-takeover proposals, and plans for going private, are not always adequate. The Commission should closely review proxy materials on management proposals and assure that there is adequate discussion of their disadvantages.

Finally, the Advisory Committee concludes that the current Commission rules and practices regarding shareholder proposals provide a workable means for a shareholder to communicate his concerns to management and to other shareholders.

So that fewer shareholder proposals are excluded because of procedural technicalities, the Committee recommends that registrants be required to state in their proxy materials the date by which proposals must be received to be eligible for inclusion in the proxy materials for the next annual meeting.

Further Integration of the 1933 and 1934 Acts (Chapter XIV)

Criticisms persist about the amount of time required to complete the registration process and about duplication in 1933 Act documents of information already filed in 1934 Act documents. In addition, registration statements for exchange offers and mergers are criticized as extraordinarily long and complex. In recent years the Commission staff has reduced some of these problems, principally by more closely integrating the disclosure requirements under both acts. The Advisory Committee believes that the Commission's initial steps have proved successful and that further integration is possible and would be beneficial.

In order to maximize the integration of the registration requirements of the Securities Act and the periodic reporting requirements of the Exchange Act, the Advisory Committee recommends the development of a single coordinated disclosure form -- Form CD ("Coordinated Disclosure").

The content of registration statements, periodic reports, and material distributed in conjunction with shareholders meetings would be prescribed by the form, assuring that disclosure requirements are uniform among filings.

Form CD would classify registrants into three levels for

1933 Act registration purposes. With respect to offerings for cash, companies which have not been 1934 Act reporting companies for three years (Level 3) would be required to file the information currently prescribed by Form S-1; companies meeting certain asset size and earnings requirements (Level 1) would be permitted to use a short form registration statement similar to the current Form S-16, incorporating certain 1934 Act reports by reference; all other companies (Level 2) would file the information currently required by Form S-7.

For exchange offers or merger proposals, information regarding the transaction would be included in the prospectus. Information furnished to shareholders regarding the parties to the transaction would vary according to each company's status as a Level 1, 2, or 3 company. Level 3 companies would be required to furnish in the prospectus the information currently required by Forms S-1 or S-14. If any party to the transaction is a Level 1 or 2 company, the registration statement would incorporate by reference that company's most recent proxy or information statement and periodic reports. These documents would be made available on request for a Level 1 company and furnished with the prospectus for a Level 2 company.

The proposed availability to some companies of the incorporation by reference option reflects the Committee's belief that when a company has a public offering of its securities the disclosures involved should recognize the extent

of information about the company already available.

An effect of incorporation by reference is the subjection of 1934 Act filings to the liability standards of the 1933 Act. Whereas the 1934 Act imposes liability on persons responsible for a false or misleading filing unless they can prove they acted in good faith and had no knowledge of a misrepresentation, the 1933 Act establishes an obligation of inquiry on all participants in the registration process. Representatives of investment banking firms have expressed their concern about this matter.

The Advisory Committee's interest in furthering integration of the 1933 and 1934 Acts through incorporation by reference leads it to recommend that the Commission adopt a definition of a standard of reasonable investigation under the 1933 Act, taking into account the fact of incorporation by reference and the nature of the underwriting arrangements. Proposed wording for this definition is included in the list of recommendations.

Reporting Requirements Under the 1934 Act (Chapter XV)

The Commission requires companies to file annual and quarterly reports on Forms 10-K and 10-Q, respectively. In addition, most companies prepare separate annual and quarterly reports for their shareholders. Although the Commission's Forms 10-K and 10-Q are intended to communicate basically the same information as the company's reports to shareholders, there often are significant differences between them. In general the writing style in shareholder reports is more

readable than that in 10-K's and 10-Q's. On the other hand, the information filed with the Commission frequently is more complete.

The Advisory Committee believes the Commission can change its rules and procedures to improve both filed and non-filed periodic reports without hampering the more communicative writing style found in reports to shareholders. Accordingly, it recommends that registrants be encouraged to use their annual and quarterly reports to shareholders as filing documents in lieu of preparing separate 10-K's and 10-Q's. If this option is widely used, the information content of corporate reports to shareholders would be upgraded and the burdens of compliance with Commission requirements reduced since one report would serve two functions.

The Advisory Committee also believes the Commission's forms should be revised to improve the quality of their content and to present the information in a more useful format. To illustrate the suggested revisions the Advisory Committee approved a revised Form 10-K. The changes proposed for the 10-K could also apply to other forms, if Form CD were amended to reflect them.

The proposed 10-K would have five sections:

(1) a fact sheet -- principally capsule financial data and a brief description of the business;

(2) background about special risks or uncertainties and about distinctive features of the registrant's

(3) management's analysis of the financial statements and forward-looking information;

(4) information currently found in Part II of 10-K (details of management's security holdings, options, remuneration, and similar data) which may be omitted if a proxy statement has been filed; and

(5) the audited financial statements.

In addition to the reorganization of 10-K, certain information is noted for deletion, certain additional information is required, and the proposed disclosure requirements are written to minimize duplication and boilerplate. The text of the revised form is included in the digest following the list of recommendations.

Financial Statement Requirements (Chapter XVI)

The Advisory Committee addressed three topics related to financial statements:

(1) communication of uncertainties;

(2) considerations for evaluating accounting standards; and

(3) deletion of rules which cause unnecessary differences between financial statements prepared in accordance with Regulation S-X and those prepared in accordance with generally accepted accounting principles.

The communication of uncertainties inherent in nearly all accounting measurements is an important disclosure problem. The Committee believes the Commission can contribute to its solution if the financial statement disclosures called for

by the industry guides for companies with extended operating cycles highlight the economic assumptions underlying asset valuation and liabilities subject to greatest uncertainties, information permitting evaluation of the impact on operations resulting in changes in those assumptions and amounts included in the current year's income which are adjustments of estimates included in prior years' income statements.

The second topic in this chapter, considerations for evaluating accounting standards, is a complex one which the Financial Accounting Standards Board is addressing in its Conceptual Framework Project. To further those efforts the Advisory Committee offers some observations and recommendations based upon its case study and also on the collective experience of its members. The Committee believes that in evaluating accounting standards consideration should be given to, among other things, (1) uncertainties inherent in the measurement process, (2) the amounts and timing of historical cash flows, and (3) the liquidity of the reporting entity.

The third topic in this chapter relates to Regulation S-X. In some cases financial statements prepared in accordance with Regulation S-X differ from those prepared in accordance with generally accepted accounting principles ("GAAP"). The Advisory Committee recommends that the Commission undertake to eliminate all financial statement disclosure required by Regulation S-X which duplicate GAAP, critically

review all S-X requirements which are supplementary to GAAP, and eliminate those which are not necessary to investment decision-making.

This recommendation reflects the Committee's view that although Regulation S-X must necessarily supplement GAAP because of the Commission's ability to deal quickly with emerging problems, some information currently required may not be useful to investors. This includes a number of the schedules to the financial statements.

Special Problems of Small Companies (Chapter XVII)

There is ample evidence, including the results of the questionnaire and interview study, that the cost burden of periodic reporting to the Commission is relatively greater for small companies than for large companies.

The Advisory Committee strongly supports the idea of reducing the reporting burden for small companies. However, it recognizes that there must be an evaluation of several factors, including whether such a reduction is consistent with the Commission's objectives, and whether analysts' interest in small companies, already limited, would be further reduced.

The Advisory Committee concludes that more study is needed to assess the tradeoffs for small companies between reducing reporting burdens and the benefits of having a reliable public data base. Accordingly, the Commission should initiate an inquiry, including public hearings,

to determine if it is desirable and possible to define a small company class of registrants, and if so, how to reduce the reporting burdens for such registrants.

The Advisory Committee believes it important for the Commission to be more cognizant of the differences among registrants. Differentiating registrants by size, like differentiating by industry as discussed in the industry guides recommendation, may improve the corporate disclosure system to the benefit of both investors and registrants.

Dissemination of Information (Chapter XVIII)

The Advisory Committee believes that the Commission has a responsibility to maintain a comprehensive, accessible repository of filed information, but that such information should also be reasonably accessible directly from registrants. To improve their usefulness, the Commission's public files should be converted from a statutory basis to a "company" basis, and a "current" company file should contain each company's latest Form 10-K and subsequent 1934 Act (10-Qs and 8-Ks) and 1933 Act filings. The Commission should also require registrants to make all 1934 Act filings available to shareholders on request and to non-shareholders at a reasonable cost.

Finally, the Advisory Committee recommends that the Commission be responsive to the information needs of holders of debt securities and warrants. All company

reports normally made available to equity holders should also be made available to debt holders. These recommendations are based upon the Committee's recognition of growing volume of new corporate bonds and the greater interest in fixed income securities.

RECOMMENDATIONS

Chapter VII

That the Commission adopt the following statement of objectives:

The Commission's function in the corporate disclosure system is to assure the public availability in an efficient and reasonable manner on a timely basis of reliable, firm-oriented information material to informed investment and corporate suffrage decision-making. The Commission should not adopt disclosure requirements which have as their principal objective the regulation of corporate conduct.

Chapter IX

Regarding Commission rule-making and monitoring practices:

The Commission should initiate the rule-making process promptly after identifying a disclosure issue of general significance rather than proceeding exclusively through administrative or enforcement procedures.

Prior to developing the text of a rule involving a major conceptual issue with which the Commission has had limited experience and concerning which there is limited conceptual literature, the Commission should publish a "concept release" identifying the matter being considered, discussing the issues presented and alternatives available and requesting public comment on the "concept" of the proposed new requirement.

Rules proposed for comment should be deemed withdrawn if not adopted or reproposed for comment in modified form within a specified period of time after the expiration of the most recent comment period. A release should be promptly issued to explain why no action was taken. Similarly, concept releases should be withdrawn if no action is taken after a specified period of time and reasons for the withdrawal should be announced.

The Commission should expand the information content of releases announcing the adoption of a rule to include certain additional information and undertakings related to monitoring of the consequences and costs of new disclosure requirements. (The monitoring undertaken may be informal and non-empirical and need not be limited to economic analysis.)

The Commission should continue to be aware of research that is relevant to its statutory mandate and, if necessary, actively encourage such research.

The Commission's annual report to Congress should reflect the information developed by these recommendations.

Regarding industry guidelines:

The Commission should develop disclosure guides for specific industries to encourage uniform textual and financial statement disclosure of material items which are unique to a particular industry.

A mechanism should be established by the Commission to assure that it receives appropriate input from the users and preparers of information in the specific industry prior to the articulation of guidelines.

A few industries should be selected initially as an experiment for these recommendations.

The effectiveness of this experimental program and the guidelines should be reviewed by the Commission within a reasonable time after adoption.

Chapter X

Regarding forward looking information:

The Commission should encourage issuers to publish forward-looking and analytical information.

Experimental programs to encourage certain types of information such as projections and future-oriented analysis should be initiated.

Monitoring of these programs is encouraged for the purpose of determining the usefulness of the information to investors, the costs to issuers, and the responsiveness of issuers to user needs.

The SEC staff review process should be coordinated to assure proper implementation of Commission policy and uniform treatment of issuers.

A safe harbor rule should be adopted to provide maximum incentive for disclosure of management projections and other forward-looking information, whether or not filed with the Commission. The purpose of the safe harbor rule would be to place the burden of proof on the person seeking to establish liability for the disclosure of a management projection, management's analysis of financial information, plans and objectives, and other items of forward-looking and analytical information. The safe harbor rule should be applicable to all registrants and should provide protection from liability unless it is proven that the information was prepared without a reasonable basis or was disclosed other than in good faith.

Regarding Projections:

The Commission should develop an experimental program to further encourage the disclosure of information concerning future company economic performance, including the following steps:

A public statement should be issued to encourage public companies to disclose statements of management projections of future company economic performance in their filings with the Commission on a voluntary basis. These disclosures should be subject only to the conditions that the projections be prepared on a reasonable basis, be disclosed in good faith and be accompanied by an appropriate cautionary statement regarding the inherent uncertainty of the information.

The Commission's statement encouraging the voluntary disclosure of management projections

should state the following:

a. Disclosure of material underlying assumptions and comparisons of projections with actual results, including management analysis of any significant variance, should be encouraged but not required;

b. The items of information to be forecasted should rest within the discretion of management, but should be those most relevant in evaluating the company's securities and should not be items whose projection would create materially misleading inferences;

c. Third party review of management projections should be permitted but not required;

d. Projections previously issued by management having currency at the time a registration statement is filed should be required to be included in the registration statement in their original form or, where necessary, in modified form;

e. The time period to be covered by the projection should rest within the discretion of management; and

f. Inclusion of projections in one Commission filing should not "lock" the registrant into including projections in future filings; likewise, registrants should be permitted to resume the inclusion of projections in filings after a prior discontinuance. However, companies should be encouraged not to discontinue or resume projections in filings without good cause.

The statement should remind companies issuing projections of their obligations under the Federal securities laws to keep such information from being or becoming misleading and to disclose projections on an equitable basis.

Regarding management analysis of financial information (Guide 22 of the Guides for the Preparation and Filing of Registration Statements under the Securities Act of 1933 and Guide 1 of the Guides for Preparation and Filing of Reports and Registration Statements under the Securities Exchange Act of 1934):

The requirement for management analysis should be modified to emphasize that registrants will be given broad latitude as to implementation of the disclosures requested.

It should also be modified to explicitly recognize two separate aspects of management analysis: (1) quantitative analysis (e.g., variance analysis) and (2) discussion of historical facts.

The requirement should be amended to call for a letter, signed by the Chief Financial or Accounting Officer of the registrant and submitted with each appropriate filing, stating that due regard was given to the requirement and in particular to that part which calls for the disclosure of any facts and contingencies known to management which would make the historical record not indicative of the future. This requirement for a letter should terminate three years after its promulgation unless it is expressly extended by the Commission.

Regarding management's plans and objectives:

The Commission should encourage disclosure of planned capital expenditures and method of financing by business segment for the current fiscal year and the succeeding four fiscal years indicating: (a) amounts thereof related to environmental control facilities; and (b) the expected effects on production capacity.

The Commission should encourage disclosure of management plans and objectives.

Regarding dividend policies and capital structure policies:

The Commission should encourage registrants to publish statements of dividend policies.

The Commission should encourage registrants to publish statements of capital structure policies.

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Chapter XI

Regarding segment reporting:

The Commission should integrate textual disclosures required in Commission forms with segmented financial statement disclosures required by Statement of Financial Accounting Standards No. 14;

In developing industry guides, the Commission should consider: (1) requiring, as necessary, disclosure of both dollar and, where appropriate, unit sales of each product line within a segment whose total sales comprised a certain percentage of consolidated sales in the previous fiscal year; and (2) developing on an industry basis the most effective product line breakdown for displaying sales information.

The Commission should require segment data in interim reports (Form 10-Q) filed with the Commission.

Chapter XII

Regarding disclosure of social and environmental information:

The Commission should require disclosure of matters of social and environmental significance only when the information in question is material to informed investment or corporate suffrage decision-making or required by laws other than the securities laws. The Advisory Committee endorses the Commission's conclusion that there are no broad categories of social and environmental information, not now covered by mandatory disclosure requirements, that should be made the subject of new requirements.

Chapter XIII

Regarding proxy statement requirements:

The Commission should require each registrant to state in its proxy material or in its annual report to shareholders, whether there is a nominating committee of the board and, if so, who the members of the committee are.

The Commission should require registrants to file under cover of Form 8-K a letter of resignation received from a director when the director requests that the registrant file the letter.

The Commission should direct the SEC staff to review intensively proxy materials which contain certain management proposals, with a view to requiring more uniform and adequate disclosure of the advantages and disadvantages of proposals which may substantially affect the interests of shareholders, including disclosure of estimated costs of any option or similar type plan and the possible impact such plan may have on the behavior of management.

The Commission should require issuers to include in their proxy materials a statement of the date by which shareholder proposals must be received by an issuer in order to be eligible for inclusion in the issuer's proxy materials for its next annual meeting.

The following recommendation passed by a slim majority:

The Commission should develop a package of disclosure requirements that, taken as a whole, will strengthen the ability of boards of directors to operate as independent, effective monitors of management performance and that will provide investors with a reasonable understanding of the organization and role of the board.

There are substantial differences of opinion on the Advisory Committee as to exactly what the substance of the new disclosure requirements should be. For that reason, and also because the Advisory Committee has not engaged in any extensive field research relating to these issues, only the disclosure requirements described above are being specifically recommended to the Commission for adoption. Certain additional proposed disclosure requirements are included in this report to illustrate the general approach to the area that the Committee believes the Commission should consider after the completion of its proposed public hearings on corporate suffrage and proxy disclosure issues.

Chapter XIV

Regarding further integration of the 1933 and 1934 Acts:

The Commission should adopt a single integrated disclosure form to be used for compliance with the registration, reporting and proxy solicitation requirements of the Securities Act and the Exchange Act.

Registrants should be classified into Levels 1, 2, and 3 (proposed definitions are offered in the text of the report) for purposes of compliance with the Securities Act.

Level 1 registrants should be allowed to use a Form S-16 type short form registration statement for primary offerings. Level 2 registrants should be allowed to use a short form registration statement containing the disclosures required by current Form S-7.

In any exchange offer or transaction subject to Rule 145(a):

(a) Level 1 companies should be allowed to utilize short form registration statements containing the disclosure currently required by Form S-16 and certain additional information with respect to the nature of the transaction, which incorporates by reference the company's most recent proxy or information statement and periodic reports, and which undertakes to furnish such documents and the company's annual report to stockholders on request;

(b) Level 2 companies should be allowed to utilize registration statements containing the disclosure currently required by Form S-16 and certain additional information with respect to the nature of the transaction and which incorporates by reference the company's most recent proxy or information statement and periodic reports, provided such reports and the company's most recent annual report to stockholders are furnished with the prospectus; and

(c) Level 3 companies should be required to utilize registration statements containing the disclosures currently required by Form S-1.

The following rule should be enacted to clarify the extent of responsibilities of officers, underwriters and others for materials incorporated by reference in a 1933 Act filing:

> In determining what constitutes reasonable investigation or care and reasonable ground for belief under the Securities Act of 1933, of information incorporated by reference into a registration statement or prospectus, the standard of reasonableness is that required by a prudent man under the circumstances, including (1) the type of registrant, (2) the type of particular person, (3) the office held when the person is an officer, (4) the presence or absence of another relationship to the registrant when the person is a director or proposed director, (5) reasonable reliance on officers, employees, and others whose duties should have given them knowledge of the particular facts (in the light of the functions and responsibilities of the particular person with respect to the registrant and the filing), (6) the type of underwriting arrangement, the role of the particular person as an underwriter, and the accessibility to information with respect to the registrant when the person is an underwriter, (7) the type of security, and (8) whether or not, with respect to information or a document incorporated by reference, the particular person had any responsibility for the information or document at the time of the filing from which it was incorporated.

Chapter XV

Regarding reporting requirements under the 1934 Act:

The Commission should encourage companies which file periodic reports on Forms 10-K and 10-Q to substitute, as official filing documents, their annual and quarterly reports to shareholders.

The Form 10-K should be reorganized and the disclosure requirements should be written in a way that will minimize duplication and boilerplate language. The reorganized 10-K should contain five sections: (1) a fact sheet consisting principally of capsule

financial data and a brief description of the registrant's business; (2) background information about special risks or uncertainties and special or distinctive features of the registrant's operations or industry; (3) an analysis of the financial statements and forward-looking information; (4) information currently found in Part II of 10-K which may be omitted if a proxy statement has been filed (this includes details about management's security holdings, options, remuneration, and similar data); and (5) the audited financial statements.

Chapter XVI

Regarding uncertainty in financial statements:

In drafting industry guides for companies with extended operating cycles, the Commission should call for disclosures which will focus on the uncertainties related to certain financial statement amounts. Financial statement disclosures called for by the industry guides should highlight: (1) economic assumptions underlying asset valuation and liabilities subject to greatest uncertainties; (2) information that will enable investors to evaluate the potential impact upon income from operations resulting from changes in those economic assumptions, and the likelihood of such changes; and (3) amounts included in the current year's income statement which are adjustments of estimates included in prior years' income statements.

Regarding criteria to be used by the Commission and the FASB in evaluating accounting standards:

The Commission (and the FASB) in evaluating accounting standards, should consider among other things: (1) the adequacy of disclosures regarding the uncertainties inherent in the measurement process; (2) the adequacy of information concerning the amounts and timing of historical cash flows; and (3) the adequacy of information useful in assessing the liquidity of the reporting entity.

Regarding Differences Between Regulation S-X and GAAP:

A continuing goal of the Commission should be the elimination of rules of general applicability which cause differences between financial statements prepared in accordance with Regulation S-X and those prepared in accordance with generally accepted

accounting principles (GAAP). When the Commission requires an extension of disclosures beyond those required by GAAP because of an emerging problem, the reasons for the extension and the underlying accounting issues involved should be stated. The Commission should then ask the FASB to consider the issue.

Chapter XVII

Regarding Special Problems of Small Companies:

The Commission should hold public hearings to determine: (1) Whether, and to what extent, the Commission should attempt to define a category of "small companies" for the purpose of requiring less burdensome reporting; (2) how such a classification, if desirable and possible, should be defined; and (3) if definition is possible, what reductions of reporting requirements are possible, consistent with the purposes of the Federal securities laws.

Chapter XVIII

Regarding Dissemination of Filings with the Commission:

The Commission should convert its filing system from a statutory reporting basis to a company basis and should maintain a "current file" for each Exchange Act reporting company containing the company's latest Form 10-K annual report and all subsequent filings, excluding exhibits, under the Securities Act and the Exchange Act.

The Commission should require public companies to make their filings with the Commission under the Securities Exchange Act available to the public upon request.

Regarding Disclosure to Holders of Debt Securities:

The Commission should be sensitive to the information needs of holders of debt securities and, if deficiencies are identified, corrective action should be undertaken.

The Commission should assure that all company reports available to equity holders are available to debt and warrant holders if requested.

Revised Form 10-K*

PART I: FACT SHEET

ITEM 1. CAPSULE FINANCIAL DATA

(a) Present in comparative columnar form the following financial data for the registrant and its subsidiaries (if any) consolidated for each of the last five fiscal years of the registrant (or for the life of the registrant and its predecessors if less): Net sales; income from continuing operations; net income; working capital; cash flow; total assets; total indebtedness; and shareholders' equity.

(b) Present in tabular form for at least the two most recent fiscal years any operating statistics called for by appropriate Industry Guide(s).

ITEM 2. PRODUCTS AND SERVICES

Present a list of all business segments identifying principal classes of products and services within each segment. For each reportable industry and homogenous geographic segment state for the registrant's last five fiscal years the approximate amount or percentage of (i) total sales and revenues, (ii) income (or loss) before income taxes and extraordinary items and (iii) identifiable assets attributable to each business segment.

INSTRUCTIONS:

1. Definitions of "reportable business segments", "principal classes of products and services," "identifiable assets" etc. would be included. The definitions set forth in Appendix A "Definitions and Guidelines for Compliance with Industry and Homogenous Geographic Segment Reporting Requirements" to the Commission's Release on Segment Reporting (1933 Act Release No. 5826) would provide an appropriate reference.

ITEM 3. MARKET FOR THE REGISTRANT'S SECURITIES

(a) State the appropriate number of holders of record as of the end of the period for which the report is filed and the number of shares outstanding of each class of equity securities of the registrant and the average weekly trading volume during the previous fiscal year.

(b) Furnish the following information, as of the most recent practicable date, with respect to any person (including any "group" as that term is used in Section

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*Instructions only appear in this draft where necessary to explain modification proposed and are not inclusive of all instructions in the revised form. A number of existing instructions will be carried over into the new form.

13(d)(3) of the Securities Exchange Act of 1934) who is known to the registrant to be the beneficial owner of more than five percent of any class of the registrant's voting securities: (i) the title of class of securities owned; (ii) name of owner, (iii) the total number of shares beneficially owned, and (iv) the percent of class so owned. Of the number of shares owned, indicate by footnote or otherwise, the amount known to be shares with respect to which such listed beneficial owner has the right to acquire beneficial ownership, as specified in Rule 13d-3(d)(1) under the Exchange Act.

ITEM 4. PROPERTIES

If applicable, identify by appropriate unit or class of units manufactured the registrant's productive capacity by segment and the extent of utilization thereof.

INSTRUCTION:

The location and general character of the principal plants, mines, and other materially important physical properties of the registrant or its subsidiaries shall be filed as an exhibit to this report. A list of all subsidiaries should also be filed.

ITEM 5. PENDING LEGAL PROCEEDINGS

Briefly describe any material pending legal proceedings, other than ordinary routine litigation incidental to the business, to which the registrant or any of its subsidiaries is a party or of which any of their property is the subject. Include the name of the court or agency in which the proceedings are pending, the date instituted, the principal parties thereto, a description of the factual basis alleged to underlie the proceeding and the relief sought. Include similar information as to any such proceedings known to be contemplated by governmental authorities.

INSTRUCTION:

Registrants are encouraged to incorporate by reference any discussion of legal proceedings appearing in the footnotes to the financial statements, however, that discussion should be supplemented by any information required by the item but not appearing in the information incorporated by reference.

ITEM 6. EXECUTIVE OFFICERS AND DIRECTORS OF THE REGISTRANT

(a) List the names and ages of all executive officers and directors of the registrant who have not held their current office with the registrant prior to the beginning of the period reported.

(b) Give a brief account of the business experience during the past five years of each executive officer named in (a) including his principal occupations and employment during the most recent five year period and the name and principal business of any corporation or other organization in which such occupations and employment were carried on.

(c) List the names and positions held of all officers and directors who terminated their employment with the registrant during the previous year.

PART II

ITEM 7. INFORMATION CONCERNING SPECIAL RISKS OR UNCERTAINTIES

Describe by business segment those factors, if any, which cause investment in the company securities to be high risk or highly speculative in nature. Examples of appropriate factors which might be discussed include the absence of an operating history of the registrant, an absence of profitable operations in recent periods, the financial condition of the registrant (including recent adverse changes therein), lack of management experience and the speculative nature of the business in which the registrant is engaged or proposes to engage.

ITEM 8. INFORMATION CONCERNING SPECIAL OR DISTINCTIVE FEATURES OF THE REGISTRANT'S OPERATIONS OR INDUSTRY

(a) Describe by business segment those distinctive or special characteristics of the registrant's operations or industry which may have a material impact upon the registrant's future financial performance. Examples of factors which might be discussed include dependence on one or a few major customers or suppliers (including suppliers of raw materials or financing), existing or probable governmental regulation, expiration of material labor contracts or patents, trademarks, licenses, franchises, concessions or royalty agreements, unusual competitive conditions in the industry, cyclicality of the industry and anticipated raw material or energy shortages to the extent management may not be able to secure a continuing source of supply.

INSTRUCTION:

This paragraph is intended to provide the investor with background information about the industry and company environment in which he or she has invested to the extent that information is distinctive or unique to either the industry or the company.

PART III

ITEM 9. MANAGEMENT ANALYSIS OF THE FINANCIAL STATEMENTS AND FORWARD-LOOKING INFORMATION

Provide an analysis for each business segment of the reported financial statements which (1) will enable investors to understand and evaluate material periodic changes in the various items of the reported financial statements, and (2) will enable investors to relate the reported financial statements to assessments of the amounts, timing and uncertainties of future cash flows for the reporting entity.

INSTRUCTIONS:

1. The analysis of material periodic changes (a) should explain material increases or decreases in discretionary items such as research and development costs, advertising expenses, and maintenance and repair expenses, and (b) should break down variances into components, such as the amounts by which changes in prices and changes in volume resulted in a material change in sales.

2. The analysis should focus on facts and contingencies known to management which would cause reported financial statements to be not indicative of future operating results or of future financial condition. This would include description of and amounts of (a) matters which will have an impact on future operations or financial condition and have not had an impact in the past, and (b) matters which have had an impact on reported financial statements and are not expected to have an impact upon future operations or financial condition.

The form and content of disclosures pursuant to this item will necessarily vary among registrants and will change from period to period for the same registrant as circumstances change. In general, the disclosures should be similar to that which the chief executive officer might prepare for the board of directors of a company. Both quantitative analysis and narrative discussions are important.

3. Voluntary disclosures of projections of future economic performance and of future financial condition, and voluntary disclosure of management's plans and objectives may be included as part of this analysis. Since management's projections, and plans and objectives will inevitably reflect some amount of management's biases, it would be desirable to disclose the major assumptions which were made in developing such projections, and plans and objectives; however, disclosure of assumptions is not required in conjunction with voluntary disclosures of projections or of management's plans and objectives.

4. Registrants are encouraged, but not required, to furnish for each business segment a description of planned capital expenditures and financing for (1) the current fiscal year and (2) the succeeding four year period. If this information is furnished, it would be desirable to disclose the amounts related to environmental control facilities and the expected effects upon production capacity, and to furnish an analysis of differences for the most recent fiscal year between previously disclosed budgets and actual capital expenditures.

PART IV: Part II of Current Form 10-K*

PART V : Financial Statements*

* Parts IV and V will remain substantially the same as in the current Form 10-k; but see recommendations regarding proxy statement disclosure (Chapter XIII) and financial statements (Chapter XVI).

DISSENTING STATEMENT OF HOMER KRIPKE

I strongly support the recommendations of the Advisory Committee with respect to projections and other soft information and with respect to monitoring.

I dissent from the remainder of the Report. I had intended to sign the Report and express some reservations. But after a majority of the Advisory Committee adopted the Introduction as its own, as described below, my views must be classified as a dissent.

Early in the Advisory Committee's history, at the October 1976 meeting, the Committee determined that it believed that a mandatory system of disclosure run by government is necessary. The minutes state that these determinations were to be enlarged upon in the Final Report, but the manner of enlargement was not indicated. I consider these determinations to be trivial, as explained below.

In a series of memos to Chairman Sommer and to the Committee before and after the October meeting, I tried to indicate that a black-or-white, all-or-none approach to the evaluation of mandated disclosure was inadequate.* After its May, 1977 meeting, which was supposed to be its last meeting at which substantive matters were to be considered,** the minutes repeated the same determinations

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* See also my article, An Opportunity for Fundamental Thinking--The SEC's Advisory Committee on Corporate Disclosure, N.Y.L.J. Dec. 13, 1976, reprinted in SEC 1977 (N.Y. Law Journal Press, 1977).

** It was to be followed only by a final meeting to consider the draft of the Committee's Report.

plus an approval of the SEC as the governmental agent, in explanation of the Committee's refusal at the meeting of my request to discuss the subject further.

Taking everyone's good faith and good will for granted, I have tried to understand the contrast between the above sparsely expressed attitudes of the Committee and its sudden loquaciousness on the subject in the Introduction to the Report. I conjecture that the original attitude was due to a confusion of the efficient market hypothesis and other new insights of economics, which would leave room for a sensitive appraisal of the costs and the benefits or usefulness of the Commission's mandated disclosure system, with the Stigler and Benston theses, which are stated on an all-or-none basis and require merely a corresponding response.* Thus the Committee never went beyond the conclusion that some mandatory disclosure was needed, to the question "How much?".

The determinations recited in October, 1976 and repeated in May, 1977 are in my opinion trivial, because they merely reject Stigler-Benston. They do not address the real issue of analysis of costs and benefits.

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* Chairman Sommer of the Advisory Committee seemed to be particularly concerned about the Stigler and Benston writings while he was a Commissioner. See Sommer, Required Disclosure in the Stock Market: The Other Side, Address before the Conference Board, New York, Sept. 27, 1973, at 5. He alluded to them again in explaining the purposes of the Advisory Committee. Sommer, The Disclosure Study: What Is It? Address before the Midwest Securities Administrators, February 17, 1976.

The Committee's sudden willingness to discuss the subject at length in the Introduction has the following background:

During the summer of 1977 I drafted, to accompany my signature to the Report, some reservations which expressed some cost/benefit hypotheses. During the same period a member of the Advisory Committee was drafting the Introduction, which developed into an advance rebuttal of my views. His first draft was transmitted to Committee members on August 31, 1977. At the final meeting of the Advisory Committee on September 6, it was understood that the Chapter would be redrafted. It was resubmitted on October 13. It was made the subject of a mail and telephone vote in the last two weeks before filing of the Committee's Report. It received the concurrence of a majority but not all of those voting.

The unsoundness of this procedure does not necessarily mean that the substance of the Introduction is unsound. The Introduction is stated to be a statement of reasons for propositions essentiallly similar to the determinations of October 1976 and May 1977, but prefatory remarks to the Introduction state these propositions somewhat differently, and add to them a rejection of the reliability of market forces. These remarks were added this last weekend.

Most readers will accept the Introduction's opposition to "dismantling" or "elimination of" the disclosure system, which is an absolutist rejection of the absolutism of Stigler

and Benston.

The reader will find cause to marvel at the Committee's fervid rejection of the possibilities of voluntary disclosure in the issuer's self interest, in view of the opposite views attributed to the Commission by Commissioner Sommer in explaining the purposes of the creation of the Committee: "We recognize that, even were there no SEC requirements, most companies would find it desirable to disclose extensive information to their shareholders and the investing world in general." Sommer, The Disclosure Study: What Is It?, Feb. 17, 1976. The reader may also wonder why the Committee rejects the remarks of its staff, who conducted extensive field interviews and in its Chapter X uses language supportive of the Commission's, not the Committee's, views. But the Committee claims that its conclusion rests on its own research.

On the paramount issue of costs and benefits, the Introduction (and the remainder of the Report) remain essentially silent.* They reject the possibility of

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* The Digest of the Report in draft form supplemented its brief discussion by asserting: " . . . subjective conclusions about cost/benefit tradeoffs underlie the recommendations found in this report." The word "conclusions" was changed to "perceptions" because one member of the Committee wrote the staff: "We really didn't have any discussion of cost/benefit tradeoffs for most of our recommendations."

a useful cost/benefit analysis by this Committee,* although the Committee's charter adopted by the Commission (including the Committee's Chairman, Mr. Sommer, who was then a Commissioner) includes the following:

> ". . . (B) The Committee's objectives are as follows:
>
> * * *
>
> 2. To assess the costs of the present system of corporate disclosure and to weigh those costs against the benefits it produces; . . ."

An underlying attitude like this must have been responsible for the frustrating history described above. I reject this defeatism. I do not, however, use this forum to set forth my own views, because they are still individual hypotheses untested by Committee discussion.

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* The spirit of the times should have precluded this kind of evasion of this question. See three articles on Regulation in the quarterly, The Public Interest, Fall, 1977. In one of these, Nichols and Zeckhauser, Government Comes to the Workplace: An Assessment of OSHA, Id. 39 at 58, it is said:

> "OSHA has steadfastly refused to subject its standards to any kind of benefit-cost analysis, repeatedly observing that there is no widely accepted method for assigning dollar values to improvements in health or longevity. While the observation is correct, OSHA's attempt to use it as a justification for failing to integrate considerations of both costs and benefits into its policy decisions is not. The rationale for government intervention in the area of workplace safety and health is not that costs should be divorced from benefits, but rather that some costs and benefits may be misperceived by, or are not borne by, private decision makers.

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I hope to address the subject at a future time.

As to the remainder of the Report:

Of course, I do not dissent from the Chapters written by the staff and containing the results of its field study. I do note, however, how little the Committee's conclusions rest on the field study. Indeed, examination of the Committee's minutes will show that all of the Committee's important conclusions except the Introduction were reached before the results of the field study were available.

I have long expressed my reservations as to the Commission's delegation of its authority over accounting principles to accountants' agencies, and I dissent from the proposed enlargement of this delegation by subordinating the Commission's requirements on accounting disclosure to those of the FASB. Until recently the Commission's spokesmen had claimed that it was retaining this jurisdiction for itself.

I dissent from the portions of the Report dealing with new additional disclosures and with revision of the forms. It is not so much the detail of these recommendations which concerns me. On questions of detail I am willing to submerge my own views in deference to majority views. Many of the proposals of the Committee's dedicated and able staff to whom I am grateful, are meritorious. Rather, my objection concerns the priorities pursuant to which the Committee devoted so much of its time and energy to these matters. The

regular staff of the Commission is capable and energetic and has been engaged in producing new disclosure requirements and revising the forms on a continuous basis for over 40 years. The regular staff is presently in the midst of a period of great productivity, proposing new requirements and revision of the forms at an astounding rate, at least supplying all of the demands of the market. What the Commission did not need was a second shift of special staff and an Advisory Committee of volunteer supervisors increasing this productive activity over normal levels, while the Committee was failing and refusing to discuss the fundamental problems.

What the Commission did need at this time--and what I thought was called for by the the Advisory Committee's charter--was a broad-gauged consideration, with an adequate perspective, of the usefulness of continuous maintenance and enlargement of the detail of the mandated disclosure system, especially for established companies. In my opinion this would have involved a sensitive consideration of (a) the present system of costs of disclosure taxed by the Commission* on issuers for the

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* And its delegate, the FASB. The heavy tax on issuers for the cost of segmented accounting disclosure was levied by the FASB, a private agency, and enforced by the Commission without any initiative or independent consideration of its own.

benefit of security analysts and the public (like transfer payments taxes to fund welfare); and (b) the limited apparent benefit of the system in the light of the fact that it is past-oriented and necessarily firm-oriented, while it becomes increasingly apparent that the macro-economic events bombarding our times overwhelm the detailed disclosures of the individual company in their impact on securities selection considerations and on securities prices.

The Report shows that the Committee never accomplished or even attempted this task, and the Introduction shows that the Committee remained fixated to the end on an all-or-none approach to mandated disclosure.

Homer Kripke
November 2, 1977

SEPARATE STATEMENT OF ROBERT A. MALIN

Perhaps owing to the composition of the Committee's membership,[1/] President Ford's and SEC Chairman Hills' challenges to seek practical methods to deregulate have gone largely unanswered. Instead, many on the Committee have proposed increased regulation, notwithstanding clear evidence that the costs of the current mandatory disclosure syscem outweigh its benefits.

The varied economic forces operating in the investment markets act to produce information flows so broad and rapid that the SEC's system of corporate disclosure is now largely supplementary (although arguably crucially supportive). After over four decades of increasingly detailed regulatory requirements the point of diminishing returns in terms of value to investors has long since been passed. It is time to attempt modest deregulation. A few examples may suggest some practical approaches:

Automatic "sunset": Most of the SEC's present and future disclosure rules could be made subject to an automatic phase-down or phase-out process; thus time alone could rid the system of outdated and/or unproductive disclosure requirements. This gradual process would allow for necessary adjustment and experimentation.

1/ The Committee has many distinguished representatives of the legal, accounting and academic professions; however, neither corporations nor investors are sufficiently represented.

Filing reviews: SEC staff reviews of registration documents generally add importantly to the cost, but contribute very little of investor value. It is clear that most corporate registrants (including their counsel, accountants, investment bankers, etc.) exercise sufficient care in registration document preparation to justify investor reliance without SEC line-by-line scrutiny.[2/]

Economic justification: The SEC could adopt rigorous cost/benefit "hurdle" tests to prevent the adoption or continuance of all but the most basic disclosure requirements, unless demonstrable economic value to investors exceeded associated costs. This would cause the focus of mandatory disclosure to shift towards clearly evident investor needs and help slow apparently irreversible regulatory momentum.

Accounting disclosure: The FASB has already proven itself both capable and willing to deal with accounting problems of both principle and disclosure. Furthermore, it is amply sensitive to investor needs. The SEC, without shirking its statutory obligation, could largely remove itself as an accounting rule-setter and enforcement agent.

Certain proposals for increased mandatory disclosure merit brief dissenting comment:

2/ It is worth noting that court decisions against corporations for material omissions or misstatements are extremely rare.

Segment reporting: To increase the extent and complexity of already burdensome and sometimes artificial segment reporting cannot be justified in terms of investor need or use; if investors require further segment information their market power can produce it. That sell-side analysts must continually press for increased SEC requirements in this area offers proof that the market won't voluntarily pay for it.

Industry guides: The beguiling arguments for the development of specialized industry disclosure guides (elimination of irrelevancies, uniformity of requirements, user participation, etc.) are only a mildly deceiving veil for what are obvious proposals for increasingly complex and detailed regulation. For decades, registrants have successfully applied the SEC's disclosure rules to their specific circumstances; an additional overlay of specialized guidelines will only make that task more difficult and introduce superficial and misleading "standardization".

Corporate "suffrage": This concept, however appealing to those seeking various social objectives, is usually meaningless to investors seeking to obtain economic return. Some social issues may involve major economic consequences, but the corporate ballot box is an awkward and inefficient means of dealing with them. The solid improvement in the performance of corporate

directors throughout American industry is continuing; the extent to which proxy statement disclosures proposed by the Committee can contribute to this manifest progress is uncertain at best.

Forecast data: In response to investor demand, corporations often voluntarily disclose various types of forecast data; that managements are presently precluded from doing so under the SEC's mandatory disclosure system works a clear disservice upon investors. But to permit and encourage registrants to provide forecast data only within a set of tightly administered mandatory "guidelines" would defeat the purpose. The data sought is inherently difficult to generate and disseminate; maximum flexibility ought to be allowed for experimentation. The "safe harbor" rule will offer managements and underwriters scant comfort until fully tested in the courts.

Companies and investors generally agree that the philosophy and practice of mandated full disclosure have facilitated capital raising and investment decision-making. But there are practical economic considerations involved in (a) complying with detailed and complex requirements and (b) making use of information so reported. The SEC's well-earned reputation for professionalism and fairness notwithstanding, the mandatory disclosure system it administers needs rigorous pruning, not new growth.

Robert A. Malin
October 5, 1977

SEPARATE STATEMENT OF DAVID NORR

(Roger Murray Concurs as Noted Below)

In view of the great importance of the subject and the limited occasions on which Disclosure is given a thorough review I wish to set forth certain observations:

1. The SEC should require a compulsory educational program for all analysts.

In preparing financial statements for sophisticated investors there is an assumption that there is a large class of well informed users. Responses from certain investors and registered representatives indicated a hunger for education. In order to assure an even-handed approach to disclosure, efforts should be made to assure corporations, accountants, registered representatives, and individual investors, that the user is well equipped to benefit from the intense level of disclosure beamed at him.

There is in existence a voluntary testing and certification program, Chartered Financial Analysts. Response over many years has not been overwhelming. The program should be reexamined; if found satisfactory it should be compulsory. If not s tisfactory, a substitute program should be designed for analysts.

This is designed to assure that the sophisticated user has been exposed to substantial details of the latest accounting theory, economics and portfolio policy.

2. Proxy Statements should be stapled into annual reports.

Proxy statements are all too often ignored by investors. One way to put the "disinfectant of sunlight" on proxy statements and give them greater visibility would be to include them in the annual report. As of now too few analysts are familiar with proxy statements of the companies they follow. Greater dissemination of proxy statements would not, it seems, unduly burden reporting companies.

3. Information in 10-Ks should also be found in annual reports.

There is no excuse for excluding, as is the current practice, important investment information from the annual report. The annual report is the basic investment document. To put added information in the 10-K serves no purpose other than creating a class of proofreaders searching for new tidbits. All the data of concern should be in one handy place. Mr. Murray concurs.

4. Segment Reporting.

No subject is more important to investors than segment reporting. But 10 years after the SEC first issued a call for this method of disclosure conspicuous gaps persist in the information available to investors. The Advisory Committee recommends that the SEC require interim reports to include segment profit data. This would result in significant improvement.

Several other reforms are necessary, however. First, where significant variations in tax rates exist, segment profit data on an after tax basis and after all allocations should be reported. This is the only meaningful way to disclose operating results and would remedy a significant omission in SFAS No. 14.

Second, SFAS No. 14 provides an exemption to integrated companies. Where there are separate markets and different rates of profit and risks in these markets, failure to require segment reporting ignores investment realities. Segment disclosure in the annual reports should be monitored by the SEC. If SFAS No. 14 fails to result in meaningful disclosure in the chemical, paper, mining, oil and other integrated industries, the SEC should remove the exemption granted integrated companies. It should be noted that President Carter has called for significant segment reporting in the oil industry.

Finally, it remains to be seen how management and accountants will interpret the foreign segment reporting requirements of SFAS No. 14. These disclosures should be monitored in the annual reports for 1977. If found inadequate, the SEC should study disclosures already made, anywhere in the world, with a view to incorporating that profit data in a summary table in the annual report, on the basis of GAAP.

Thus, if a local affiliate has an annual report available in German, another has a report available in Italian, if a loss is reported in Sweden, if there is a filing with a government agency in Japan, if there is a response to a Fortune 500 International request, if French bondholders receive a prospectus with French results, if there is a filing in the UK under the Companies Act, -- then all those items should be recapitulated in the annual report.

Note that this data is now publicly available. The results should be adjusted to GAAP in preparing the consolidated U.S. report. The FASB failed to consider this. The SEC should not ignore the vast information publicly filed around the world.

5. Cutting through the detail.

Wallace Olson of the AICPA raised this point in a speech a year ago. What can be done to simplify the proliferation of footnotes to tell the essential story? Forecasting is certainly a step in the right direction. Are there other moves that can be made?

The problem is readily evident if one contrasts an investment analysis with an annual report. One is historical, and the other analytical and future oriented. Regrettably, the Committee did not address this issue adequately.

David Norr
November 3, 1977

SEPARATE STATEMENT OF ELLIOTT J. WEISS

I express my concern about the second sentence of the Committee's recommendation pertaining to the objectives of the disclosure system, which states that the Commission should not require disclosure where its "principal objective" is to influence corporate conduct. The Committee, in explaining that statement, makes clear that its intent is only to bar disclosure where the information sought is immaterial. However, I believe the language of the recommendation itself is ambiguous and could be misinterpreted as suggesting that the Commission should not require disclosure of information it believes to be material where its principal objective in requiring disclosure is to influence corporate conduct. Consequently, the sentence in question should have been deleted or changed to conform more closely with the language explaining its purpose. I note that the Committee explicitly acknowledged that there have been situations where the Commission believed information to be material but where it required disclosure primarily to influence corporate conduct, and that the Committee decided not to question the propriety of those actions. ASR 165 is an example of such a situation; there the Commission required disclosure relating to changes of auditors for the stated purpose of strengthening auditors' independence.

I also believe that in situations where the

Commission's principal objective is to influence corporate conduct, the Commission should state both the reasons why it wishes to influence corporate conduct and the reasons why it believes the information it is requiring be disclosed is material. By following that procedure, the Commission would make clear the purpose of its actions and would facilitate judicial and legislative evaluations of its actions.

Elliott Weiss
November 3, 1977

SEPARATE STATEMENT OF FRANK T. WESTON

(Roger Murray Concurs As Noted Below)

I am disappointed that the Committee has taken a narrow view of a portion of its charge--"to articulate the objectives of a system of corporate disclosure"--and has limited its consideration to the objectives of the Securities and Exchange Commission in its administration of the present disclosure system. A broader approach would have developed information as to the current environment which would have been useful in assessing the appropriateness of the present corporate disclosure system.

I believe that the recommendation regarding the voluntary disclosure of projections should provide that, when a projection is disclosed, disclosure of the major assumptions is mandatory. In my view, a projection which does not disclose its major underlying assumptions is of very little value and may be misleading, particularly if the assumptions differ significantly from those anticipated by the reader. Such disclosure also helps to communicate to users that there are significant uncertainties involved in the projection process and thereby cautions users as to the limitations of projections of operating results. Mr. Murray concurs.

I also believe that the report should make clear that there is, in effect, a mandatory requirement that a published projection be revised whenever it differs significantly from

management's current projection for the specified period and thus could be considered currently misleading. The treatment of this matter in the report is far from clear. Mr. Murray concurs.

With respect to the recommendations as to management's analysis and the revised Form 10-K, I believe that the requirement that management disclose "facts and contingencies known to it which would cause reported financial statements to be not indicative of future operating results or of future financial condition" is equivalent to requiring a forecast or projection of future operating results. I believe that this should be made clear in the report. This mandatory forecast requirement is inconsistent with the Committee's view expressed elsewhere in the report--with which I agree--that the disclosure of projections should be on a voluntary basis for the foreseeable future in order to encourage such disclosure.

With respect to social and environmental information, I believe that the Committee has failed to take a sufficiently broad and objective view of the increasing importance of the measurement and disclosure of corporate social performance. Disclosure of the social consequences of business actions is becoming an integral part of modern accountability and the corporate suffrage process. The Committee has failed to explore this important area and to take a responsible position to encourage the expansion

of this type of disclosure. Mr. Murray concurs.

The recommendations as to financial statements include a requirement that financial statements for certain industries disclose "information that will enable investors to evaluate the potential impact upon income from operations resulting from changes in those economic assumptions [underlying asset and liability valuations subject to greatest uncertainties], and the likelihood of such changes." I object to this requirement since it introduces into the historical financial statements forecasts of the impact of future events on future results of operations and also requires management to indicate the probability (likelihood that such changes will occur. While I favor the publication of forecasts of operating results, I believe that the results of this process should be displayed separately from the historical financial statements. The introduction of this type of information in financial statements--particularly when limited to certain items--is bound to confuse users and reduce the credibility of financial statements.

Frank T. Weston
October 5, 1977

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Introduction

The most fundamental questions which the Committee addressed, and the answers to which are basic to its entire work, including the recommendations contained in this Report, are relative to whether there is under present conditions sufficient reason to continue essentially in its present form the SEC-administered system of mandatory company-originated information. This most fundamental question has been raised by economic studies, such as the efficient market hypothesis; by eminent scholars, such as Professors George J. Stigler and George J. Benston, who have questioned the benefits of the system; by renewed interest in the reduction of the scope and quantity of regulation; by the dissatisfactions with the present system

voiced by many of the participants in the system, especially issuers which bear most heavily the costs of the system. If the answer to this fundamental question is negative, of course, the recommendations contained in this report are without logical or practical foundation.

The answer to this question depends upon the validity of four basic propositions. These are:

1. Reliable and timely information sufficient to the needs of those who have the responsibility for the allocation of investment (capital) resources is essential to the efficient allocation of resources in any economy;

2. Market forces and self-interest cannot be relied upon to assure a sufficient flow of timely and reliable information;

3. Such being the case, there must be present in the system an effective mandate to assure that sufficient, timely and reliable information is available to investment decision-makers; and

4. In view of its experience, expertise and record, the federal government, and more particularly, the Securities and Exchange Commission, is the appropriate agency to provide such assurance.

All members of the Committee who are signatories to this Report concur in these statements. Committee member

Beaver's qualifications are set forth in the Chapter written by him.

* * * *

The following statement, prepared by a member of the Committee, is intended to provide economic and non-economic justifications for these conclusions; these are not exhaustive or definitive. This statement is concurred in by a majority of the members of the Committee.

The Disclosure Study had its origins in many circumstances and considerations. Among "participants" in the process -- issuers, analysts, auditors and others -- there had developed considerable criticism of the process. Some, notably issuers, complained that they were being subjected to increasingly heavy burdens of disclosure without clear evidence that the information was either useful or used by investors. Disclosure documents had become increasingly complex and the recurrent complaint was that few, if any, read them. Even among experienced securities analysts, there were complaints that, for instance, the footnotes to financial statements had expanded to such a point that truly useful information was obscured. Many users of documents filed with the Securities and Exchange Commission complained that long standing, now antiquated, Commission policy prevented issuers from including in such documents information of types which had been demonstrated to have utility, particularly so-called "forward-looking information": earnings forecasts, estimates, appraisals, management projections and the like. Also, federal agencies increasingly were urged to concern themselves with cost-benefit analyses; critics of the SEC administered disclosure system suggested that the benefits from expansions of disclosure bore little relationship to the costs that were

imposed upon issuers and others in complying with these new requirements.

These sources of the Study are dealt with in other parts of this Report. This chapter is concerned with a more fundamental consideration, namely, whether there are presently economic and public policy justifications for the existence of a disclosure system that, at least with respect to company-originated information, is characterized by a strong mandatory dimension regulated by a federal agency.

The Committee carefully considered, in the course of its study and deliberations, the various economic theories which have been propounded in recent years with respect to securities and securities markets. The staff, as well as Committee members, reviewed extensively the literature which has developed concerning these matters in the last two decades. While recognizing that the work that has been done with respect to securities markets disclosure and related topics is fully deserving of the most careful scrutiny and attention by regulatory agencies and others as well, the Committee cannot conclude at this time that the research so far justifies a dismantling of the present disclosure system or a radical reorganization of its structure. However, the Committee does encourage the Securities and Exchange Commission to monitor constantly the development of economic

thinking with regard to securities markets and the economics of disclosure and as this research continues, to modify its policies when such studies result in sufficiently certain conclusions, including conceivably at some point in the future a conclusion that, at least with regard to a portion of the universe of securities traded, forces other than direct regulation of disclosure are sufficient to safeguard the interests of investors.

The Committee believes that at the present time there continues to be a need in this society and in this economy for a disclosure system with respect to company-originated information that is characterized by a substantial mandatory element administered by a federal govenmental agency; the Committee further concluded that, given its expertise, experience and proven record of competence, the Securities and Exchange Commission is clearly the most logical agency to administer the system. The reasons for these conclusions constitute the remainder of this chapter.

The Origins of Federal Regulation of Disclosure

The adoptions of the Securities Act of 1933 and the Securities Exchange Act of 1934 were preceded by very little theoretical economic discussion before Congressional committees or in Congress. This is not surprising. Congress, like the rest of the nation, in 1933 and 1934 confronted a

severe economic crisis in the country and the world. As Congressional investigations sought out the causes of the national catastrophe, it quickly appeared that there had existed during the 20's serious abuses in the public markets for securities. There had been sordid manipulations on the exchanges, so called "bear raids", grave misuses of options and other speculative techniques, and a host of other abuses. It appeared that singular among those abuses was the failure by issuers and those in control of them to provide the public with important information about the securities being sold during distributions and traded on exchanges. It was these shortcomings in the distribution process that Congress first attacked through the Securities Act of 1933. Later, in 1934 it expanded the disclosure philosophy to include periodic reporting by listed companies and also attacked other manipulative practices as well.

It is not surprising that Congress gave little attention to economics. Prior to 1933 there had been little research done with respect to securities markets. Furthermore, at the time when Congress was formulating these statutes, economists were frantically trying to understand the national trauma which was then continuing and develop mechanisms and techinques which might abate or reverse the disastrous deflation which had afflicted the country.

Non-disclosure and false statements having been identified as widely present during the distribution of securities in the 1920's, Congress attacked that evil in a direct and, in the estimation of many, relatively unsophisticated. fashion. The actions it undertook had some foundation in the common law. The applicability of deceit, fraud, and other common law actions to securities transactions was well established. However, it was often virtually impossible for investors to utilize the remedies provided by common law or by state statutes, because of difficulties in proving the necessary elements of the offense and in hounding down the miscreants in a country as large as the United States. Thus, an investor defrauded in, say California, might be confronted with the necessity of bringing suit in New York if he could find there the one who had harmed him. Furthermore, many who ostensibly bore responsibility to the public were, because of common law doctrines such as privity, reliance and the like, able to escape liability even when they could be found and sued. Thus Congress, perhaps somewhat simplistically, having seen evil done on "Main Street" by conduct often indistinguishable from outright fraud, opted for a system bearing elements of the common law, strongly influenced by the British experience under the Companies Acts, and plainly inspired by the

Brandeisian axiom concerning the efficacy of sunshine and the electric light as policing instruments. The legislative history of the 1933 and 1934 Acts contains little effort to determine whether had there been more candid disclosure in the 20's, the financial catastrophe might have been avoided or mitigated; experience during recent speculative orgies casts doubt on the easy assumption that it would have.

Changes in Securities Markets

Since the enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934 there have been profound changes throughout society; industry and the securities markets have been among those most dramatically changed. Increasing amounts of investable wealth have been concentrated in the hands of so-called "institutional investors". It has been estimated that approximately 70% of the dollar volume of trading on the New York Stock Exchange is institutional. Concurrently with this, and somewhat anomalously, the number of individual investors has, at least until recently, steadily increased, reaching a peak in 1970 of over 30 million. The causes of the decrease in numbers since that time are uncertain: an apparent decline in profit opportunities in equity securities has been suggested as the possible reason. During this period, a virtually new profession emerged, that of financial analyst. At the time

Congress enacted the 1933 and the 1934 Acts, Messrs. Graham and Dodd were in the final stages of preparing their monumental work on security analysis. This enormously influential book was in the eyes of many responsible for the development of a profession devoted to the collection and analysis of corporate, industry and economic data and the drawing of conclusions with respect to investment decision-making from that analysis. Because of the increasing presence at the edges of the marketplace of skilled, well-trained analysts, there arose a greater demand for larger and larger amounts of complicated information concerning issuers, information of a volume and complexity little suited to the needs of individual investors. That the disclosure system enacted by Congress might yield an information system of only limited direct utility to unsophisticated investors was not surprising. This was recognized in the course of Congressional deliberations and was also discussed by Professor (later Chairman of the SEC, later, Justice) William O. Douglas. In an article which appeared in the Yale Review (N. S.) Professor Douglas suggested that the disclosures mandated by Congress and the SEC were too complex for the understanding of the ordinary investor and stated that any benefit accruing to him would be the consequence of intermediation by brokers and others able to assimilate, condense and communicate the information.

Since 1934, there has also developed a sophisticated, extensive, variegated dissemination network through which information concerning issuers, industries, and the domestic and world economy flows in various formats to many audiences of differing skills and needs. Thus, many brokerage houses supply extensive research, not only to institutional investors, but to individuals as well. In addition, a multitude of advisory services and information services have developed, so that it may be fairly said that there is available to investors a vast variety of sources of information, advice, format, condensation and analysis so that they are not dependent for information on mastering the SEC-filed documents. The extent to which these services supplement, and depend on, the SEC information system is discussed later in this chapter.

Along with these forces, there has, of course developed an increased complexity in industrial and commercial organization. "Multinationals" and "conglomerates" are essentially terms of the current generation. While in the 1930's, many American companies had export activity, relatively few had extensive overseas operations. Furthermore, while there were in the 1930's some businesses engaged in activity in more than one industry, these were scarce. During the 1960's particularly, American companies expanded their

activities dramatically abroad and diversified them through acquisitions as well as by internal development. The communication of information about such companies in a meaningful and useful way became a challenge to management, but dealing with it and interpreting it was also a challenge to analysts who were increasingly troubled by the absence of segmented data and to the Securities and Exchange Commission confronted with increasing evidence of serious deficiencies in disclosure policy.

During this time there developed new legal theories, which to a large extent had the effect of restricting the opportunity of "insiders" to use information not publicly known in making investment decisions. These legal theories appeared to have as their predicate the belief that there should be created in the market as large a measure of equality in access to information as practicable, i.e., investors, large and small, should be brought to as close a position of parity as possible.

Concomitantly with all this there developed strong pressures for change in the procedures and institutions of the accounting profession. The history of the 1960's and early 1970's suggests that the accounting profession, as well as the business community, experienced tremendous difficulty in adapting accounting principles and auditing

standards to the new necessities of disclosure posed by multi-national and multi-industry companies. The development of new means of conducting business, new kinds of enterprises, and new techniques for the inflation of profit placed considerable pressure upon conventional standards and often the inadequacy of these standards become painfully apparent when some companies displayed drastic financial reverses.

Finally, in the early 1970's there developed a considerable interest in, and considerable political pressure to achieve, "deregulation", with a substitution of market forces for direct intervention of the government. The system of securities regulation was not immune from these pressures.

The Problem of Allocating Resources

As long as resources are less than demands for them, a society, whether it be socialistic, capitalistic, communistic or a mixture, must allocate its resources among the competing demands. In an authoritarian society, this function is in large measure performed by centralized, bureaucratic authority, although even in such societies there is frequently present a limited amount of allocation by operation of market forces.

In the United States the allocation function is largely performed by market forces and is accomplished through a

multitude of individual decisions. Each family, each person, is constantly making allocation decisions as between consumption and savings. With respect to the portion of resources allocated to saving, there is then the necessity of dividing that allocation among numerous opportunities for investment. Not only are individuals and families confronted with that kind of decision, but this kind of decision is constantly presented for business enterprises and governments.

It is a fundamental desideratum of all persons having the responsibility for the allocation of resources that the allocation be made in a manner that maximizes benefits flowing from the allocation; in the case of consumption allocations, these are varied -- they may be pleasures of the senses or the mind, a sense of well-being, and so on. When the allocation decision relates to investment the benefit is usually defined in terms of "return", that is, either income or increases in value of the amount allocated to the investment. Essential to investment decisions are perceptions with respect not only to return but to risk as well; investment portfolio theory has made significant contributions to the development of these concepts and the nature of their relationship.

Ideally, resources saved, that is, investment resources, would be allocated in the most efficient manner possible so

that the marginal return of each allocation is equal to the marginal return on every other allocation with similar risk characteristics. That is generally accepted as the objective of those having responsibility for the allocation of resources.

It would appear to be self-evident that the quality of any investment allocation decision, that is, the extent to which it maximizes return, will in large measure be determined by the quantity and quality of the information that is available concerning the potential investments which may be made. Thus, if among the investment options available are the securities of corporations, then information concerning those corporations is essential in any allocation decision. This is not to suggest that the only information pertinent to an investment decision is information concerning the issuers whose securities may be under consideration for the portfolio; given the nature of the investment universe, obviously information concerning industries as a whole, information concerning corporations other than the one under consideration, information concerning the economy of the country and the economy of the world and much besides may be important to an allocation decision maker; this is evident from the Study's analyses of security analysts' decision-making processes.

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The best proof of these rather elementary propositions lies perhaps in trying to conceive an economy in which no information whatsoever was permitted to be disseminated concerning corporations. Except for "bootlegged" information, there would be no way for an investor to assess risk and return as between General Motors and American Motors, as between General Electric and any other company.

If, then, information is essential concerning investment opportunities, it would follow that the most efficient allocation of resources will occur when the information is sufficient for the purposes of those making decisions, when it is reliable, and when it is disseminated in a timely manner. To the extent that any of these elements is lacking, there is posed the danger of an inefficient allocation of resources, that is, an allocation that does not yield the best utilization of the resources of the society in terms of marginal returns. If the information is not sufficient, or if it is not reliable, then resources may be committed to an enterprise having characteristics different from those perceived by the decisionmaker, thus resulting in a loss of efficiency; similarly, if information is not timely disseminated, then at least during the interim until the information is disseminated, there is posed the prospect of an inefficient allocation of resources.

In our society allocation decisions are made by a vast multitude of people. The evidences are that increasingly these decisions are being made, or at least strongly influenced, by persons who are professionally trained to make such decisions and have the ability to assimilate and utilize a vast and complex variety of information. However, the capacities, the abilities, the educability and the resources of allocation decisionmakers stretch across a seemingly infinitely varied spectrum. At one end are relatively unsophisticated, inexperienced individuals possessing investable resources but having little ability to utilize information in making decisions; for the most part these people appear to rely upon others having higher skills to assist in their decisionmaking. At the other end of the spectrum are highly sophisticated financial analysts, portfolio managers, research specialists and others, who do have significant skills and training. It is impossible to design a single set of disclosures that will by legislative or regulatory fiat serve directly the needs of this entire spectrum of users; the reasons for this and the manner in which the present system serves this variety of investors are discussed later.

In discussing the necessity of information to the operation of our resource allocation system, the influence

and value of judgment should not be overlooked. Facts are not pristine, clearly defined, unequivocal, or susceptible of a single interpretation. As the complexities of industrial enterprise have grown the opportunities for diverse judgments concerning the importance of individual facts or complex configurations of facts have multiplied, with the result that investors frequently perceive the same new information in sharply different lights: to one, it may have a bullish connotation, to another, it may seem equally bearish. This is seen in the Griffin paper which appears as Chapter XXII of the Study.

Market Forces and Disclosure

If, then, sufficient, reliable, timely information is essential to the most efficient allocation of resources, how can it be assured that information having those characteristics is available and disseminated?

It has been suggested that this can be assured through market forces. Essentially the argument is this. At the present time, securities markets are characterized by the presence of a large number of professionals who are constantly seeking out information from corporations, especially large ones (the researches of the Committee indicated that less than 1,000 corporations out of the more than 10,000 which file periodic reports with the SEC are followed by one

or more analysts at any time). These analysts have an interest in securing reliable information on a timely basis and, it is agreed, it is often in the interest of issuers to provide that information to them. The latter's interest derives, it is said, from a desire to have a good market for the company's securities, the necessities of tapping the public market for financing, the benefits of a corporate image that reflects integrity and honesty in dealing with the public, and the awareness that a failure of disclosure or misrepresentations would have an adverse affect upon all of these desired benefits. It is suggested then, that at least with respect to large companies followed by analysts, sufficient timely information would be available even without any governmental mandate. It is suggested that as analysts procure this information they, or their clients, make buy or sell judgments based upon it, thus causing new information discovered to be quickly reflected in the prices of securities. It is this consequence of the efficient operation of the market that assures investors in general that they are paying an essentially "appropriate" price (the word is that of Professor J. Lorie and M. Hamilton, authors of The Stock Market: Theories and Evidence (1973)), one which reflects all information available to the market, thus putting them on an equal footing with all other investors, including professionals.

A further extension of this argument is that, with respect to offerings, the potential liabilities of underwriters and others associated with the underwriting process -- attorneys, auditors, directors and so on -- will be a sufficient assurance that there will be full disclosure in the offering literature without the necessity of preparing the cumbersome documents filed with the SEC and the review process that attends public offerings. Essentially, the self interest of underwriters and other participants in the process and their desire to avoid legal liabilities will be sufficient to assure that sufficient information will be disseminated in connection with the offering.

These arguments were not unappealing; it would be preferable if market forces could be substituted for regulatory forces whenever the benefits of the latter can be adequately secured through the former. However, many members of the Committee believe that the researches conducted by it and by others previously and their own experiences as participants in or students of the disclosure process and securities markets indicate that, at least at the present time, market forces may not safely be relied upon to secure for investors the benefits presently flowing to them from the regulatory mechanism that has been established.

In the course of interviews with them, many analysts indicated to staff members that, in the absence of the requirements imposed by federal law, they believed that they would be seriously handicapped in securing information that was sufficient, reliable and timely. They frequently cited as an example their difficulties prior to 1969, when the Commission first mandated segmented disclosure, in securing useful information with respect to the various constituent parts of a conglomerate business. They state that even since the inception of such requirements they have still been unable in many instances to secure more than the bare minimum required, even though there appears to be a widespread belief among analysts that such is insufficient for adequate analysis. They cite too the difficulties that they have experienced in many cases in securing from management estimates with respect to earnings, information concerning management's plans (especially capital spending plans) and objectives, and similar types of information which are regarded by virtually all classes of investors as useful to their decisionmaking.

Furthermore, even if it were true that over the long run the market would penalize issuers which withheld useful information or engaged in misrespresentations, frequently

the "run" is indeed a long one. In the meantime, many investors would make improvident investments and there would thus be inefficient allocations of resources. There have been many instances known to members of the Committee which demonstrate that falsified financial statements and other abuses of the disclosure process have endured for a long time without market forces in any way bringing about sufficient, reliable or timely disclosure; in these cases, the remedy usually lay not in the market but in intervention by the Securities and Exchange Commission.

A recent demonstration that market forces are insufficient to produce adequate disclosure is in the area of municipal financing. Until the New York City crisis focused attention upon disclosure practices with respect to those securities, notwithstanding the perception by many analysts that the information available was incomplete and unreliable, very few municipalities or other governmental units had adopted disclosure policies that would satisfy the analysts.

Even if the assertions of those who would substitute market for regulatory forces are correct with respect to securities followed by analysts, the fact is that many millions of dollars are invested in companies which are not followed by analysts; analysts have virtually no interest in a company with a market capitalization of less than $50 million and less than one in ten reporting companies are

monitored by one or more analysts. Thus, with respect to the overwhelming number of publicly-held companies there would be no analysts having a sufficient interest to systematically seek out and utilize in investment decision-making information secured from issuers. Among the thousand-odd companies followed by analysts, many of them are followed only sporadically by analysts and often at most by a single individual.

Analysts typically seek information for proprietary purposes, that is, for the purpose of realizing some private gain, either by selling the information to clients who are willing to pay whatever their fees may be, by communicating it to the investment decision-makers who employ them, or by investing themselves on the basis of the information secured. They do not regard themselves as surrogates for the universe of investors and hence do not feel under obligation to disseminate widely information which they secure (the present state of the law, of course, under Rule 10b-5 does oblige them to refrain from trading on the basis of, or communicating, material information received from a corporate source which has not been publicly disclosed). Thus in a system where reliance was placed upon analysts to secure information (obviously reliance upon the analysts to procure information and cause it by their buying and selling activity to be reflected in market price

would require that there be no restraints on the use of material "inside" information), could result in both a substantial delay in the dissemination of information and the unfair use of inside information by some professional group. Another potential problem could result if the information were available initially to investors without sufficient resources to fully translate it into market price. As an example, if an analyst managing a portfolio with an aggregate value of $10,000 and no capacity to borrow learned that General Motors had developed and placed in production a device that would double the mileage of its automobiles, this information would obviously not become fully expressed in the market prices of General Motors stock if the analyst used his total resources to buy General Motors stock -- namely, $10,000. A far larger amount of money would be necessary to translate this information into a fully adjusted market price; until that was done the price would not be "appropriate" and the market would not be efficient. In the meantime, those who came into possession of the information before it was fully reflected in the market price would have the opportunity to realize what economists call "abnormal profits" at the expense of those denied the information.

Of course, the foregoing discussion is confined to essentially economic considerations. In discussing disclosure, its uses, the effect of disclosure upon markets, and

similar subjects it is not sufficient to confine the discussion to market efficiencies. There is a notion of fairness and equity which has become so deeply ingrained in the expectations of American investors that any modification of the system of disclosure that appeared to jeopardize fairness to the extent it now exists in the market would be politically unrealistic and publicly unacceptable.

Reliance upon market forces -- the energies of analysts and the self interest of issuers -- to bring forth into the marketplace sufficient reliable timely information to serve the purposes of investors would result in a high degree of likelihood that unacceptable inequities would be created among investors. As mentioned above, analysts regard information that they procure otherwise than through public sources as proprietary -- information which they can (to the extent permitted under Rule 10b-5) and do use for the private benefit of their clients, their employers or themselves. Under a system which principally relied on the activity of analysts to secure new material information and cause it to be impacted in the prices of securities, either they would be allowed to continue in that posture, or they would be required to become the instrumentality for accomplishing public disclosure, in which case there would be no economic incentive for them to perform the function, since they would not be able to purvey to any limited universe

of clients anything of value, inasmuch as they would be under an obligation to make the same information publicly available. Assuming the latter role of the analyst would be economically untenable, i.e. that is there would be no one to pay them, then they would be left in the same position they are at present -- namely, purveyors of a proprietary product, but in the hypothesis discussed this "product" would be material undisclosed information. Obviously their clients would be the beneficiaries of information that would permit them to realize profits not realizable by others who were not clients of the analyst in possession of the information. Thus, at least for some period of time, and conceivably for a substantial period of time, others in the market would be severely disadvantaged, at least until the information had been sufficiently widely disseminated that enough resources would be committed on the basis of the information to cause the information to be totally reflected in the price.

A market-motivated system would significantly undermine well-developed and historically established notions of fairness in the marketplace and more importantly, would likely result in benefits being realized by some investors at the expense of others. The opportunities for abuse by insiders and for collusion between analysts and insiders, the temptation to chicanery are all too reminiscent of the events of the 1920's which resulted in passage of the 1933 and 1934 Acts. It appears beyond reasonable doubt at the present time that

the dismantling of the disclosure system, even with respect to a relatively narrow spectrum of large companies, might very well result in a serious and lasting impairment of public confidence in the fairness of the securities markets, a confidence that is already seriously lacking. If this were to occur, the present difficulties of corporations in securing equity financing would undoubtedly be further exacerbated, resulting conceivably in the necessity of public intervention in the capital allocation process, a result totally at variance with the hopes of those who urge the substitution of market forces for regulatory forces in effecting disclosure.

The arguments of those who would rely upon market forces to perform the role of a regulatory agency in the dissemination of company-originated information are based upon the assumption that those responsible for disclosure policies of issuers would recognize the perils in the marketplace of misrepresentation, undue delays and other distortions in the dissemination process and adopt policies that would cause dissemination to be made fully, accurately and promptly. Again, discussions with analysts in the course of the Committee's research indicated that good news concerning a corporation is generally much more quickly and willingly forthcoming than bad news. The experience

of some Committee members confirms this. Very often there are significant motives for at least temporary concealment of adverse information on the part of corporate executives. Often a sizable part of management's total compensation, such as benefits from stock options or stock bonus plans, depends upon the price level of the company's securities. Frequently, their direct compensation -- salary and bonuses -- will depend upon the earnings of the company, thereby providing strong motivation to enlarge artificially the Company's earnings. In addition, there is often simply the hope that bad news will be temporary and thus need not be disclosed.

The Securities and Exchange Commission's enforcement cases demonstrate that even in a regulatory environment such as exists and even with the potentially severe penalties that attend misrepresentation and non-disclosure, Some corporate executives take the risk of suppressing adverse information or tilting disclosure to a favorable bias. A review of the quality of disclosure contained in Form 10-Ks filed with the Commission with the corresponding annual reports to shareholders shows that even with the discipline of required filing of the Form 10-K, annual reports habitually present a more favorable picture than the Form 10-Ks. While there is some evidence that such

disparity is less noticable with regard to large publicly-held companies, nonetheless, even among them it is sufficiently frequent to give pause before assuming that market forces would be a sufficient substitute for regulatory forces.

The same conclusion must be drawn with regard to disclosure in the course of underwritten public offerings. Again, the evidence suggests that even the heavy burdens undertaken by underwriters in the course of a public offering have not always been sufficient deterrents, as evidenced by experience in the new issue market during the periods when new issues were common. Notwithstanding the vigilance and diligence of the Securities and Exchange Commission, some underwriters have engaged in questionable practices, have been indifferent to the demands of due diligence, preferred to take the risk of liability, rather than incur the expenses of proper diligence. If these deficiencies occur in a closely regulated securities distribution process, it may be safely assumed that they would be multiplied if the regulatory mechanism were less pervasive or vigilant. It may be stated almost as a principle of human nature that short-term considerations, particularly when they entail substantial profits, are often able to override judgments with regard to long-term negative consequences and dangers.

The foregoing discussion of the need for a mandatory element with respect to company-originated information is not to deny the fact that much of the dissemination of such information is accomplished as a result of market forces. As is noted later, information filed with the SEC is often in a format and detail and of such limited accessibility that is is often unusable directly by most investors. Their needs are satisifed by various kinds of disseminators who, responding to their perceptions of the market for information presented in different ways, take the information filed with the SEC, as well as other information, and summarize, reformat, condense, simplify and analyze it in ways they think will appeal to the markets they pursue and try to serve. The integrity and competence of these disseminators--matters not considered in this report--are of course of considerable importance to the quality of investment decisions and the efficient allocation of resources.

These conclusions about the desirability of a disclosure system including mandatory requirements for company-originated information, of course, make no statement with respect to the optimum amount of information that a mandated system should require; the determination of that involves careful examination of the investment process, the needs

of investors, the fashioning of concepts of "materiality", all of which are elsewhere discussed in this report.

Fundamental Research and the Efficient Market Hypothesis

Fundamental to consideration of the corporate disclosure system is the question whether fundamental research -- that is, the study of company-originated and other financial and other information -- can yield for investors superior investment results. This question has been the focus of extensive academic discussion for many years, with, as might be expected, those engaged in security and financial analysis asserting that, indeed, superior results can be obtained, with others, predominantly economists, asserting that empirical evidence suggests that over the long term, whatever that span may be, results average out.

One of the early theories was the "random walk theory." While, as Professors James H. Lorie and Mary T. Hamilton have pointed out, the "random walk " had been of interest to statisticians since the early part of the century, it was not until 1959 that it attracted the attention of scholars concerned with the functioning of the securities markets. Professor Burton G. Malkiel has stated the theory in this fashion:

> The history of stock price movements contains no useful information that will enable an investor consistently to outperform a buy-and-hold strategy in managing a portfolio.

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In effect, this says that the "technicians", the "chartists" and similar market watchers cannot outperform the market.

A direct outgrowth of this work has been the "efficient market hypothesis". Since the 1950's there has emerged a considerable economic literature addressed to the functioning of securities markets and theories based upon these analyses.

The availability of information is, of course, intrinsic and essential to the efficient market hypothesis, since the heart of the hypothesis is that the market price is an accurate reflector of information that is available. One writer has said, "Black, Fama, Francis, Lorie and others have set forth various requirements for an efficient market. They include: 1. Effective Information Flow. This means that news is disseminated quickly and freely across the entire spectrum of actual and potential investors ..." (Kuehner, "Efficient Markets and Random Walk," in Financial Analysts' Handbook, Vol. 1, p. 1227). This hypothesis, which was extensively considered by the Committee and by the staff, has been stated in various ways. Essentially it appears to say two things: one, at any given moment the price of a security in the market reflects all of the information which is publicly available about the company

and the security (this is the so-called "semi-strong" version of the hypothesis); and two, any new information which becomes publicly available is quickly, almost immediately, assimilated into the price. One member of the Committee, a noted academician and portfolio manager, has suggested this articulation of the efficient market hypothesis: "Market prices so quickly reflect the prevailing interpretation of widely available information that superior returns cannot be earned from analytical effort unless it produces a more accurate interpretation of the information." This statement takes the efficient market hypothesis beyond simple factual assimilation and introduces an element of judgment and suggests that superior judgment may, notwithstanding the efficient market hypothesis, yield "abnormal" profits, that is, profits in excess of those realizable by investing in the market as a whole.

The efficient market hypothesis, as commonly articulated, is indifferent to the quantity and quality of information that is available to investors. The market price of a security reflects true information and false information with equal efficiency, as long as the quality of the information is not itself a part of the information in the market place. Thus, a fraudulent income statement,

not known to be false, will be reflected in the market price of the security to the same extent as a true one. Furthermore, the market is efficient in terms of whatever information is available: if there is one "bit" of information available, the market price will reflect that, theoretically, and be efficient; if there are a million "bits" of information available, the market will reflect those and be efficient.

Thus the efficient market hypothesis, as is readily admitted by its proponents, makes no statement with respect to the optimum amount of information which should be made available or the desirable accuracy of it. Thus conclusions concerning the desirable quality or quantity of information must have their foundation elsewhere than in the efficient market hypothesis.

Some scholars, notably Professors George J. Stigler and George J. Benston, assert that their empirical research has established that there is no evidence whatsoever that the disclosures mandated under the 1933 and the 1934 Acts have provided protections to investors or been the occasion for the introduction of new, useful information in the marketplace. Their conclusions, which have been sharply disputed by equally eminent scholars, such as Irwin Friend, would appear to be consistent with the efficient market

hypothesis, although there does not appear to be any necessary conceptual link between their studies and the hypothesis.

The disputes concerning the meaning of the efficient market hypothesis, the researches of Messrs. Stigler and Benston, portfolio theory and the beta coefficient continue vigorously.

In considering the efficient market hypothesis and fundamental research, it should be recognized that few, if any, believe that satisfactory investment decisions, assuming the validity of fundamental research, can be made solely on the basis of information that is contained in documents filed by issuers with the SEC, or for that matter, can be made on the basis only of company-originated information. Experienced analysts universally equip themselves not only with company-originated information, but with extensive information as well concerning other components of the industry, the state of the United States and world economy, trends in the economy, expectations with respect to interest rates and a host of other data. To the extent that the criticism of the Commission is justified that it has administered the securities laws as if filed information were sufficient for investment decision-making, the Committee strongly urges the Commission to take steps to

clarify the limitations of information filed with it. One member of the Committee has suggested that perhaps Commission filed and required documents should bear a legend informing users of the need for seeking out and using data in addition to that contained in the document in making investment decisions.

Those who assert that fundamental research cannot yield "abnormal" results support their contentions with significant empirical data. A number of studies have been published indicating that, for instance, investment companies over specified periods of time have under-performed popular stock averages by amounts at least equal to transaction and management costs; similar studies with respect to bank portfolios and other managed assets appear to confirm these indications. The theoretical justification for this is that the market operates with a high degree of efficiency in assimilating new information, so that there is virtually no opportunity for any investor to gain advantage from the utilization of information before it is impacted in the security price. Recent studies by efficient market devotees have suggested that there may be a very short period during which the market is assimilating information and that during this relatively short period there may be an opportunity for investors to realize "abnormal" profits,

although it must be emphasized that the period suggested before assimilation is quite brief.

If these contentions are correct, then we confront a confusing anomaly which Professors Lorie and Hamilton have described:

> In order for the hypothesis to be true, it is necessary for many investors to disbelieve it. That is, market prices will promptly and fully reflect what is knowable about the companies whose shares are traded only if investors seek to earn superior return, make conscientious and competent efforts to learn about the companies whose securities are traded, and analyze relevant information promptly and perceptively. If that effort were abandoned, the efficiency of the market would diminish rapidly." (The Stock Market: Theories and Evidence, p. 98 [1973]).

If analysts cannot over the long run realize "abnormal" profits for their clients, or their portfolios, then there is no economic benefit to be derived from employing them; on the other hand, however, if their employers all acted on this apparent phenomenon, then a major factor in the formation of securities prices would be removed from the marketplace and prices would presumably no longer be efficiently established. It is suggested that the justification for the activity of analysts is the performance by them of what is essentially a public good by being the mechanism through which the efficient market operates. It may be suggested that such would be

scant consolation to those bearing the costs of financial analysis and it would not be inappropriate for them to suggest that the cost of performing a public good should be borne by the public. It has been suggested by one member of the Committee that as soon as departures of analysts from the market reached proportions that impaired the efficiency of the market, then analysts would perceive opportunities for "abnormal" profits and would return to activity in the market until such time as the market reached a level of efficiency again. Obviously there might be significant time lags while analysts moved in and out of their professional endeavors.

The Committee believes that notwithstanding the interesting and clearly significant work done by economists and others in developing the efficient market hypothesis, the evidences that fundamental research is essentially useless are not yet, and may never be, sufficiently telling to justify the elimination of a disclosure system premised on the proposition that such research is useful and necessary.

Many of the Committee members have known of extremely successful investors who have relied upon fundamental research, and for that matter, there are members of the Committee who have themselves achieved significant success in this manner. Furthermore, there are other studies

that appear to contradict the statistical researches and seem to indicate that some portfolios organized on the basis of fundamental research have exceeded, sometimes in significant degree, the "index" portfolios. It should also be remarked that virtually all of the research done with respect to the efficient market thus far has been focussed upon New York Stock Exchange-listed companies which, as a group, are confessedly the most liquid and which have the highest measure of analyst and professional following.

It is difficult to reject the evidence afforded simply by the existence of a substantial analyst profession for whose services literally millions of investors are willing to pay often substantial fees for the benefits of information and advice based upon fundamental research. This does not deny that frequently the public is the victim of widespread myths and commits substantial resources in pursuit of them. However, given the facility of communication, economic studies, and personal experience of investors it is difficult to believe that this elaborate industry and profession would be perpetuated and financed by sophisticated, knowledgable, expert investors when there is no value whatsoever to be secured from it.

Even those who have been clearly identified with espousal of the efficient market hypothesis are reluctant to deny totally the possibilities of superior profits from analysis. For instance, Professors Lorie and Hamilton have said:

> A belief in an efficient marekt is not exactly equivalent to a disbelief in the possibility of superior security analysis. There can be individuals in the world who have a quicker or more profound understanding of the economic consequences for individual firms of changes in the economic environment or changes within the firm itself. (Lorie and Hamilton, The Stock Market: Theories and Evidence, p. 104 [1973]).

Again, Professor Burton G. Malkiel has said, after discussing favorably the random walk theory (progenitor of the efficient market hypothesis),

> I walk a middle road. While I believe that investors must reconsider their faith in Super Analyst, I am not as ready as many of my academic colleagues to damn the entire field." (A Random Walk Down Wall Street, p. 170 [1973]).

And he then lays down some investment rules clearly inconsistent with random walk and efficient market notions.

Portfolio Management Theory and Disclosure

Also emerging during this time were various theories with regard to portfolio organization and the so-called "capital asset pricing model". Increasingly portfolio managers were attentive to the so-called "beta coefficient" which was a measure of risk. Emerging portfolio theory

suggested that sensible investment policy entailed a judgment with respect to the degree of risk desired in the portfolio and the investment of the portfolio resources in securities having beta coefficients which would average out to the desired degree of risk. These theories do not militate against a mandatory disclosure system. If anything they suggest a maximization of the quantity and quality of disclosure through a mandatory component in order that the beta of securities may more accurately reflect the degree of risk.

The Means of Achieving A Mandated Disclosure System

Having reached the conclusion that a corporate disclosure system needs, at least in part, especially with respect to company-originated information, to have a mandatory dimension, the question of the means by which mandates should be established and enforced must be addressed. There are a number of approaches available; these may be roughly broken down between non-governmental and governmental.

It is theoretically conceivable that there might be developed some sort of a compact between issuers and analysts and other users of company-originated information with respect to the contents, timeliness and other characteristics of disclosure by corporations. Apart from possible problems under the antitrust laws, such an approach appears at a

minimum to be impractical in an economy as large as the United States' because of the very substantial number of issuers which are publicly-held and the very substantial number of analysts and others who use information. Furthermore, it would seem difficult to develop a system of enforcement and penalties which would be satisfactory.

A second non-governmental approach might be to rely, either in part or in whole, upon the exchanges. Prior to the enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934, the New York Stock Exchange, at least, had been moving in the direction of, and for that matter, had been the principal force in developing, mandates and standards for disclosure by listed companies. Thus, the Exchange had required that all listed companies publish audited financial statements and certain other information. This continues to be the pattern in the United Kingdom and in his study comparing American and United Kingdom financial disclosure Professor Benston has concluded that the British system is functioning satisfactorily. There is some reason to believe that a large part of the success of the British system derives from the unique nature of the financial community in Great Britain where it would appear that peer pressures, the geographical concentration of the financial community in London, the influence of the Bank of England, the merchant banks and the London Stock Exchange, together with a long history, have been significantly effective in enforcing integrity among various elements of the financial community.

Notwithstanding this, there have been a number of financial scandals in Great Britain which have led to strong pressures for the supplementation of the present system by governmentally imposed requirements.

A governmentally ordained and operated mandatory disclosure system may take several forms. One form would consist simply of antifraud rules that might be enforced by criminal prosecution and civil litigation by injured parties. Obviously, the effectiveness of such a system would in this country be substantially greater than, for instance, in Great Britain, because of the relatively permissive attitude of federal courts with respect to class actions. As a variation of this system conceivably a governmental agency might be empowered to seek civil remedies; this mode of enforcement of antifraud prohibition is, of course, a significant part of the federal securities regulatory scheme at the present time and appears to work satisfactorily. The agency could, like the Commodities Futures Trading Commission, provide investors a forum for seeking reparations for rules' violations. Another variation of an essentially antifraud approach would entail the establishment of detailed rules by the governmental instrumentality with regard to disclosure, much like the content of the various forms adopted by the Commission, with departures from those rules enforced through civil or criminal proceedings, but without requirements of filing and review.

Whether any configuration consisting essentially of antifraud rules, either stated generally or with particularity, would provide satisfactory protection to investors is uncertain. In general, it appears that the experience in other countries with other modes of regulation has not proved satisfactory since there has been a significant increase in the number of countries opting for what may be called essentially the SEC approach. Furthermore, the interaction between issuers, users and the SEC through the filing and review process is helpful to the Commission in developing meaningful disclosure standards; without those elements of the system it would not be expected that standards would be as responsive to the public interest as they now are.

Members of the investment community who had experience with disclosure prior to the 1933 and 1934 enactments are often strong in their averment that the securities acts have been extremely effective in raising the levels of disclosure, and certainly in significant measure this is attributable to the system of filing and review mandated under them and extended by the Commission through it rulemaking authority. It seems doubtful that any other available system would be as effective in developing the sensitivities of issuers and those who control them to the needs of the financial market.

The Committee believes that an essential component of a satisfactory system of corporate disclosure is the significant involvement of the federal government in establishing the rules of disclosure and in the enforcement of them. The functioning of the securities markets is heavily freighted with considerations of public good; the confidence of the public in the integrity of those markets is essential if private capital is to be committed to private corporations, and particularly to the equity securities of those corporations. Notwithstanding the strong belief of members of the Committee that in many areas of government it is desirable that there be a reduction in the scope and extent of regulation, most of the Committee members believe that a significant retreat of the federal government from regulation of the disclosure process as presently constituted would have unfortunate impact upon securities markets and the ability of private corporations to raise capital in them. In addition, they believe that there are strong arguments to be made for the belief that the most efficient method of regulating the securities markets is through a system of filing, review, rulemaking, and governmental enforcement, coupled with extensive opportunities for private enforcement.

The Committee also addressed the question whether

filings made with the Commission add to the information that is available to the market. Many have suggested that the filings are redundant or at most only confirmatory of information that had been absorbed and used in the marketplace long before it appeared in a Commission filing. The Committee believes that in large measure this is true. However, it believes also that there are other benefits that accrue as a consequence of the filing process with the SEC. First, issuer knowledge that information otherwise made publicly available will, when it is incorporated in a filing with the Commission, become potentially the subject of serious liabilities under the securities acts will cause the information when initially released to be more credible and reliable. Thus the subsequent filing has what might be regarded as a disciplining effect in assuring that the earlier release is accurate. Furthermore, the information contained in the filings is usually much more extensive than that released earlier. Thus, it provides to analysts and others a means by which the more abbreviated information released may be qualitatively reviewed, parsed, and assessed. To some extent, the detail itself may constitute additional necessary information which would not be available but for the requirements contained in the various filing forms.

The Committee recognizes that the portion of the corporate disclosure system administered by the Securities

and Exchange Commission satisfies directly the needs of only a small proportion of the users of company-originated information in investment decision-making. Most investors, particularly those customarily referred to as individual investors, secure their information from a host of sources that present, format, summarize and simplify in varying degrees and ways in an effort to secure the favor and patronage of various classes of users. These privately operated sources of information are extremely important parts of the total disclosure system, for they provide accessability, both from the dissemination standpoint and the understandability standpoint.

These sources of information are the beneficiaries of the Commission disclosure system and without that system their activities would be severely hampered. Much of the information that they disseminate they secure from Commission filings. Further, the mandatory disclosure system, with its possible penalties not only for misstatements and omissions in filed material but in other corporate disclosure as well, provides a high degree of assurance that all information furnished by corporations, privately and publicly outside filings as well as in them, will be responsible and accurate.

The important role of the private disseminators of information is enhanced significantly by the presence of a mandatory dimension to the system.

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Summary

The Committee has concluded that, notwithstanding the arguments of economists and others that the efficient market hypothesis, the random walk theory and the strength of market forces, have rendered obsolete or unnecessary much or all of the mandatory disclosure system administered by the Securities and Exchange Commission, these arguments are not sufficiently compelling to justify dismantling the existing system at this time. Some of these theories, while having gained widespread academic acceptance, appear to be contradicted by some evidence and have not been fully explored in their application to all markets for publicly-held securities. Others, while useful to professional portfolio managers, do not reflect the actual manner in which innumerable investment decisions are being made.

Beyond these considerations, the disclosure system has worked well during the four-plus decades of its existence. American securities markets are recognized world-wide for their integrity and the quality and quantity of information available about American corporations. Anomalously, it has been suggested that the ease and small expense with which money can be raised in the Eurobond market, where no formal disclosure requirements exist, is because the companies seeking funds there have been compelled to make full disclosure in the United States, thus permitting underwriters and purchasers

in that market to invest with assurance concerning the quality of their investments.

In concluding that radical change is not now desirable, the Committee would reiterate its belief that the Commission should observe closely developments in economic theory and should modify its policies to reflect such developments when they have achieved a tenability sufficient to sustain policy.

To conclude the foundations of a structure are sound is not to conclude that refurbishing, repairs and remodeling are not desirable. The recommendations of the Committee which follow are intended to be of that nature.

PART I

PARTICIPANTS IN THE DISCLOSURE PROCESS*

* In an effort to meet its charge to describe the current operation of the corporate disclosure system, the Advisory Committee identified six major categories of participants in the system, and attempted through a series of questionnaire-interview case studies and questionnaire surveys conducted by the Committee's staff and others to develop an understanding of each category's role in and view of that system as it relates to shareholders.

Part I of this reports summarizes the results of this field work. Chapters I, II, III and IV are based on responses to questionnaires and follow up interviews designed to trace the flow of information from the publicly held company to its investors. Twenty-six companies were surveyed to determine how their disclosure programs operate and at what cost (Chapter I). Names of financial analysts familiar with the particular case study companies were obtained from the companies, and inquiry was made of them as to the information and sources of information used in investment analysis (Chapter II). Portfolio managers who had recently purchased or sold securities of a case study company were interviewed to determine how that decision was made (Chapter III). Finally information disseminators were questioned in an effort to determine their role in the process by which information flows from the company to the user (Chapter IV). All four groups were invited to suggest methods by which the operation of the system could be improved.

Chapters V and VI report the findings of two questionnaire surveys. In an effort to identify the role played by the registered representative in the investment decision-making process, the Committee requested the Securities Industry Association to survey registered representatives concerning their practices and views (Chapter V). Chapter VI reports on a survey of 11,574 individual investors who owned between 50 and 1000 shares in one of fifteen case study companies. Again this survey was designed to elicit information concerning how investment decisions are made and how the operation of the disclosure system is viewed. A total of 4,922 questionnaires were returned.

In all cases participation was voluntary. All questionnaires used in the survey are included in the appendices to this report. More detail about the methodology used is included in each chapter in this part, and in Appendix I-A, which describes the total research program.

CHAPTER I

THE ROLE OF THE COMPANY

A. Introduction

At the center of the corporate disclosure system in the United States are some 10,000 publicly held corporations generating information for use by numerous and varied audiences. The federal government, state and local governments, trade associations, competitors, partners, public interest groups, employees and their unions, the news media, creditors and investors and their advisers--these constituencies and others look to the publicly held corporation for information regarding its impact on their particular sphere of interest. In partial fulfillment of its charge to describe the current corporate disclosure

system, the Advisory Committee has attempted to identify the role of the corporation in the disclosure process and understand management's views of that process with respect to one of these constituencies---investors and their advisors.

Section B of the discussion which follows sketches how publicly held corporations make information available to investors; Section C evaluates the Commission's role in that process from management's point of view; Section D discusses the cost of disclosure to investors. This chapter is based on an analysis of the responses of the managements of twenty-six publicly held companies to a questionnaire prepared by the Committee and a follow-up interview of the participating management by the Committee's staff.[1/] The Committee has also drawn upon the responses of the corporate community to issues raised in Securities Act Release No. 5707 (May 18, 1976), to the extent those responses bear upon the issues discussed in this chapter.

1/ A twenty-seventh company did not return a questionnaire but did participate in the interview phase and also participated in the survey of individual investors. The questionnaire used is included as Appendix I-B. The method of selection of participating companies is described in Appendix I-C. It should be noted that because of the lengthy nature of the questionnaire the staff experienced some difficulty securing participation. As a result a number of companies (7) which finally did participate did so not as result of the process described in Appendix I-C, but rather because of the personal efforts of particular Advisory Committee members or staff.

B. The Disclosure Process

Disclosure to investors by publicly held companies is accomplished through a variety of methods:

(a) government-mandated reports, principally those filed with the Commission pursuant to the requirements of the federal securities laws, but also to some extent, those filed with other governmental agencies (particularly in the case of regulated industries);

(b) company reports to shareholders;

(c) the analyst relations program;

(d) news releases; and

(e) responses to individual shareholder inquires.

In addition, information useful to investors and their advisors may be indirectly available from the company's customers and suppliers.

Mandatory Reports. All publicly held companies having a class of securities registered on a national securities exchange or having 500 shareholders and $1,000,000 in assets are required to file an annual report with the Commission on Form 10-K,[2/] quarterly re-

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2/ The requirements of Form 10-K include description of business, summary of operations, property, parents and subsidiaries, pending legal proceedings, changes in securities outstanding, approximate number of equity security holders, executive officers of registrant, indemnification of directors and officers and certified financial statements. (Footnote continued on next page.)

ports on Form 10-Q,[3/] and periodic reports on Form 8-K.[4/]

If shareholders' proxies are solicited in connection with an

(Footnote [2] continued)
The report on this form must be filed within 90 days after the end of the fiscal year covered by the report. The report must also contain additional information if definitive proxy material or a definitive information statement is not filed within 120 days of the close of the fiscal year.

3/ The requirements of Form 10-Q include furnishing a condensed income statement, balance sheet, and statement of source and application of funds on a consolidated basis. The income statement must be presented for the most recent fiscal quarter, for the period between the end of the last fiscal year and the end of the most recent fiscal quarter, and for corresponding periods of the preceding fiscal year. The balance sheet must be presented as of the end of the most recent fiscal quarter and for the end of the corresponding period of the preceding fiscal year. The statement of source and application of funds must be presented for the period between the end of the last fiscal year and the end of the most recent fiscal quarter and for the corresponding period of the preceding fiscal year. A management analysis of this information is also required. The 10-Q also requires disclosure of legal proceedings, changes in securities, changes in security for registered securities, defaults upon senior securities, increase or decrease in securities or indebtedness outstanding, matters submitted to a vote of security holders, and other materially important events which have occurred in the quarter. The report is due 45 days after the end of each of the first three quarters of each fiscal year.

4/ The Form 8-K must be filed within 15 days after the occurrence of the earliest event required to be reported. The events required to be reported include changes in control of the registrant, acquisition or disposition of a significant amount of assets, bankruptcy or receivership, changes in the registrant's certifying accountant, and other materially important events.

annual meeting, definitive proxy material[5/] is distributed to shareholders and is filed with the Commission. If proxies are not solicited but an annual meeting is to be held, an information statement is required to be distributed to shareholders and filed with the Commission.[6/]

Although materials prepared in connection with an annual meeting are distributed to all shareholders, the 1934 Act periodic reports are not widely disseminated. It does appear to be a customary business practice for loan agreements to include a covenant that lenders be provided with copies of all filings with the Commission, including reports on Forms 10-K, 8-K, and 10-Q. Further, most companies maintain a list of security analysts to whom the 10-K is automatically sent each year. Beyond these two groups who receive the 10-K automatically

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5/ Proxy solicting material contains information with respect to the revocability of the proxy, dissenter's rights of appraisal, persons making the solicitation, interest of certain persons in matters to be acted upon, 10% beneficial owners, nominees and directors, renumeration and other transactions with management, relationships with independent public accountant and matters to be voted upon. The security ownership of certain beneficial owners and management, directors, and renumeration, options, and interest of management in certain transactions is required to be included in the 10-K if proxy soliciting material or an information statement is not filed with 120 days of the close of the fiscal year.

6/ The information statement contains all of the information which would be required if proxies were solicited except information with respect to the revocability of the proxy and the person making the solicitation.

and routinely, the only others who receive the report are analysts not on the mailing list who request the 10-K, and shareholders who request it pursuant to Rule 14a-3 of Regulation 14a.[7/] Very few shareholders request the document.[8/]

Although the 1934 Act periodic reports themselves are not widely disseminated some of their content is disseminated in other formats. Much of the information in the 10-K is also included in the annual report to shareholders.[9/] Most companies participating in the survey report that a news release is issued prior to or concurrently with the filing of an 8-K if management views the event reported as material. Quarterly reports to shareholders at least include the summary income statement portion of the 10-Q. In addition, news releases announce summary financial information quarterly and at year end.

7/ Rule 14a-3 requires the reporting company to provide a copy of Form 10-K for the most recent fiscal year at no charge to all shareholders who make written request for it.

8/ See tabulation of results to Question 7 of the Issuer Questionnaire appended to this chapter as Attachment I-A.

9/ Rule 14a-3 under the 1934 Act requires that if a proxy solicitation is made on behalf of the management of the issuer, and relates to an annual meeting, that an annual report to security holders be provided. It specifies certain information which must be in the annual report, including certified financial statements for the last two fiscal years, summary of operations, brief description of business, segment information, identification of principal officers and directors. All of this information is also contained in the 10-K.

To the extent companies are involved in the public sale and distribution of securities, 1933 Act registration statements are filed with the Commission and the prospectus delivery requirements of Section 5 of the Securities Act of 1933 ("1933 Act") are complied with.[10/] It does not appear that prospectuses are disseminated routinely to any user groups other than offerees, purchasers, or creditors pursuant to lending agreements.

In addition to these reports and filings, many companies also have other governmental reporting obligations which result in output potentially useful to investors. This is particularly true in the case of regulated industries. Although analysts do use reports prepared pursuant to these obligations, and management does believe that the reports may contain additional incremental information which may be useful to investors,

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10/ Although the content of registration statements varies with the characteristics of the issuer and the nature of the offering, the basic S-1 registration statement requires disclosure of the terms of the offering, capital structure, summary of earnings, organization of the registrant, parents of the registrant, description of business, description of property, pending legal proceedings, directors and officers and their renumeration, options to purchase securities, security ownership of certain beneficial owners and management, interest of management in certain transactions, financial statement and certain other information filed with the Commission but not included in the prospectus.

management is not of the view that any of the additional information in these reports is material or necessary to investment decision-making.[11/] It should also be noted that filings with foreign governments may also contain some useful information.

Company Reports to Shareholders. The second major category of disclosures by corporations to investors is comprised of reports and communications sent directly to shareholders. The principal examples are the annual and quarterly reports to shareholders.[12/]

Although there is a considerable variation among annual reports to shareholders, at a minimum they are required by Rule 14a-3[13/] to contain a full set of certified financial statements for the two most recent fiscal years;

11/ Fourteen companies indicated that other filings might be somewhat useful to analysts. Ten of these companies were aware that analysts used these reports. The reports cited included filings with the Federal Power Commission, the Civil Aeronautics Board, the U.S. Department of Commerce, the Wage and Price Stabilization Board, and filings with various state and federal banking regulatory agencies. Four companies indicated that filings with foreign governments might contain some useful information.

12/ Some companies have shareholder magazines or newsletters in addition to the annual and quarterly reports; however such companies appear to be the larger ones and are relatively few in number. Accordingly, these reports will not be discussed here.

13/ See note 9 supra.

a management description of company operations; segment information; identification of officers and directors; markets in which securities are traded; and the sales prices for securities for each quarter during the most recent fiscal year. Most reports also contain a pictorial presentation on the company and a letter from top management reporting on operations.

The annual report certainly is the most widely disseminated company prepared disclosure document. In addition to being distributed to all shareholders,[14/] it is released to the news media, it is provided to analysts and brokerage firms which follow the company and generally to anyone else who requests one, including teachers who use it as an educational tool for students from elementary through business school. It is also routinely provided to lenders, and sometimes to current or prospective employees, customers, and suppliers. These uses, however, are clearly ancillary to the report's use by investors and their advisers.

The quarterly report usually presents summary profit and loss information for the quarter. It also often contains a brief letter to shareholders discussing performance

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14/ Rule 14a-3 under the 1934 Act requires that an annual report to shareholders accompany or proceed proxy soliciting material. Rule 14c-3 imposes the same requirement when an information statement is distributed.

during the quarter. It is difficult to generalize about the dissemination of this report because there is no requirement that a quarterly report be distributed. The New York Stock Exchange and the American Stock Exchange require the announcement of quarterly earnings information but do not require that a report be distributed to shareholders. At a minimum, it appears to be common practice for listed companies to do so, however.

It should be noted that the financial information in the quarterly and the annual report is first made publicly available in a news release accompanying or preceding the mailing of these reports.

In contrast to the 10-K and 10-Q, both of which are viewed as compliance documents prepared to satisfy the federal securities laws and the Commission's requirements pursuant thereto rather than for any corporate purpose, these company documents are prepared to achieve identifiable corporate objectives.

In the context of investors and their advisers, the objective is to provide the information upon which to base an investment or voting decision. With respect to current shareholders (as distinguished from potential investors) some

managements frame this objective in terms of reporting on the stewardship of management, identifying the objective of these disclosure reports as being the presentation of information with which to evaluate management's performance in the utilization of the company's assets. This articulation leaves implicit the shareholder's recourse to sell or vote his stock to express dissatisfaction.

It should also be noted that while the objective of these reports may be the same for all investors, the same information may not satisfy the objective with respect to every user. Financial analysts and their clients are perceived as having more sophisticated information needs and using more detailed and complex information than "average investors." One of the most difficult problems which management must confront in preparing reports is that of balancing the needs of these different groups. Some companies have responded by developing sections of the annual report or even separate documents directed solely at the needs of the professional analyst and investor.

Analyst Relations Program. The third method by which information is disseminated to the investment community by the corporation is through the analyst relations program --those company activities and resources directed specifically toward informing analysts and satisfying their information needs. Components of an analyst relations program may include activities such as management presentations at

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meetings of analysts' societies, the hosting of company meetings for groups of analysts, the granting to analysts of interviews and tours of company facilities, and responding to analysts' telephone inquiries.

In addition to granting interviews, participating in meetings, and responding to telephone inquiries, most companies provide other services for their analysts. Companies with considerable analyst following may distribute fact books or statistical supplements providing general background information about the company and its industry and/or more detailed operating statistics than are generally included in the annual report.[15/] Many companies also automatically distribute to analysts news releases reporting earnings figures, major acquisitions, new products, top management changes and other announcements which analysts might view as important, concurrently with or shortly after they appear on the wire services.

Analysts, of course, use the written documents which are the output of the mandatory and company reporting systems described above. Indeed, the documents which make up these two systems are ranked as vital by security

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15/ This information would either be available to all shareholders upon request or would be automatically provided to them. However, individual investors would not be the user group for whom the supplement was prepared.

analysts participating in the case study. However, they view the output and opportunities available to them through their telephone and interview contacts with management as more important.[16/]

Their reasons relate both to the kind of information disseminated and its timeliness. The subject matter of interview and telephone inquiries fall into two categories.[17/] Most frequently occuring are those questions which are forward-looking, seeking information of the type not normally found in Commission filings or in annual reports. Most often, this type of inquiry takes the form of analysts "trying" their earnings estimates on management to see if they can get a feel for the company's views as to the accuracy of their projection. In addition to forward-looking inquiries related to earnings and sales projections, other frequently asked questions relate to financing plans, trends in prices and costs, anticipated acquisitions, growth rates and new products anticipated.

The second major category of information which is disseminated through interviews and responses to telephone inquiries is information of a more specific or timely nature than that usually included in the annual report or Form 10-K. This may be information more current than is con-

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16/ See also Chapter II at 66-68.

17/ Attachment I-B which appears at page 31 lists the questions most frequently asked of case study participants by analysts.

tained in any disclosure document, or information more detailed than that which appears anywhere in written form. Included within this category are responses to questions relating to current inventory position, current availability of raw materials, market share, tax rate, the impact of the current economic situation on the company, new product acceptance and sales and earnings information segmented on bases other than the reported lines of business.

It is interesting to note that there is considerable variation among companies in the frequency of analyst contacts which they experience.[18/] This variation is apparently a function of the attractiveness of a particular company as an investment opportunity. Thus companies with a high market capitalization appear to have more frequent contact with analysts. Further, those companies which appear to present an unusual opportunity for growth elicit considerable analyst interest. For example, it appears that companies with sizeable research and development activities experience greater analyst interest that might be expected based on previous earnings records or market capitalization.

18/ Attachment I-C comparing the frequency of analysts contacts reported by survey participants with their market capitalization appears at page 32.

News Releases. The fourth method by which management disseminates information is through news releases. The frequency with which news releases are issued varies greatly depending on the size of the company and company practice concerning the level of importance information must have before a news release will be triggered.[19/]

The content of these releases ranges from earnings announcements to reports on mid-level management promotions. Events which generally are announced by news release include new products, major capital expenditures, material litigation, personnel changes, acquisitions and dispositions of assets, disposition of matters before regulatory bodies and acquisition of significant contracts. As indicated above, many companies distribute copies of relevant news releases to the analysts on their mailing lists.

News releases almost always are the first company announcement of the event reported. Survey participants indicated that the news release is the customary method by which material information is first reported to the public, usually preceding a report in either mandated disclosure documents or company documents.

19/ Attachment I-C lists the approximate number of financial news releases issued by case study participants in 1975.

Management's primary concern in this area is that the news release receive prompt dissemination. Large companies have no difficulty securing adequate media coverage. Smaller companies, however, do sometimes experience difficulty in this regard.

Individual Shareholder Communications. The final major category of disclosures by corporations to investors consists of responses to inquiries from non-institutional shareholders. These inquiries may be made by telephone, in writing, or at the annual meeting.

Written inquiries clearly predominate and relate almost exclusively to administrative matters concerning the owner's shares. Questions commonly asked include: "How do I transfer my stock into another name?" "How much did I pay for my stock?". The only commonly reported questions which might be viewed as investment decision-making related are "When will the dividend be increased?" or "When will the price for my stock go up?".

Individual shareholders do not write or call their company to ask questions about financial performance. Although there are occasional letters complaining about financial performance and asking for an explanation, only rarely does a shareholder write or

call with a question similar to one an analyst might ask. If a shareholder does make such an inquiry it is responded to in the same manner as a similar question from an analyst would be answered.

One additional method by which shareholders make their feelings known to management is by jotting down comments on the proxy card. Remarks about management compensation, financial performance and the like can not be characterized as frequent, but do occur.

C. Management's Perspective On The Mandatory Disclosure System

Having as it does a virtual monopoly on micro-information about the corporation, management is in the position to accurately prepare and initially disseminate most, if not all, material, firm-specific information useful in evaluating the company as an investment opportunity, including the evaluation of the impact on the firm of external social, economic, and political forces.

Moreover, management accepts the principle of disclosure to investors not only because management believes it is an obligation which it owes shareholders, but also because of certain positive consequences perceived as resulting from a well-functioning disclosure program. Appropriate disclosure is viewed as aiding the market performance of the company's securities because a credible disclosure program is viewed as

essential to maintenance of a favorable relationship with analysts. Analysts are viewed as playing a role in creating and sustaining demand in the market for the company's securities, thereby raising the price and the price-earnings ratio.

To say that management accepts the principle of disclosure, however, is not to say that management is completely satisfied with the system as it presently operates. Further, to the extent management is dissatisfied, the Commission is often viewed as the party responsible.

As management sees the problem, the Commission's requirements result in too much unnecessary and/or meaningless disclosure. Managers object because of the cost of compliance, because they believe too much information is as effective as too little in frustrating informed investment decision-making, and because managers simply dislike having to comply with requirements they do not view as being worthwhile.

The requirements which management opposes are of several varieties. First are those requirements which call for disclosures which management views as unnecessary to investment decision-making. Examples include the requirements for disclosure of the information in the supplementary schedules to financial statements

required by Regulation S-X, the footnotes to the financial statements reporting on non-capitalized financing leases, replacement costs and stock options, the lists of properties and parents and subsidiaries in Form 10-K, increases and decreases in securities outstanding whether reported on Form 10-K or 10-Q, and disclosure of pending administrative or judicial proceedings arising under any state, federal, or local environmental provisions where a financially non-material amount is at issue.[20/]

One reason offered by management in partial explanation of the unnecessary requirements, is an assertion that the Commission responds too readily to the demands of professional security analysts, who are viewed as possessing an almost insatiable demand for information. The result of the Commission's catering to this demand is perceived as being bulky, complex, and for many investors, unusable disclosure documents. Some managers believe that in responding to this group, the Commission is serving "speculators" rather than investors.

The second category of requirements which management opposes are those which mandate the reporting

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20/ This list is based on the tabulation of the results to Question 1 of the Issuer Questionnaire. Table I-D at 33 summarizes these results.

of soft or analytical information which it is not feasible for management to report meaningfully.[21/] Two examples are illustrative of this kind of requirement.

The first is the requirement that management discuss the company's competitive position. This may be material information, but because of the number of competitors a large company may have, and because of the unlikelihood that any company will admit it is not involved in an internally competitive industry, it may not be practicable to discuss competition in any meaningful way. A boilerplate disclosure results.

The second example is the current pattern of disclosure with respect to the energy crisis. All industrial corporations are certainly affected by the fuel shortage. Yet, all are attempting to arrange for a supply sufficient to meet their needs. These two facts are making their way into disclosure documents but they probably have zero utility to investors.

Managers are also critical of disclosure requirements imposed on all reporting companies regardless of whether or not the particular disclosure is germane to the particular reporting company. Managers view this as derogative of their responsibility to determine what is material to investors in the company which they manage.

21/ Managers would classify any requirement for disclosure of projections in this category. They are considered so unreliable that disclosure could only harm the firm's credibility.

An illustration is afforded by the Commission's current requirement that certain registration statements and periodic reports include a "Managements' Discussion and Analysis of the Summary of Earnings ("the Guide")." Certain percentage tests are set forth in the Guide to suggest when an item should be discussed in the analysis; the tests are presented as being appropriate guides for all companies. In management's view this results in mechanistic, stylized, boilerplate disclosure which is not informative or useful. The Commission's reporting requirement is viewed as removing from the company the decision which it is in the best position to make: Is this information important to investors and shareholders?

A fourth category of requirements which management believes could be deleted consists of those which resulted in disclosure of information relevant and useful when initially required but which remain embedded in the documents long after the disclosure has lost its value. For example, utility companies still report on the unusual problems they faced in the early 1970's.

Finally, managers object to duplicative reporting whether it results from the separate disclosure systems set up by the 1933 and 1934 Acts; from the same information being reported year after year; from the overlapping information content of documents under the same act; or from the same information appearing twice in the same document.

Managers assert that the result of the requirements described above is disclosure documents replete with unnecessary information and meaningless boilerplate. This is an unnecessary burden on both reporting companies and the users of the disclosure documents. To the extent these kinds of requirements can be eliminated the Commission-administered disclosure system will be improved.[22/]

D. Costs of Disclosure

There appear to be three major categories of costs associated with corporate disclosure: (1) hard-dollar costs of preparing and disseminating information; (2) competitive costs; (3) costs incurred because of the adverse impact of disclosure on a miscellany of corporate advantages: management's incentive to innovate, corporate credibility; and the ability to raise capital.

The staff of the Advisory Committee was unable to measure the latter two categories at all. Accordingly, remarks on these two groups are limited to two observations.

First, although companies do use the disclosure documents of their competitors to compare performance, there does not appear to be any significant competitive

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22/ There were also a number of suggestions for amendment or change in Commission policy. The most frequently cited were to maximize integration of the 1933 and 1934 Act, to increase company access to beneficial owners and to clarify the concept of the blackout period. See Attachment I-E at 35.

cost associated with current reporting obligations.[23/]

Secondly, management views corporate credibility as an important asset and resists disclosure requirements which are viewed as affecting it adversely. The primary example of such a requirement would be one that required mandatory earnings forecasts.

The concern was voiced that if a requirement for earnings forecasts were imposed, management would alter its behavior by projecting an earnings figure it was confident of attaining and avoid riskier projects rather than disappoint analysts' and investors' expectations.

Costs of Preparation of Registration Statements and Periodic Reports. The staff was able to gather limited information on the costs of preparing primary disclousre documents. Although the case study companies numbered 26, only 22 companies provided usable cost estimates of preparing and assembling documents which the case study company had filed with the Commission during the year 1975.

The companies were requested to supply the incremental costs--the direct costs incurred to prepare a disclosure

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23/ Only three companies acknowledged the existence of a competitive cost associated with current disclosure requirements. Two of these were concerned because their principal competitors are privately held and not because they have experienced any disadvantage. Half a dozen companies did assert that more detailed line of business information would have a competitive cost.

document--attributable to each filing.

Thus, for example, the auditing and accounting costs included in the estimate of Form 10-K preparation reflects only the extra accounting and auditing costs associated with the more detailed financial statements and accompanying footnotes required by Regulation S-X. The participants were advised not to allocate to the preparation costs of a document a share of general overhead expenses. Also, the initial one-time "start-up" costs incurred specifically to establish a record keeping system for a continuing disclosure requirement was not to be counted as an incremental cost.

Subsequent to return of the questionnaire, the staff conducted direct "follow-up" interviews with key corporate officials. As part of the interviews, a review of the assumptions underlying the cost definitions and suggested methodology contained in the questionnaire was discussed with the corporate staff responsible for the preparation of the cost estimates. This verification procedure, usually carried out by a trained auditor on the Committee's disclosure staff, resulted in various adjustments which had the effect of enhancing the comparability of each case study company's cost estimates.

The cost of disclosure documents was solicited for the principal forms for registration of securities, S-1

S-7, S-14 and S-16, the periodic reporting Forms 10-K, 10-Q and 8-K and the proxy statement. The costs associated with production of certified financial statements and the annual report to shareholders were also solicited.

Table I shows the incremental cost of the disclosure documents. The table shows the average (mean) and the middle value (median) cost, the range of costs and the number of observations for each document. As can be seen from the table, the mean value is substantially greater than the median value for a number of cost figures. This is due to unusually high costs associated with one or two companies' preparation.

Because of the strong effect exerted on the arithmetic mean figures by a couple of high cost observations, it is suggested that a more reasonable estimate of the typical costs of preparing and assembling the indicated disclosure documents is given by the median values.

Table II shows the average cost by industry size: above $1 billion in total assets, between $1 billion and $100 million, and below $100 million in total assets.

In general, for the periodic reporting forms, average absolute cost of disclosure documents are greater for larger firms. For the principal forms for registration of securities, S-1, S-14 and S-16, the sample is too small to suggest any relationship.

TABLE I.

COSTS OF DISCLOSURE DOCUMENTS

CASE STUDY COMPANIES

Incremental Costs:	Average Incremental Costs (Mean)	Middle Value Cost (Median)	Range	No. Observations
1. Assembling and preparing certified end-of-fiscal year financial statements	$357,710	$165,500	$1,700,000 - $14,400	22
1a. Audit fees component	$211,111	$110,000	$830,000 - $12,000	20
1b. Audit fees % of year-end statement costs	59%	67%		
2. Cost of preparing, reviewing, and disseminating company's Annual Report (excluding auditing costs in 1.)	$92,900	$63,690	$201,000 - $18,269	20
3. Costs of preparing Form 10-K	$24,638	$13,000	$164,000 - $3,070	21
4. Costs of preparing Form 10-Q	$2,624	$1,550	$12,000 - $270	22
5. Costs of preparing Form 8-K	$460	$800	$3,079 - $100	20
6. Costs of proxy solicitation	$22,505	$15,200	$60,000 - $2,800	13
7. Costs of preparing S-1	$105,151	$93,000	$203,000 - $28,207	8
8. Costs of preparing S-7	$163,450	$182,384	$299,000 - $21,200	9

TABLE II

AVERAGE COST OF DISCLOSURE DOCMENTS

ABSOLUTE BY SIZE OF TOTAL ASSETS

Company size by Total Assets	Certified End of Fiscal Year Financial Statements	Audit Fees	Annual Report to Stockholders	10-K	10-Q	8-K	Proxy	S-1	S-7	S-14	S-16
Large-Greater Than $1 Billion	$728,375 8*	$410,000 7	$149,938 8	$45,300 8	$3,731 8	$289 6	$30,183 6	- 0	$183,750 6	$151,500 2	- 0
Medium Between $1 Billion and $100 Million	$243,229 6*	$194,745 5	$54,291 6	$13,311 6	$1,686 6	$331 6	$22,094 4	$49,804 2	$122,835 3	- 0	$2,075 1
Small Less Than $100 Million	$72,906 8*	$47,313 8	$55,376 6	$10,734 7	$2,223 8	$686 8	$7,700 3	$123,600 6	- 0	$257,500 2	- 0

* Number of Observations

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It is interesting to note that if the cost for each document per $100,000 of sales is examined relative to the total sales of the companies significant return to scale can be observed. That is, the larger the corporation, the less the cost per $100,000 of sales the company incurs in producing the disclosure documents (See Table III). Thus, relative to total sales, it is less expensive for large companies to prepare disclosure documents than it is for smaller companies to do so.

TABLE III

Average Cost/$100,000 Sales for Preparing Disclosure Documents

Size	10-K	S-1	S-7	10-Q
Large	$ 2.41	--	$ 7.59	$ .27
Medium	3.21	$ 27.30*	28.52**	$ .64
Small	$121.41	$1849.91	--	$30.87

* Two observations

**Three observations

The costs reported should not be considered conclusive due to the small sample, but rather are suggestive of the cost of disclosure. Moreover, the cost figures also do not include intangible economic costs, such as the effect the disclosure of corporate data might have on the company's capital value, how management behavior might be influenced by disclosure, etc.

E. Conclusion

In considering the results of the case study as they reflect on the company's role in the disclosure process, the following conclusions have influenced the Committee's recommendations:

(1) Reports prepared pursuant to the requirements of the 1934 Act are not widely disseminated; the annual report to shareholders is;

(2) News releases are usually the first company announcement of the event in either mandated disclosure documents or company documents;

(3) Analysts' questions to management indicate a strong interest in future-looking information and information of a more specific or timely nature than that usually included in the annual report or Form 10-K.

(4) Management's principal criticism of the SEC's mandated disclosure system is that the Commission's requirements result in too much unnecessary and/or meaningless disclosure.

(5) The cost of compliance appears to weigh more heavily on small companies than on larger ones.

ATTACHMENT I-A

SHAREHOLDER REQUESTS FOR FORM 10-K ANNUAL REPORTS

No. of Record Owners	1974	1975
34,000	300	400
46,300	180	79
9,075	100	100
22,500	200	300
5,089	270	300
122,000	433	300
6,700	50	100
2,400	21	32
1,650	—	250
15,000	100	97
6,400	75	150
9,000	57	34
98,152	973	845*
45,000	204	285
6,615	58	185
48,800	220	485
1,546	50	100
1,554	—	155
7,000	400	125
26,000	400	450
99,000	50	50
6,207	150	125
2,500	50	50
117,609	100	100
45,295	220	450

* To August.

ATTACHMENT I-B

SUBJECT MATTER OF QUESTIONS MOST FREQUENTLY ASKED BY ANALYSTS*

**Earnings and Sales Projections	23
Trends in Prices and Costs	16
Financing Debt (Long and Short Term)	15
Capital Expenditures Planned	14
Sales and Trends	12
Expansion or Acquisitions Anticipated	8
**Profit Margins on Products	7
Effect of Government Regulation	7
**Sales and Earnings on Segmented Basis Other than By Reported Line of Business	7
Availability of Raw Materials	6
New Products Anticipated	6
Dividend Policies	5
Inventory Position	5
Growth Rates	5
**Market Share	5
Reasons for Stock Price Strength or Weakness	4
Depth of Mangement	4
Tax Rate	4
Manner in Which Current Economic Situation Impacts Company	4
Uniqueness of Company	4
Competition	3
Backlog	3
Energy Exposure	3
Depreciation for Year	2

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* In the view of the participating companies there is no distinction between buy-side and sell-side analysts in terms of questions asked. Furthermore, all questions that only appeared once or which related to a company's specific product or project have been omitted.

** These are questions which management typically declines to answer or answers only in a most general way.

ATTACHMENT I-C

MARKET CAPITALIZATION*	ANALYSTS CONTACTS	FINANCIAL NEWS RELEASES
1	2,000**	15
1	12	0***
2	197	26
1	37	12
1	82	16
3	152	17
2	286	44
3	297	-
3	837	29
3	1,410	540
2	326	36
2	190	36
2	178	12
2	35	32
1	0	6
1	0	2
2	200	54
2	287	15
3	572	36
1	104	14
3	208	26
1	70**	16
1	150**	17
1	15	10
1	119	10

* 1 = less than 100 million
2 = 100 million to 1 billion
3 = greater than 1 billion

** High technology companies.

***Distributes Commission filings in lieu of press releases.

ATTACHMENT I-D

DISCLOSURES IDENTIFIED AS NOT MATERIAL TO INFORMED INVESTMENT DECISION-MAKING*

Narrative Disclosures

Item	Frequency
Increases and Decreases of Securities Outstanding	16
Indemnification	10
Environmental Proceedings	9
List of Properties	9
List of Parents and Subs	9
Exhibits	6
Guide 22 (Guide 1)	6
Energy Shortage in Business	5
Management Compensation	5
Submission of Matters to a Vote of Security Holders	4
Approximate Number of Security Holders	3
Certain Transactions with Management	3
Amendment of Articles of Incorporation	3
Lists of Underwriters	2
Income Statement (One believes two years is sufficient	2
Legal Proceedings (other than environmental)	2
Backlog	2
Government Contracts	2

Financial Statement Disclosures

Item	Frequency
Schedule 1	0(1)
Schedule 2	1(3)
Schedule 3	3(4)
Schedule 4	1(2)
Schedule 5	15(22)
Schedule 6	15(22)
Schedule 7	5(8)
Schedule 8	2(3)
Schedule 9	4(5)

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*In tabulating these results each disclosure was counted only once for each company regardless of the number of times it was marked for deletion in different documents. Excluded from the tabulation is one response that indicated the entire 10-K was immaterial and four responses that indicated the entire 10-Q was immaterial if a quarterly report was distributed to shareholders. In addition, one company did not consider the financial statements. Numbers in parentheses indicate the number of companies which provide the schedule in question.

Item	Frequency
Schedule 10	0(1)
Schedule 11	1(1)
Schedule 12	10(15)
Schedule 13	4(4)
Schedule 14	0(0)
Schedule 15	0(0)
Schedule 16	5(8)
Note on Stock Options	11
Note on Non-Capitalized Financial Leases	10
Note on Income Taxes	6
Replacement Cost Information	6*
Supplemental Profit and Loss Information	6
Earning Per Share Calculation	5
As if Accounting	5
Parent Company Financials	5(5)
Inventories for Cost of Sale	4
Note On Supplementary Income Statement Information	3
ASR-177	2
Financials for an Unconsolidated Subsidiary	2

*Although replacement cost information appeared in the filings of only six companies, all but one management interviewed indicated that the Commission's requirement should be deleted or substantially modified.

ATTACHMENT I-E

SUGGESTION*	FREQUENCY
Maximize Integration of 1933 and 1934 Act Documents	6
Increase Access of Companies to Beneficial Owners	4
Clarify the Concept of the Blackout Period	4
Provide Two-Year Consolidated Balance Sheet Information	2
Develop Accounting for Human Resources	2
Financial Information Should Read from Left to Right	2
Abandon S-8	2
File Commission Reports in All Regional Offices	1
Ease the Burden of 10b-5	1
Clarify Ambiguities Associated with Insider Trading	1
Do Something to Make S-14 Manageable	1
Develop a Summary Prospectus	1
Cover of Filings Should Highlight Company Name	1
All Financial Information Should be Together in Document	1
Principal Officers Should Sign 10-K	1
Financial Statements Should be Signed by Chief Financial Officer	1
Require More Disclosure on Short Form Debt and Past Due Receivables	1
Summary Should Appear in Front of Every Prospectus	1
Improve Operations of Public Reference Room	1
Open Up S-7 By Deleting Earnings Requirement	1
10-K Should Disclose Unusual Risks	1
Permit Filings to be Made in Regional Offices	1
Instead of Replacement Cost Information the Notes to the Balance Sheet Should Disclose if the Current Market Values of Assets are Significantly Higher or Lower than Cost	1
Use S-16 Approach for S-8	1
Provide Examples and Illustrations to Companies Which Need Improvement in Their Disclosures.	1
Provide Additional Clarification of Recent 10-Q Amendments	1

*General suggestions such as simplifying disclosure, stop imposing new requirements etc. are not included in this compilation.

CHAPTER II

THE ROLE OF THE SECURITY ANALYST

A. Introduction

Professional security analysts are employed by investment banking and brokerage houses, trust and pension departments of commercial banks, investment counselors and mutual funds, insurance companies and endowment and pension funds and foundations. Based on statistics of the Financial Analysts Federation, summarized in the table below, there were 14,646 securities analysts in 1977.

PROFESSIONAL SECURITY ANALYSTS

Institution	Number		Percentage of Total	
	October** 1971	May* 1977	October 1971	May* 1977
Broker-Investment Banking	4,082	4,152	31.4%	28.4%
Commercial Bank-Trust and Pension	3,224	3,094	24.8	21.1
Investment Counselor and Mutual Fund	2,648	3,279	20.3	22.4
Insurance	1,443	1,255	11.1	8.6
Endowment, Pension and Foundation	299	250	2.3	1.7
All other***	1,368	2,616	10.1	17.8
Total	13,064	14,646	100.0%	100.0%

* The 1977 figures are unpublished and were prepared at the request of the staff of the Committee by the Financial Analysts Federation. It is the opinion of responsible officials of the Financial Analysts Federation that these data reasonably represent the population of professional security analysts.

** Based upon published report of the Financial Analysts Federation, Compensation of Professional Investors, February 27, 1972.

***Composed of analysts employed by financial research firms, industrial corporations, colleges and universities, and government.

The professional analyst, together with the registered representative and the information disseminator, appears to be an important intermediary in the process by which investor-oriented information is communicated to investment decision makers. Because of the obviously important function played by analysts, the Advisory Committee sought to determine whether answers might be elicited to the following questions:

1. What is the role of security analysts in the mechanism by which information becomes impounded in stock prices, and how is that role performed?

2. What are the limitations on the ability of security analysts to perform this role?

3. What are the policy implications for the SEC?

In order to gain insight into the role that security analysts play in the corporate disclosure system, the Advisory Committee undertook a survey of security analysts associated with registrants in the Case Study.[1/] The specific objectives of the survey of security analysts and decision-makers were:

1. To gain a better understanding of the roles that security analysts and investment decision-makers play in the investment information system.

1/ The questionnaire to which participating analysts responded is included as Appendix II-A.

2. To identify what information security analysts and investment decision-makers use.

3. To identify primary sources of information used by security analysts and investment decision-makers for investment decisions.

4. To identify what, if any, additional information security analysts and investment decision-makers want.

5. To determine what differences, if any, exist between sell-side (those who produce research which is for sale to customers of the brokerage firm and others) and buy-side (those who frequently purchase research from brokerage firms) analysts.

The Advisory Committee also requested the Financial Analysts Federation to ascertain whether there is an identifiable segment of publicly held companies which is not the focus of significant fundamental security analysis by professional security analysts.

B. Companies Followed by Equity Analysts

More than ten thousand companies have securities registered with the Securities and Exchange Commission. In order to determine the criteria used by analysts in selecting securities to actively follow, the Advisory Committee addressed the following questions to the Financial Analaysts Federation:

> In the universe of publicly held companies, is there an identifiable segment comprised of companies which are not the focus of significant fundamental security analysis by financial analysts? If so, can you identify their characteristics and discuss the implications of this proposition on the quality of disclosure available with respect to these companies?

To answer the above questions, the Financial Analysts Federation mailed a questionnaire to 758 research directors who are members of societies affiliated with the Financial Analysts Federation.

The results describe a stock research environment where considerations of market capitalization and stock marketability are dominant factors in governing which stocks are researched by professional investors. Management credibility, disclosure quality, and earning power seem to further limit the decision to research.

Portions of the results of the study are given below. The entire report is included as Appendix II-B.

Of the 208 usable replies, 79 (or 38%) of the responding analysts were employed by NASD members, almost evenly divided between those with New York City head offices and those domiciled elsewhere. The balance were institutional investors, divided between trust departments of banks (65), life insurance companies and privately administered pension funds (12), and investment counsel, nonlife insurers, mutual funds, etc. (52).

The number of stocks "closely followed" by both brokers and institutions is relatively small. The relevant statistics are as follows:

. . . 57% of the New York city brokers follow closely about 100 or less stocks and only 21% follow more than 300.

. . . 83% of regional brokers follow closely about 100 or less stocks and only 6% follow more than 300.

. . . 57% of institutions surveyed follow closely about 100 or less stocks and only 11% follow more than 300.

The Financial Analysts Federation attempted to determine from their survey results the number of companies followed by each analyst. To compute this number, they divided the number of stocks a firm followed by the number of full-time stock analysts in that firm. The key finding is that institutional analysts are spread more thinly in terms of the number of companies followed than are brokerage analysts. Almost all brokerage analysts covered less than 15 stocks, while almost half of the institutional analysts followed more than 30.

The survey questionnaire asked the research directors to indicate a bottom limit of market capitalization that restricts new additions to their lists of closely followed companies. Of the respondents to this question, 78% reported that they work with a threshold as low as

$50 million, and 54% with a threshold of about $100 million. Only brokerage firms (especially regional firms) show significant tolerance for less-capitalized companies. This is presumed to result from investment banking relationships and individual investor interest rather than institutional interest. By contrast, trust departments and life companies show an overwhelming preference for stocks whose capitalization is at least $50 million or more.

Another way to look at the market capitalization factor is to examine the percentage of all closely followed stocks which have low market capitalizations. The question posed by the Financial Analyst Federation read (in part) as follows: "What percent of closely followed stocks have a market capitalization between $50-$100 million, and less than $50 million?"

Of the institutions that responded, 80% indicated that companies having an aggregate market value of less than $50 million accounted for less than 5% of all companies followed. Of the New York City brokerage firms 80% indicated that less than 5% of the companies they followed had market values of under $50 million. On the other hand, 70% of the analysts with regional brokerage firms indicated that companies having market values of less than $50 million accounted for 10% or more of the companies they followed.

C. Staff Survey of Equity Analysts[2/]

This section describes in detail the procedures, the findings, and the staff interpretations of these findings of the Advisory Committee's survey of security analysts. These findings should be viewed only as presumptions because of the small number of analysts surveyed.

The following methodology was employed in the staff survey of equity security analysts:

2/ Since 1970, a substantial increase has taken place in the number of brokerage houses and independent advisors servicing corporate bond investors with credit market research. In addition there has been a growth of in-house institutional bond research. This growth has come about as a result of a dramatic increase since 1970 in the amounts of corporate bonds outstanding and held in individual and institutional investor portfolios. Statistics published by Salomon Brothers show that in 1970 the amount of public corporate debt held by individual investors was $16.5 billion; by 1976 this had increased to $57.2 billion, an increase of 246%. During the same period the amount of public debt held by institutional investors also increased substantially from $108.1 billion to $183.6 billion. Kaufman, McKeon, Cohn, Prospects for the Credit Markets in 1977, Salomon Brothers, (1977). Not only have the amounts increased, but there has been more active trading in these instruments. It appears, that investors are now more interested in the current or near term liquidity of the debt instrument and less interested in holding the debt to maturity.

The Committee was not able to specially focus on the debt analyst. The Committee on Corporate Disclosure of the Fixed Income Analysts Society was invited to submit their views to the Committee. That report is attached as Appendix II-C. But see Chapter XVIII at 551 et.seq.

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1. From each company participating in the case study, the staff obtained a listing of both "sell-side" and "buy-side" security analysts who followed the company closely.

2. From these lists, the staff selected for interview two sell-side analysts, two buy-side analysts and one investment decision-maker (affiliated with the buy-side analyst) for each participating company. (An attempt was made to obtain a representative cross-section of banks, mutual funds, pension funds, foundations and other institutions in selecting the buy-side analysts and investment decision-makers and a representative sample of sell-side analysts [3/] from New York and regional brokerage houses).

3. The staff mailed each selected sell-side analyst and buy-side analyst the following:[4/]

3/ See Table A following the narrative portion of this chapter. For convenience of presentation all tables appear at the conclusion of the narrative discussion unless otherwise indicated.

4/ The original plan of the study was to request security analysts to "mark up" the following documents:

1. Form 10-K Annual Report
2. Annual Report to Stockholders
3. Form S-14 Proxy Statement
4. 1933 Act Registration Statement
5. Form 10-Q Quarterly Report

However, it became apparent after the first few interviews that the staff might be imposing an undue burden on the participating analysts by requesting them to mark up all documents; faced with this burden, analysts seemed less likely to mark up any documents. Accordingly, all analysts interviewed subsequent to the first few were requested to mark up only the Forms 10-K and 10-Q, inasmuch as they were deemed to contain most of the information items that were in the other documents.

a) "Financial Analyst Questionnaire" (included as Appendix II-A)

b) Form 10-K of the participating company (to be marked up indicating items used and not used)

c) Form 10-Q of the company (to be marked up signifying items used and not used).

4. After receipt of a completed questionnaire the staff scheduled an interview. A total of 58 buy-side analysts were contacted, 27 were interviewed and 26 returned questionnaires. Fifty-eight sell-side analysts were contacted, 43 were interviewed and 33 returned questionnaires.

The experience of the staff in conducting the survey reinforced the results of the Financial Analysts Federation in its report to the Advisory Committee. The staff was only able to locate analysts who followed companies having small market capitalization among the regional brokerage and regional investment advisory concerns.

The case study reveals an information system which can best be characterized in terms of its diversity both from the perspective of the sources of information and the kinds of information used by security analysts. Security analysts were found to select the source and kind of information used by weighing the incremental costs of obtaining it against the incremental benefits to be derived either

from sale of the information or from the reduction of uncertainty associated with purchase of an investment security.

The survey results disclosed differences between "sell-side analysts" and "buy-side analysts" in the extent to which they use the work of other analysts in arriving at their investment recommendations. Although both categories have as their primary output an earnings forecast and an investment recommendation, the sell-side analyst seems more inclined to rely solely on his own research than his counterpart on the buy-side. Secondly, as was observed by the report of the Financial Analysts Federation, the analysts who worked for institutional investors tended to follow closely a greater number of securities than did analysts working for New York-based and regional-based brokers. Finally, the results show that analysts on the buy-side and the sell-side tend to distribute their time differently among study of the overall economy, the industry, the company in the survey, other companies in the same industry, and other industries, with the buy-side analysts spending more time in studying the overall economy and companies in other industries, than the sell-side analyst. 5/

The analytical approach taken by security analysts appears to be divided into three general categories:

5/ See Table B.

1. Analysis of the direction of the general economy;

2. Analysis of the direction of the industry, sector or market, in which the company at interest is situated; and

3. Analysis of the specific company itself.

The chapter will discuss first the reasons why analysts believe that an understanding of the general economy and the industry, sector or market in which the company appears is important and will set forth the principal sources the analysts use to obtain this information. The chapter will then review the types of information about a particular company the analysts find important and describe where they go to find the information. The next section will examine the structure of the periodic disclosure system and the current disclosure system and the manner in which these two systems are used by analysts. This will be followed by a section which will examine the importance, from the viewpoint of the analyst, of the various items (both narrative and financial statement) of the Form 10-K.

C-1 Information Concerning the General Economy and the Industry, Sector or Market. Virtually all analysts surveyed indicated that both statistical data regarding the overall economy and interpretation of that data were important to

their analyses of an individual security.[6/] Both buy-side and sell-side analysts rely primarily on newspapers and magazines, government publications and in-house economists for statistical and analytical information about the economy. For analytical information about the economy, buy-side analysts also rely heavily on brokerage-house reports which have been prepared by sell-side analysts.[7/]

Modern theories of portfolio management have quantified the extent to which macroeconomic factors affect the price of a given security. Some have hypothesized that both the level of the overall market and the level of the security price are determined by economic events (e.g., inflation, interest rates, growth rate of real GNP).[8/] Studies have shown that between 30 percent and 60 percent of the variations in monthly returns of individual securities may be explained by the security's movement with the market.[9/] To the extent that the market movement is dependent upon macroeconomic events, then it is clear why all security analysts spend a considerable

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6/ See Table C.

7/ See Table D.

8/ See Rosenberg & Guy, "Prediction of Beta from Investment Fundamental" Fin. A. J. 60 (May-June, 1976).

9/ See King "Market and Industry Factors in Stock Price Behavior," 39 J. of Bus. 139 (1966).

portion of their time assessing the sensitivity of the market and individual security price to changes in the economic events.

Security analysts interviewed were uniformly interested in information about the industry [10/] and their primary sources were industry trade publications and government publications. Buy-side analysts also rely heavily on brokerage reports for statistical industry information. For analytical information about the industry, sell-side analysts rely primarily on industry trade publications while the buy-side analysts rely on industry trade and other publications and brokerage reports.[11/]

The importance placed by analysts on study of the industry is supported by academic research. Studies of security price movements have shown that security prices of companies in the same industry tend to move together in response to the same economic s[illegible]. One such study found that there was support for [illegible]thesis that the systematic portion of security price changes can be broken down into market and industry components.[12/]

10/ See Table E.

11/ See Table F.

12/ See King, supra note 9.

Other studies have also noted the high uniformity of response securities of companies within a given industry have to the same economic events.[13/]

C-2 Information Concerning a Particular Company

Theories of modern portfolio management hypothesize that the overall contribution to the risk of a diversified portfolio caused by factors peculiar to an individual company in the portfolio will be negligible because of the tendency of these factors to be canceled out by diversification. Consequently in a well diversified portfolio most of the variability of the return can be explained by general economic or industry factors. Theoretically, then, it could be argued that it is futile to analyze individual companies in an effort to discover factors unique to the company which are not related to market or industry factors. However, there has been a growing awareness that changes in fundamental characteristics of the firm, such as financial structure, management, and diversification, can change the responsiveness of that company to economic events, and that consequently for many companies the responsiveness does not remain constant over time.[14/] One of the primary purposes of company

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13/ See, e.g., Rosenberg & Guy "Prediction of Beta from Investment Fundamentals, Part II" Fin. A.J. 62 (July-August, 1976).

14/ Id.

analysis is to identify and predict changes in these fundamental characteristics which foreshadow changes in the responsiveness of that company to economic events. Analysts consult many sources both inside and outside the company in order to ascertain fundamental changes in:

1. The market for the company's products and services;

2. The tendency of management to respond to economic events and the effectiveness of that response;

3. The effect upon the company of governmental regulations regarding social and environmental matters; and

4. The general characteristics of the company's customer population or availability of raw material supplies.

Sources of information for each of these items will be examined in detail below. In addition, there will be a discussion of the extent to which management's forecasts of future performances and analysis of general economic and specific industry factors influence analysts.

The Market for the Company's Products and Services. Security analysts spend a great deal of time attempting to ascertain what share of market is enjoyed by each of a company's major products or services. This is considered vital information by most analysts.[15/]

15/ See Table G.

The majority of sell-side analysts obtained the information from personal contact with the company, company generated written communications, industry publications and the company's annual report; the majority of buy-side analysts relied on SEC filings of customers and competitors as well as the company's annual report and industry publications.[16/]

Analysts interviewed by the staff expressed considerable dissatisfaction with the public availability of information concerning the sales and earnings contribution of the various products and services. Their complaint was that the segmentation provided by companies pursuant to the existing requirements of the SEC has not given adequate information about companies' products and services which are subject to differing degrees of risk either because of the nature of the product, the production process for that product or the nature of the market served by that product (including geographic location).

Management Response to Economic Events. It is clear from the interviews conducted by the staff that assessment of management ability is one of the vital ingredients to investment analysis.[17/] In making this assessment analysts agreed that there was no substitute for personal contact with

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16/ See Table H.

17/ See Table I.

the management. Several analysts emphasized the importance of ascertaining the personal goals of the senior executive (e.g., money, power, ego gratification, etc.) in assessing the direction in which the company was heading and the motivations for actions by the company. Others mentioned that management ability could only be assessed through the earnings record of the company.

Sources of this information seem to vary between sell-side and buy-side analysts.[18/] Sell-side analysts obtain their opinions of management directly from contact with the management. The primary source of this information for buy-side analysts appears to be the sell-side analysts' research reports. Indeed, most sell-side analysts interviewed seemed to feel that this was one of the primary outputs of their work.

Effect of Social and Environmental Regulation. The analysts responding to the questionnaire indicated a limited interest in this type of data,[19/] although buy-side analysts seem to be more concerned with this type of information than those on the sell-side. Discussions with investment professionals have raised the possibility that this increased concern might be a reflection of the need for analysts who work for

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18/ See Table J.

19/ See Table K.

institutions which manage portfolios of socially conscious investors to be more concerned with these types of issues. A further explanation might be that buy-side analysts occasionally have to make recommendations with regard to voting on social issues in shareholder proxy statements. To the extent the above conditions are true, buy-side analysts might tend to be more sensitive to the economic significance which could be attached to such issues.

The sell-side analyst who seeks this type of information obtains it from filings with governmental agencies and industry publications, whereas the buy-side analyst obtains the information from industry publications, newspapers and magazines and brokerage house reports.[20/]

Characteristics of Customers and Suppliers. Analysts interviewed expressed an interest in learning of changes in customer mix or availability of raw material supplies.

Approximately 81 percent of the buy-side and 72 percent of the sell-side analysts responding expressed the opinion that this type of information was at least supplementary in their decision-making processes.[21/]

20/ See Table L.

21/ See Table M.

Primary sources of this information are customers and competitors, personal contact with the company and industry publications.[22/]

Projections of Economic Performance. Most security analysts, particularly on the sell-side, consider the company forecast as the end product of their work. The forecast is calculated from their evaluation of both non-financial and financial background information.

To a surprising degree the survey disclosed that managements' own projections of the company's performance were considered by analysts as being vital information in the first instance rather than simply confirmatory of the analysts' projection. In designing the questionnaire the staff distinguished between three types of projections as follows:

Type of Projection	Distinguishing Characteristic
Business Objectives	Management's goals for the company to shape the future
Budgets	A commitment to action. The financial embodiment of the corporate plan for the company which quantifies the corporate plan and serves as a basis for controlling the execution of that plan.
Economic Performance	Management's estimate of the future after the planning and budgeting processes have helped shape the future

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22/ See Table N.

1. Security analysts interviewed seek to determine not only what management's goals are for earnings per share growth or return on equity but also why the company's products and production capacity can be expected to achieve those goals. As a corollary they are also interested in what strategic decisions management plans to take to achieve its goals (e.g., what capital investment is necessary) and what industry or competitive conditions will affect that strategy.[23/]

The major source of information about objectives is the interview with company management.[24/] Many companies have also begun to include this type of information in the "President's Letter" sections of annual reports.

2. As mentioned above a budget is a definite commitment to action directed toward shaping the future of the company. Analysts interviewed indicated interest in forecast information at this level of detail because it enabled them to gauge the sensitivity of operating results to changes in management's assumptions concerning the future.[25/]

The primary source of budgetary information is personal contact with the company and company generated

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23/ See Table O.

24/ See Table P.

25/ See Table Q.

written communications.[26/] Again, it is clear that the informal system is more effective than the formal system in conveying this type of information.

3. As stated above the performance projection has been defined as management's estimate of the results of operations resulting from implementation of the budget in accordance with the business objectives of the company. In a sense, then, both the budget and the business objectives become analogous to the assumptions underlying the performance projection.

In general, virtually all analysts participating in the survey obtained forecast data in some form from company management.[27/] Virtually all obtained and used management forecasts to a greater or lesser degree in their assessment of the company and formulating their own projection of the company's operating results. Most of this information was communicated to analysts through personal contact with the company and company generated written communications.[28/]

26/ See Table R.

27/ See Table S.

28/ See Table T.

Management's Analysis of General Economic and Specific Industry Factors. Previous sections described the importance to effective security analysis and investment decision-making of identifying historical relationships between both the level of general economic factors and the company and performance of the industry as a whole and the company. Particularly important to the timing of investment decisions is the identification and prediction of changes in these relationships.

In the questionnaire security analysts were requested to rate the importance to their analytic process of management analysis of the historical and projected impacts of both the general economic and specific industry factors upon the company.

With respect to management's analysis of the historical impact of general economic factors, the sell-side analyst was more likely to find the information confirmatory rather than vital while the buy-side analysts were about equally divided in finding it vital or confirmatory.

With respect to the projected relationship of general economic factors upon the company, the sell-side analyst again appeared more likely to find the information confirmatory rather than vital while buy-side analysts were about equally divided between vital and confirmatory.

The primary sources of these kinds of information were personal contact with the company and company generated written communications. 29/

The tendency of sell-side analysts to evaluate the historical information as being less useful is not surprising in view of their general tendency to view their capability of performing this analysis as superior to management's for many companies. However, the relatively high number of analysts of both categories rating this information as "confirmatory" suggests that management's analysis, if not conclusive in the first instance, at least serves to confirm, or validate, the analysts' own analyses.

As discussed above, the historical relationship between the company's performance and performance of other companies in the same industry is an important indicator of the ability of company management to compete effectively and react quickly to either overcome adverse industry conditions or to maximize favorable conditions. Analysts are aware of the company's past performance in this area and are constantly attempting to learn, primarily through personal contact with the company and from company generated written communications, information which will assist them in

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29/ See Tables U and V.

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determining whether the company will compete and react to industry-wide factors more or less effectively in the future. 30/

The formal disclosure system (as reflected in annual reports and SEC filings) apparently does not provide an important source of information to investment professionals regarding either the historical or the projected performance of the company in relation to its competitors within the industry. Some analysts feel that at least the historical performance could be disclosed in filings with the Commission. This question will be discussed in the section in this chapter devoted to the Form 10-K and in some depth in Chapter X entitled "Soft Information."

C-3 Structure of the Periodic and Current Disclosure System

General. The previous section surveyed the importance of sources of non-financial statement information and found the SEC filings to be but one of many sources of information for the equity security analyst. It was found that generally for purposes of providing information about the economic environment of the company and the place of the company products in that system, Commission filings may not play a significant role.

30/ See Tables W and X.

The purpose of this section is to examine the structure of the formal periodic disclosure system (composed of SEC filings and annual and quarterly reports to shareholders) and the informal and formal current disclosure system (composed of all other methods available to corporations for disseminating information to investors, and the Form 8-K) and to ascertain, if possible, what roles the various filings comprising the formal and informal systems play in the total disclosure system.

The Formal Periodic Disclosure System. The preceding sections have evaluated the role of Commission filings in providing non-financial statement information. This section evaluates the importance of specific filings in providing all kinds of information for investment decisions.

The table on the following page shows that analysts believe Form 10-K's are vital to their work and registration statements and Form 10-Q's less important.

Although analysts interviewed remarked in general that the 1933 Act prospectus disclosures have become less important as the quality of disclosure in Form 10-K has improved, most believe that the quality of disclosure in the prospectus is still slightly better than in the Form 10-K; however, because of the infrequency of registrations of securities by most companies, prospectuses are not considered a source which can be relied upon as a primary source.

Relative Importance of Specific SEC Filings

Number of Respondents

	Sell-Side				Buy-Side			
	No. "Vital"	No. "Confirmatory"	Total Respondents	% Responding to Question	No. "Vital"	No. "Confirmatory"	Total Respondents	% Responding To Question
1) Registration Statements								
Form S-1	10	6	18	55%	12	1	17	64%
Form S-7	7	5	13	39	11	1	16	48
Form S-8	2	3	7	21	-	-	2	8
Form S-14	2	5	9	27	2	-	4	15
Form S-16	2	3	7	21	-	-	2	8
2) Form 10-K	21	6	27	82	21	1	23	88
3) Form 10-Q	12	10	26	79	14	6	23	88
4) Proxy Statements	11	8	28	85	7	9	23	88
5) Stock Ownership Reports	7	10	[illegible]	100	-	5	16	62
Total analysts responding to question			[illegible]				26	

It appears that the Form 10-K is the most frequently used and the 10-Q the second most frequently used of the SEC filings by all analysts.

From the preceding analysis of the use of all information sources, it appears that the Form 10-K is used most often to obtain a general description of company products and services and to a certain extent, (particularly for the buy-side analysts), to relate the historical performance of the company to its industry. However, these uses would not seem sufficient, in themselves, to account for the high number of respondents who identified the Form 10-K as being a "vital" source of information.[31/]

The results of staff interviews with security analysts suggest that the answer lies in the compelling need for security analysts to produce investment ideas which have not been discounted by the market and hence impounded in in the price of the stock. This need forces analysts (particularly on the sell-side) to value highly that information which is proprietary and non-public. Information included in Form 10-K embodies neither of these two characteristics and hence compared with information sources which have the potential for these attributes, the Form 10-K may not be given as high a rating. However, the analysts'

31/ 42 of 50 buy-side analysts rated the Form 10-K as a vital source of information.

assignment of high importance to the Form 10-K establishes the role of this document in providing a reliable frame of reference or structure against which the analyst can evaluate the significance of that proprietary, non-public information which he is able to obtain via less formal means. Thus in this context the analyst can be justified in assigning both high and low importance to the Form 10-K. It is "high" because without it he would have to construct the information contained therein himself, and in a sense it permits him to operate at a much higher level than he would otherwise be able to operate. It is "low" because very little of the information in the Form 10-K has not already been impounded in the price of the stock, and therefore it has little incremental value to the analyst for the purpose of a buy or sell recommendation.

Perhaps as important to understanding the reason for this disparity in responses is that the latter analysis evaluated the importance of the Form 10-K including the financial statements while the former did not. This may establish the financial statements as one of the most important categories of information provided by the Form 10-K.

The importance of the annual report to shareholders parallels that of the Form 10-K. Analysts attributed slightly higher importance to the annual report primarily

because it is generally published earlier and contains (at least with respect to the larger companies) more analytical information than the Form 10-K.

The importance of Form 10-Q must be evaluated in comparison with the quarterly report to shareholders.[32/] The quarterly report to shareholders, because it is more timely, provides the primary source of quarterly financial information about the company. Although the Form 10-Q provides some of the same information as the quarterly report to shareholders, it is not rated as useful because it is generally not as timely as the quarterly report. Several analysts questioned the purpose of having two sets of documents dealing with quarterly financial information. However, others argued that the SEC through the vehicle of the Form 10-Q is able to affect and improve disclosures in quarterly reports to shareholders.[33/] Many analysts commented that it might be better for all concerned if the SEC could require companies to provide additional disclosures in quarterly reports directly rather than indirectly via the Form 10-Q.

32/ See Table Y.

33/ Several analysts noted the improvement in disclosures contained in quarterly reports to shareholders pursuant to the SEC's adoption of Accounting Series Release No. 177 dealing with expanded disclosures in Form 10-Q, but expressed concern that there still were significant disclosures in Form 10-Q which were not in the quarterly reports to shareholders.

In summary, the formal, periodic disclosure system (defined by registration statements, Forms 10-K and 10-Q, and the annual and quarterly reports to shareholders) serves the dual functions of (1) providing a framework within which the impact of current economic and political events, both internal and external to the company, can be evaluated and (2) providing an earnings benchmark against which analysts' estimates of the effects of these events upon the company's operating results can be measured. For those companies which are followed by analysts the formal, periodic disclosure system provides little new information concerning the economic and political events themselves.

A third function of this system is to induce disclosure by the company of current economic events via the informal current system (such as press releases) by requiring periodic disclosure of these events in the formal, periodic system. To the extent that a company would not freely disclose via the informal system information about the impact of material events (particularly those events the disclosure of which might have a negative impact upon the price of its stock or the firm itself), this function may provide a valuable service in maintaining an orderly market for a company's securities.

The Current Disclosure System. The role of the informal, current disclosure system has been discussed in general

terms in previous sections of this chapter. In the succeeding paragraphs that system and the role that the Form 8-K is meant to play in that system will discussed in more detail.

The informal system is characterized by the categories "personal contact with company" and "company generated communications." The table on the following page presents an analysis of the relative importance of each of the sources listed within these two categories.

It is clear from this tabulation that personal conversations with management (both in person and by telephone) provide the most important means for communicating to analysts the impact of the effect of current events. Form 8-K seems to be about as effective as other forms of written communication in providing a source of useful information for analysts. Based upon the staff's survey analysts were mixed in evaluating the information contained in Form 8-K's as "vital" or "confirmatory" but most placed these filings in one of these two categories.[34/]

34/ The split in rating the Form 8-K between "vital" and "confirmatory" may be explained by the research of Professor Victor Pastena of the Columbia University Graduate School of Business Administration reported in an unpublished paper entitled "The Efficacy of SEC Regulations Requiring the Disclosure of Unusual Events." Professor Patena tested the market price effects of disclsoures under Item 10(a) of Form 8-K. Of 258 Item 10(a) events reported to the SEC, between 1973 and 1975, 46 had not been disclosed to the public through the Wall Street Journal or were disclosed substantially after the SEC filing date. In most cases, those which

	Number of Respondents					
	Sell-Side			Buy-Side		
Personal Contact with Company	No. "Vital"	No. "Confirmatory"	Total	No. "Vital"	No. "Confirmatory"	Total
Personal Conversations with Management	26	2	28	22	2	24
Telephone Conversations with Management	19	2	21	20	4	24
Informal Q & A Sessions with Management	14	11	26	13	5	19
Management Presentations at Analysts Meetings	13	9	27	18	5	24
Management Presentations at Company Meetings	19	8	29	18	5	23
Company Tours	6	11	25	14	5	21
Other Management Presentations	6	6	14	10	5	19
Company-Generated Communications						
Press Releases	12	10	24	16	6	22
Company Newsletters	7	13	27	12	7	23
Letters to Shareholders	13	8	26	12	10	24
Written Copies of Management Speeches	20	8	28	18	6	24
Other Written	1	2	4	11	1	12
Formal Current System						
Form 8-K	9	12	27	7	8	23

C-4 Analysis of the Importance of Form 10-K Items

General. As described above, the analysts feel that the most important function of the Form 10-K is to to provide reliable background information about

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34/ (con't.)

were reported in the Wall Street Journal were reported in that paper prior to filing with the SEC. Professor Pastena's paper concluded the following with respect to the impact of Item 10(a) information on stock prices:

1) Item 10(a) disclosures seem to contain information which is not anticipated by the market and thus is used by the market in setting stock prices.

2) Stock price changes seem to be greater in Item 10(a) announcement periods than in randomly selected periods.

3) Stock price changes caused by the unanticipated information contained in negative Item 10(a) announcements are greater than the unanticipated information contained in annual earnings announcements.

4) While management's press releases generally provide more timely sources of information to investors and creditors, the Item 10(a) disclosures contain relevant information which is not included in the typical press release (i.e.: Item 10(a) required the disclosure of the future income and cash flow consequences of an unusual event).

The evidence presented in this work suggests that although Item 10(a) information has an effect upon stock price determination, it is not always reported in the financial press. In those cases in which there was no newspaper announcement the Item 10(a) disclosure would be the primary source of information about the unusual event for the analyst and hence the Form 8-K would be more apt to be rated as "vital."

the company and confirm information disseminated via the current disclosure system. In light of these functions, the Advisory Committee requested analysts to mark the most recent Form 10-K of the participating case study company to ascertain how they used each of the Form 10-K items.

Of the fifty-nine usable questionnaires completed by analysts, only thirty were accompanied by marked-up Form 10-K's. Furthermore, because of the large number of industries represented by companies in the case study,[35/] analysts exhibited more differences than similarities in their assessment of importance of Form 10-K items. Notwithstanding the above limitations, these responses, combined with information obtained during staff interviews, permit the staff to draw several generalizations concerning the use of the individual Form 10-K items.

Textual Items. There are several categories of information called for by the Form 10-K and analysis of these categories can give some insight into the reasons for the analysts' responses to the individual items. Based upon staff review of analysts' responses and of the content of Form 10-K items, the following categories were established:

1. Constant factual information
2. Variable factual information
3. Soft information

35/ Seventeen different industries were represented.

Constant factual information changes little from year to year. Generally it provides background about the company for those who are unfamiliar with it, but by its nature it cannot provide new information to a security analyst who follows the company on a regular basis. Generally speaking, significant changes in this information materially affect the structure or earning power of the corporation and have significance for its long run profitability. Items in Form 10-K which are included in this category are:

Item No.	Item Description[36/]
1(a)	Products and Services
1(b)(2)	Customers[37/]
1(b)(4)	Sources and Availability of Raw Materials
1(b)(5)	Patents[38/]
1(b)(7)	Material Effects of Compliance with Environmental Regulations
1(b)(8)	Number of Employees
1(b)(9)	Seasonality of the Business[39/]
3	Properties
4	Parents and Subsidiaries
7	Approximate Number of Equity Security Holders
8	Executive Officers of the Registrant
9	Indemnification of Officers and Directors

36/ See Tables Z, AA, BB, CC, DD, EE, FF, GG, and HH.

37/ No analysts responded.

38/ Only two analysts responded--Both "Vital."

39/ No analysts responded.

With the exception of Items 9 and 1(b)(7), which few analysts considered useful for investment decision-making, the analysts interviewed considered this category of information important because it served as a convenient reference about the company which would be updated regularly.

Of course, certain of these items were considered more or less important depending on the nature and geographical locations of the business done by the corporation. For example, although all companies in the survey included a list of properties in the Form 10-K, analysts attributed greater importance to those lists which included locations of foreign operations. These analysts indicated that knowledge of foreign locations is important and that for these companies such a list was the only public disclosure of the locations of foreign operations. Additionally, for other companies, certain Item 4 ("Parents and Subsidiaries") disclosures relating to "parents" of the corporation were noted as giving insight regarding the liquidity of the corporation's stock.[40/] Analysts noted that Item 7 ("Approximate Number of Equity Security Holders") was also useful for this purpose.

40/ A small number of analysts have found the list of subsidiaries useful for obtaining financial statements of subsidiaries, particularly those located in foreign countries.

Form 10-K disclosures of the backgrounds of executive officers were noted to be more important with respect to a small company than a large one. All analysts voiced their opinion that particularly in a smaller company, knowledge of the background of the key executives is one of the most crucial ingredients in determining whether or not to invest in that company. In a larger company, analysts emphasized the importance of obtaining an insight into the chief executive's personal motivations (e.g., power or money) in order to gauge his reaction to events which might affect the company. These analysts added, however, that the best means of obtaining an assessment of management was to meet and talk with the chief executive. They questioned whether this could ever be communicated effectively via the Form 10-K.

Many analysts expressed considerable dissatisfaction with the necessity of reading through many pages of stylized prose in a Form 10-K to determine whether there had been a change from the previous period in one of the items listed above. Notwithstanding the requirement of Item 1(b) to describe any material changes and developments in the items required in Item 1(b), none of the companies included in the case study highlighted changes in 1(b) items. Analysts noted that improvements should be made in identifying changes in this information to eliminate the necessity for the user to compare the current year's Form 10-K with the one for the preceding year to identify them.

Variable factual information includes firm-specific factual information which changes from period to period. Items in the Form 10-K which fall into this category are:

Item No.	Item Description [41/]
1(c)	Line of Business Information
2	Summary of Operations [42/]
5	Legal Proceedings
6	Increases and Decreases in Outstanding Securities
10	Financial Statements [43/]

Almost without exception analysts evaluated these items as more important than Items in the previous category. In general, Items 5 ("Legal Proceedings") and 6 ("Increases and Decreases in Outstanding Securities") were judged as being confirmatory of other information which had been communicated to them less formally by management. Financial statements, including the summary of operations, and line of business information, are used as a benchmark against which to compare earnings and to assist in forecasting future periods' earnings.

41/ See Tables II, JJ, KK.

42/ See Section C-5.

43/ See Section C-5.

Based upon survey responses, line-of-business information was considered the most important information provided in Item 1 of the Form 10-K. The reason for its importance is that the line-of-business analysis provides information which enables the analyst to relate the separate areas of business activity of a diversified corporation to their economic environments. Because of the reluctance of many managements of even the best reporting companies to provide this information prior to the Commission's requirement to disclose it,[44/] analysts have looked to the Form 10-K as their primary source of this information. However, this area was also considered by analysts as that which was in need of the most improvement because of the reluctance of most managements to provide analysts informally with line-of-business information in greater detail than that provided in the Form 10-K. The following tabulation exhibits the extent of their dissatisfaction with existing line-of-business information.

44/ Seven of the twenty-one respondents to Question VIII of the Financial Analyst Questionnaire (which is included as Table PP) reported that the survey companies did not provide this information before it was required by the SEC.

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SECURITIES ANALYSTS' DESIRES FOR IMPROVEMENTS TO LINE OF BUSINESS DISCLOSURES IN FORM 10-K

Item of Information	Importance: Vital	Supplementary or Confirmatory	No Immediate Use
1. Domestic Operations			
More detailed list of business breakdown of sales and by geographic markets	22	2	
Quarterly line of business information	7		
Better information about product prices	3		
Standardization of line of business reporting by industry	2		
Inclusion of product assets in line of business reporting	2		
Better information about the sales and profits from new products	1		
Line of business reporting of after tax profits for each year	5	1	
For oil companies, should be separate disclosure of sales and contribution to profit of both the exploration and production functions and refining and marketing functions		1	

Item of Information	Importance: Vital	Supplementary or Confirmatory	No Immediate Use
Quarterly sales backlog information by line of business	3		
2. Foreign Operations			
There should be better disclosure of foreign earnings by major country	7	1	
There should be better disclosure of foreign operations by line of business	1		
Foreign operations should be disclosed quarterly	1		
Should be disclosure of net monetary assets by major country	1		

Soft information includes the following 10-K items:

Item No.	Item Description 45/
1(b)(1)	Competitive Conditions in the Industry
1(b)(3)	Backlog
1(b)(6)	Research and Development Activities
3	Production Capacity
Guide 22	Management Analysis of the Summary of Earnings Forecast data

Some of this information is characterized by being so subject to change that disclosure may be materially correct as of the date of measurement but not necessarily on the effective date (or even the filing date) of the disclosure document (backlog and competitive conditions in the industry are included in this category). Another characteristic of this information is its proprietary nature (i.e., research and development activities, forecast data, and capacity), and its disclosure is often perceived by management as facilitating action by others which would be detrimental to the company. Finally a characteristic of this information is its subjective nature (management analysis of the summary of earnings and forecast data are included in this category).

45/ See Tables LL, MM, NN and OO.

The characteristics, changeability, subjectivity and proprietary nature of soft information cause managements to be reluctant to be sufficiently specific in their SEC disclosures to make these disclosures useful to security analysts. Therefore such disclosures as are made are usually vague generalities couched in boilerplate jargon. On the other hand, because much of this information is constantly changing, it is unlikely that even the most specific disclosures in a Form 10-K about these items would be timely enough to eliminate the need for security analysts to update their information through the informal system. Furthermore, most analysts believe that managements are apt to be more candid in an informal interview than in a filed document.

As discussed earlier, analysts found the management discussion of the summary of earnings one of the most useful types of non-financial disclosures in Form 10-K. The response of analysts to the disclosures in management discussion and analysis is surprising in view of the general comments made during the staff interviews that such disclosures were too shallow to be useful to them. A further analysis of these evaluations shows that buy-side analysts seem to rate the management's discussions in the Form 10-K's as a primary source of information in more cases than d› their counterparts on the sell-side. An explanation for this may be that sell-side analysts are in the business

of selling non-public, proprietary information, and generally no analytical information in Form 10-K would fit either of these categories.

Even analysts who reported these disclosures useful advised that most companies do not make adequate use of the potential of this section to provide meaningful analysis, and improvements in this area were seen by them as being desirable.

Table PP shows that a surprising number of analysts in the survey (18 of 47 responding to this item) admitted to having access to company projections. As the table on the following page shows, several analysts responded that they would like more disclosure of this information in Form 10-K.

The table on the following page presents the desired improvements to soft information in Form 10-K which analysts noted during the survey. As can be seen, with the exception of segment information this represents the greatest area for improvement noted by analysts.

C-5 Financial Statements

The role of the security analyst is to place a value on the firm. As discussed above, the analyst uses many sources to evaluate the existing, and predict the future, economic and industry environment of the firm. However, in the final analysis he must relate this evaluation and prediction to the current and prospective results of

SECURITY ANALYSTS' DESIRES FOR ADDITIONAL SOFT INFORMATION

Item of Information	Vital	Supplementary or Confirmatory	No Immediate Use
1. Disclosure of Components of Cost Sales			
The major components of cost of sales should be disclosed, including an index of price changes of such components when they occur	8	1	
Labor cost should be broken down between wages and fringe benefits	1	1	
Amount of corporate overhead in cost of sales should be disclosed	1		
Information about raw material usage	2		
2. Forward-Looking Information			
Company expectations including underlying assumptions	7		
Long term plans and objectives	3		
3. Productive Capacity			
Should be inflation-adjusted financial statements	3		
Production capacity and Production rate information	4		
Separate disclosure of capital expenditures pursuant to environmental or other government requirements	1		
4. Other			
Better industry information—including competition	11		
Year-to-year reconciliation of crude oil and natural gas reserves	1		

operations of the firm and then to the attractiveness of other available investment alternatives. The primary means of expressing the results of operations is through the financial statements; therefore, the primary link for expressing the effects upon the firm of events occurring in the general economy or industry is the financial statements.

Security analysts in the survey approached their job in different ways, but essentially, all attempted to develop answers to the following questions:

1. How sensitive has sales volume in each line of business been to changes in the industry or economy?

2. How responsive has management been in expanding or contracting its level of operations by line of business in response to an increase or a decline in sales volume?

3. Which costs of production or service has management been able to expand or contract in response to increases or decreases in operations? Which have been more resistant than others to such control?

Financial statements provide the framework within which these questions are answered. Because financial statements presently do not provide direct answers to these questions, the analyst must often use the informal system to obtain

such answers. Financial statements fail to answer these questions for the following reasons:

1. Lines of business are not always disclosed by homogeneous product groupings which are subject to similar economic and political risks.

2. There is not always segregation between the amounts of changes in total sales and cost of operations attributable to changes in volume sold and unit price.

3. There is not always an analysis of the components of operating costs to assist the analyst in evaluating the sensitivity of cost changes to changes in sales volume.

4. There is not always disclosure of the amounts of those items included in cost of operations which are discretionary in nature (e.g., startup and relocation expense, advertising expense) to assist the analyst in assessing what costs could be eliminated in a difficult economic period.

5. Similar economic events are frequently accounted for by different methods which are both acceptable under Generally Accepted Accounting Principles.

6. Financial statements seldom disclose the economic assumptions underlying balance sheet accruals and the effects on earnings of changes in these assumptions.

To compensate for the above deficiencies security analysts frequently contact management. But notwithstanding the deficiencies of financial statements there can be no substitute for the framework of accurate information about the historical results of operations which they provide.

The tabulations in Tables QQ through TT present the evaluation by analysts in the survey with regard to the importance of financial statements. The tabulations are presented in three increments:

1. The basic financial statements
2. Footnotes to the financial statements
3. Schedules to Form 10-K and parent company financial statements.

As can be seen from the tabulations in Table QQ, practically all analysts who marked up a Form 10-K evaluated the balance sheet and income statement components of the basic financial statements presented in Form 10-K as "Vital" information. The statements of changes in financial positions were evaluated as less important because in many cases they are merely a recasting of the balance sheets and income statements or a confirmation of financing and capital expenditure information which had been reported by the company earlier in the year. Several analysts mentioned to the staff during interviews that this statement would be

much more useful if it were balanced to changes in cash rather than to changes in working capital as is currently generally the case. This concept will be discussed in greater depth in Chapter XVI on "Financial Statement Requirements."

Analysts, with a few exceptions, did not evaluate the footnotes to the financial statements. Although any explanation is dangerous, it appears to the staff that analysts read footnotes selectively. Some footnotes were more useful to analysts than other footnotes. The most useful footnotes contain information which had not previously been publicly available, while the least useful contained information which had been disclosed in previous financial statements. Furthermore, the potential information content of footnotes seems to vary from industry to industry and from company to company. Where there is greater uncertainty associated with the valuation of financial statement amounts, the footnotes have greater information content. For example, insurance company analysts consider the reconciliation of statutory to GAAP accounting income as the most important information in the financial statements. As a result of these differences, it is difficult to generalize on an overall basis regarding the importance of a particular footnote to security analysts. Several analysts explained to the staff that they did not study the footnotes and

schedules to the financial statements unless management of the company in which they were interested gave conflicting information in response to questions posed by the analyst. At that point they indicated that they would review the footnotes in depth to confirm other information which they had been told by management. In other words, the footnotes and schedules seemed to present for these analysts a source of credible information against which to evaluate information communicated via interviews with company managements.

Although analysts may use footnote information to substantiate information obtained via management interviews, they do not always use the information for its intended purpose. The following examples illustrate this point.

All security analysts indicated an interest in the footnotes explaining the components of deferred income taxes and reconciling the major differences between the effective tax rate accrued on the income statement and the statutory rate of 48 percent. However, interviews with analysts revealed that the most important uses for this information were not to learn about the tax liability but to give insight into other factors such as:

1. The major valuation reserves booked by the company;

2. The effect upon income of accounting for expenses by a more conservative method (for example, accruing

depreciation expense by an accelerated method rather than by the straight line method); and

3. The amounts included in net income earned in foreign countries and not expected to be brought to the U.S., and hence, not available for payment of dividends.

Many analysts believe that financial statement income has moved too far from a focus on cash, and the disclosures in this footnote help them to reconcile the financial statement income with a measurement of income which is ordinarily closer to cash. Presumably, then, a statement reconciling cash income to accrual income would probably fill the analysts' needs more directly.

Analysts' evaluation of specific footnotes is provided in Table RR. For the most part it is not possible to evaluate the importance of specific footnotes from the data presented alone because most footnotes are not equally important to all industries. However, of those footnotes to which more than ten analysts responded, it appears that the stock options footnote provides the least information.

In order to test the credibility of the survey data relating to the importance of specific footnote disclosures, the staff obtained the evaluation sheets used by the seventeen industry committees of the Financial Analysts Federation Corporation Information Committee in their evaluations of financial statement disclosure for 1975. The

disclosures evaluated on these sheets was compared with the responses to the Advisory Committee's survey results for each requirement in Regulation S-X. This comparison is presented in Table SS.

As with footnotes to the financial statements, security analysts read the schedules to Form 10-K selectively. Table TT tabulates the analysts' responses to specific schedules. It is clear from studying the responses that the analysts interviewed have differing opinions regarding the importance of these disclosures. These differences result primarily from the fact that the information provided by some schedules has greater significance for some classes of companies than others. Another reason for the differences results from the divergent approaches of the analysts themselves (e.g., one analyst might focus more on the financial statements while another might concentrate more heavily on the market for a company's products and services). However, many analysts advised that much of the information in the schedules was duplicative of information required in the basic financial statements and related footnotes.

The three security analysts interviewed who concentrated on conglomerate companies were in agreement that separate parent company financial statements were vital information in assessing the restrictions on cash flow available for dividends and payment of principal and interest on funded debt.

D. Conclusion[47/]

The survey conducted by the staff of the Advisory Committee sought to study by means of questionnaires and follow-up interviews what information security analysts use in making investment decisions and, in particular, how the Commission filings are used in these decisions. In total the staff interviewed twenty-seven buy-side and forty-four sell-side analysts and received usable questionnaires from twenty-six buy-side and thirty-three sell-side analysts. Analysts interviewed followed twenty-six companies in seventeen industries. Because of the small size of the sample, the results of the survey are viewed as presumptions rather than conclusions regarding the analytical processes of all analysts.

Based on this survey, the staff concluded that the primary role of the security analysts is to relate the current economic performance of a company to its current economic environment as a basis for predicting the future economic performance of that company. In performing this role the analyst uses many information sources, only one of which is the company's filings with the Commission.

Analysts interviewed most often obtain background information about a company from its annual report to shareholders. The analysts also use the financial statements, particularly the line-of business analysis, in the annual

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47/ Tables UU through YY are tabulations of survey responses which are not discussed separately in this chapter.

report both to assist in predicting the future ecomonic performance of the company in each of its major markets and to assist them in comparing previous estimates of company performance with actual current operating performance. Analysts study the Form 10-K and any registration statements to identify any information not provided in the annual report.

In addition they rely heavily upon press releases, conversations with company management and other informal means to obtain greater detail regarding information which will assist them in relating changes in the economic environment of a company to corresponding changes in that company's operating results. Through these means analysts interviewed attempted to obtain a greater degree of segmentation of the results of operations both by industry and by geographical (i.e. foreign vs. domestic) segment than is available in the annual report or Form 10-K. They also seek to obtain management's assessment of the effect of the past and future economic events upon the company's operations and thereby update their projections of the company's future performance.

The heavy reliance upon the informal system and the annual report by analysts leads to two questions from the point of view of Commission policy.

1. In view of the heavy reliance by analysts upon the system which exists outside of Commission filings as the basis for their investment recommendations and decisions, what functions do these filings perform?

2. Does the disclosure to analysts via the informal system give them an unfair advantage over non-professional investors and those who do not have access to professional advice?

Analysts interviewed addressed the first question by making the following points:

a. The SEC requirements make it possible for the informal system to exist. Without this system many analysts believe they would not have sufficient background information about the company to enable them to pose intelligent questions to management. Many companies are disposed toward disclosing only the minimum required by the Commission, and they seem more willing to disseminate information via the informal system when they know they will eventually have to disclose it in a Form 10-K.

b. The SEC filing system provides a reliable data base of information about the company on which analysts can rely regardless of the economic fortunes of the company. As such it provides a "fail-safe" disclosure system about reporting companies. Many companies are not as willing to talk to analysts when they are having unfavorable economic results.

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c. Because companies having small market capitalizations are substantially less likely to be followed by analysts, such companies would have little incentive to communicate with investors if it were not for the information required to be provided in SEC filings.

Analysts we interviewed did not adequately resolve the question concerning unfair advantage. Nevertheless they did make the following points:

a. Analysts are constantly questioning the public assertions of company managements regarding the success of their corporate ventures by independently relating the assertions to the potential for success in the market place. In doing so analysts comprise the only professional group performing this function and perform the role of facilitating the efficiency of the market place. (Some analysts claim they alone make the market place efficient.) If, in performing this role, they obtain information which is not publicly known, it will then be rapidly impounded in the market price of the stock. Through this process all investors will be benefited by making the stock price approximate more closely the intrinsic worth of the company.

b. Sell-side analysts indicated that they make the information they have learned through interviews with the company management available to the investing public through

their recommendations to registered representatives in brokerage houses.

c. Many large New York Stock Exchange listed companies have investor relations departments which will respond to questions raised by individuals on the same basis as they respond to questions raised by analysts.

TABLE A

SECURITY ANALYSTS SURVEYED BY ADVISORY COMMITTEE

	Buy-Side		Sell-Side	
	Rec'd. Questionnaire	Inter-viewed	Rec'd. Questionnaire	Inter-viewed
New York Broker and Underwriter	-	-	20	25
Regional Broker	-	-	13	18
Commercial Bank	5	5	-	-
Insurance	6	6	-	-
Investment Counselor and Mutual Fund	11	11	-	-
Endowment, Private, Pension and Foundation	2	3	-	-
All Other	2	2	-	-
	26	27	33	43

TABLE B

Average Percentages of Overall
Time Spent Studying Various Areas

	Buy Side	Sell Side
Number of respondents to question	32	21
Overall Economy	12%	8%
Industry of Survey Company	19	20
Other Companies in Same Industry	30	40
Survey Company	10	19
Other Industries	29	13
	100%	100%

TABLE C

IMPORTANCE OF MACROECONOMIC INFORMATION

	Number of Respondents	
Statistical Information	Sell Side	Buy Side
Vital Information	11	14
Confirmatory or Supplementary Information	17	10
No Usefulness	2	1
	30	25
Analytical Information		
Vital Information	11	15
Supplementary of Confirmatory Information	14	10
No Usefulness	3	-
	28	25

TABLE D

ANALYSTS' SOURCES OF INFORMATION ABOUT THE ECONOMY

	Number of Respondents*	
Statistical Information	Sell-Side	Buy-Side
Newspapers and magazines	8	7
Government publications	7	8
In-house economists	6	7
Brokerage house reports	4	3
Industry publications	2	3
Statistical services	2	-
Company generated communications	2	-
Personal contact with the company	-	1
Total Sources	31	29
Analytical Information		
In-house economist	7	6
Government publications	5	7
Newspapers and magazines	5	6
Brokerage house reports	3	9
Industry publications	3	3
Statistical Services	1	-
Company generated communications	1	-
Personal contact with company	-	1
Total Sources	25	32

* Some respondents indicated that they used more than one source.

TABLE E

IMPORTANCE OF INDUSTRY INFORMATION

Statistical Information	Number of Respondents	
	Sell-Side Analysts	Buy-Side Analysts
Vital Information	22	20
Confirmatory or Supplementary Information	10	4
No Usefulness	1	1
Total Respondents	33	25

Analytical Information	Number of Respondents	
	Sell-Side Analysts	Buy-Side Analysts
Vital Information	21	20
Confirmatory or Supplementary Information	9	4
No Usefulness	2	1
Total Respondents	32	25

TABLE F

ANALYSTS' SOURCES OF INFORMATION ABOUT THE INDUSTRY

	Number of Respondents	
Statistical Information	Sell-Side Analysts	Buy-Side Analysts
Industry trade publications	12	10
Government publications	8	14
Prepared by other analysts in the firm	2	3
Customers and competitors	2	3
Brokerage reports	2	8
Personal contact with company	2	4
Newspapers and magazines	1	6
Statistical services	1	-
Company generated communications	-	2
SEC filings	-	1
Annual Report	-	1
Total Respondents	30	52
Analytical Information		
Industry trade publications	12	7
Government publications	5	3
Customers and competitors	5	2
Prepared by other analysts in the firm	3	5
Brokerage reports	3	9
Personal contacts with company	3	3
Newspapers and magazines	1	6
Statistical services	1	-
SEC filings	1	-
Annual report	1	-
Company generated communications	-	2
Total Respondents	35	37

TABLE G

IMPORTANCE OF INFORMATION ABOUT THE MARKET FOR COMPANY PRODUCTS AND SERVICES

	Number of Respondents	
	Sell-Side Analysts	Buy-Side Analysts
Vital Information	23	16
Confirmatory or Supplementary Information	7	7
No Usefulness	2	2
Total Respondents	32	25

TABLE H

ANALYSTS' SOURCES OF INFORMATION ABOUT THE MARKET FOR COMPANY PRODUCTS AND SERVICES

	Number of Respondents	
	Sell-Side Analysts	Buy-Side Analysts
Personal Contact with Company	10	5
Company Generated Communications	9	5
Industry Publications	7	6
Annual Report	7	8
SEC Filings	5	7
Customers and Competitors	5	7
Government Publications	3	-
Brokerage House Reports	-	4
Other Analysts with the Firm	-	1
Total Respondents	46	43

TABLE I

IMPORTANCE OF INFORMATION ABOUT MANAGEMENT ABILITY

	Number of Respondents	
	Sell-Side	Buy Side
Vital Information	22	17
Supplementary or Confirmatory Information	7	6
No Usefulness	-	-
Total Respondents	29	23

TABLE J

ANALYSTS' SOURCES OF INFORMATION ABOUT MANAGEMENT ABILITY

	Number of Respondents	
	Sell-Side Analysts	Buy-Side Analysts
Personal Contact with Company	32	7
Other Analysts with the Firm	4	5
Brokerage House Reports	-	13
Company Generated Communications	-	4
Industry Trade Publications	1	2
Annual Report	-	2
SEC Filings	-	1
Total Respondents	37	34

TABLE K

IMPORTANCE OF EFFECT OF SOCIAL AND ENVIRONMENTAL REGULATION

	Number of Respondents	
	Sell-Side	Buy-Side
Vital Information	2	7
Supplementary or Confirmatory Information	5	10
No Usefulness	18	4
Total Respondents	25	21

TABLE L

ANALYSTS' SOURCES OF INFORMATION ABOUT THE EFFECT OF SOCIAL AND ENVIRONMENTAL REGULATION

	Number of Respondents	
	Sell-Side	Buy-Side
Filings with Governmental Agencies	4	-
Industry Publications	4	4
Newspapers and Magazines	3	4
Company Generated Communication	1	-
Personal Contact with Company	1	2
Brokerage House Reports	-	4
SEC Filings	-	1
Internal Research	-	1
Total Respondents	13	16

TABLE M

IMPORTANCE OF CUSTOMER AND SUPPLIER INFORMATION

	Number of Respondents	
	Sell-Side	Buy-Side
Vital Information	7	7
Supplementary or Confirmatory Information	16	10
No Usefulness	9	4
Total Respondents	32	21

TABLE N

ANALYSTS' SOURCES OF INFORMATION ABOUT CUSTOMERS AND SUPPLIERS

	Number of Respondents	
	Sell-Side	Buy Side
Customers and Competitors	9	4
Personal Contact with Company	6	1
Industry Publications	5	4
Annual Reports	2	2
Internal Research Reports	2	2
Company Generated Communications	1	-
Brokerage House Reports	1	3
Government Publications	1	-
SEC Filings	1	1
Newspapers and Magazines	1	1
Total Respondents	29	18

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TABLE O

IMPORTANCE OF INFORMATION ABOUT BUSINESS OBJECTIVES

	Number of Respondents	
	Sell-Side	Buy-Side
Vital Information	19	18
Supplementary or Confirmatory Information	8	4
No Usefulness	5	1
Total Respondents	32	23

TABLE P

ANALYSTS' SOURCES OF INFORMATION ABOUT BUSINESS OBJECTIVES

	Number of Respondents	
	Sell-Side	Buy-Side
Personal Contacts with Company	15	13
Other Company Generated Communications	11	9
Annual Report	7	3
SEC Filings	3	-
Brokerage House Reports	—	1
Total Respondents	36	26

TABLE Q

IMPORTANCE OF INFORMATION ABOUT BUDGETS

	Number of Respondents	
	Sell-side	Buy-side
Vital Information	17	15
Supplementary or Confirmatory Information	13	3
No Usefulness	-	-
Total Respondents	30	18

TABLE R

ANALYSTS' SOURCES OF INFORMATION ABOUT BUDGETS

	Number of Respondents	
	Sell-Side	Buy-Side
Personal Contact with Company	11	12
Company Generated Communications	9	7
Annual Report	7	-
SEC Filings	2	1
Newspapers and Magazines	1	1
Brokerage House Reports	-	-
Total Respondents	30	21

TABLE S

IMPORTANCE OF INFORMATION ABOUT PERFORMANCE PROJECTIONS

	Number of Respondents	
	Sell-Side	Buy-Side
Vital Information	14	16
Supplementary or Confirmatory Information	14	8
No Usefulness	3	1
Total Respondents	31	25

TABLE T

ANALYSTS' SOURCES OF INFORMATION ABOUT PERFORMANCE PROJECTIONS

	Number of Respondents	
	Sell-Side	Buy-Side
Personal Contact with Company	15	12
Company Generated Communications	11	7
Annual Report	6	3
SEC Filings	3	-
Brokerage Reports	-	1
Total Respondents	35	23

TABLE U

IMPORTANCE OF MANAGEMENT ANALYSES OF GENERAL ECONOMY

	Number of Respondents	
	Sell-Side	Buy-Side
Historical Relationships		
Vital Information	6	11
Supplementary or Confirmatory Information	19	12
No Usefulness	5	1
Total Respondents	30	24
Projected Relationships		
Vital Information	10	12
Supplementary or Confirmatory Information	16	10
No Usefulness	3	1
Total Respondents	29	23

TABLE V

ANALYSTS' SOURCES OF MANAGEMENT ANALYSES OF GENERAL ECONOMIC FACTORS

	Number of Respondents	
	Sell-Side	Buy-Side
Historical Relationships		
Personal Contact with Company	13	10
Company Generated Communications	9	10
Annual Reports	7	3
SEC Filings	6	2
Total Respondents	35	25
Projected Relationships		
Personal Contact with Company	13	11
Company Generated Communications	8	9
Annual Reports	5	2
SEC Filings	2	2
Total Respondents	28	24

TABLE W

IMPORTANCE OF MANAGEMENT ANALYSES OF SPECIFIC INDUSTRY FACTORS

	Number of Respondents	
	Sell-Side	Buy-Side
Historical Relationships		
Vital Information	10	13
Supplementary or Confirmatory Information	18	11
No Usefulness	3	-
Total Respondents	31	24
Projected Relationships		
Vital Information	16	16
Supplementary or Confirmatory Information	12	4
No Usefulness	4	-
Total Respondents	32	20

TABLE X

ANALYSTS' SOURCES OF MANAGEMENT ANALYSES OF SPECIFIC INDUSTRY FACTORS

	Number of Respondents	
	Sell-Side	Buy-Side
Historical Relationship		
Personal Contact with Company	14	10
Company Generated Communications	9	10
Annual Reports	6	3
Brokerage House Reports	-	3
SEC Filings	5	1
Total Respondents	34	27
Projected Relationships		
Personal Contact with Company	14	11
Company Generated Communications	9	8
Annual Reports	4	1
Brokerage House Reports		3
SEC Filings	2	-
Total Respondents	29	23

TABLE Y

IMPORTANCE OF QUARTERLY FINANCIAL INFORMATION

	Number of Respondents	
	Sell-Side	Buy-Side
Quarterly Report to Shareholders		
Vital Information	25	23
Confirmatory Information	4	-
Interesting Information	-	-
Not Useful	-	-
	29	23
Form 10-Q		
Vital Information	12	14
Confirmatory Information	10	6
Interesting Information	3	3
Not Useful	2	-
	27	23

TABLE 2

	Products and Services		
	Form 10-K Item 1(a)		
	Number of Respondents		
	Sell-Side	Buy-Side	Total
Vital Information	8	7	15
Confirmatory Information	2	1	3
Interesting Information but no Immediate Usefulness	3	4	7
Not Useful	4	3	7
	17	15	32

TABLE AA

	Sources of Raw Materials Form 10-K Item 1(b)(4) Number of Respondents		
	Sell-Side	Buy-Side	Total
Vital Information	7	7	14
Confirmatory Information	-	4	4
Interesting Information but no Immediate Usefulness	1	1	2
Not Useful	1	-	1
	9	12	21

TABLE BB

	Environmental Disclosures Form 10-K Item 1(b)(7) Number of Respondents		
	Sell-Side	Buy-Side	Total
Vital Information	1	1	2
Confirmatory Information	2	1	2
Interesting Information but not Immediately Useful	-	1	3
Not Useful	2	-	2
	5	3	9

TABLE CC

	Employees Form 10-K Item 1(b)(8) Number of Respondents		
	Sell-Side	Buy-Side	Total
Vital Information	3	3	6
Confirmatory Information	3	2	5
Interesting Information but not Immediately Useful	1	2	3
Not Useful	-	1	1
	7	8	15

TABLE DD

	Properties		
	Form 10-K Item 3		
	Sell-Side	Buy-Side	Total
Vital Information	2	2	4
Confirmatory Information	4	6	10
Interesting Information but not Immediately Useful	2	4	6
Not Useful	4	3	7
	12	15	27

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TABLE EE

	Parents and Subsidiaries Form 10-K - Item 4		
	Number of Respondents		
	Sell-Side	Buy-Side	Total
V'tal Information	-	1	1
Confirmatory Information	4	5	9
Interesting Information but not Immediately Useful	5	5	10
Not Useful	4	4	8
	13	15	28

TABLE FF

	Number of Security Holders Form 10-K - Item 7		
	Sell-Side	Buy-Side	Total
Vital Information	1	1	2
Confirmatory Information	2	4	6
Interesting Information but not Immediately Useful	5	7	12
Not Useful	3	4	7
	11	16	27

TABLE GG

	Executive Officers Form 10-K - Item 8		
	Sell-Side	Buy-Side	Total
Vital Information	3	4	7
Confirmatory Information	3	4	7
Interesting Information but not Immediately Useful	6	5	11
Not Useful	1	3	4
	13	16	29

TABLE HH

Indemnification of Officers and Directors
Form 10-K - Item 9

	Number of Respondents
Vital Information	1
Confirmatory Information	-
Interesting Information but not Immediately Useful	5
Not Useful	21
	27

TABLE II

	Line of Business Form 10-K - Item I(c) Number of Respondents		
	Sell-Side	Buy-Side	Total
Vital Information	7	12	19
Confirmatory Information	-	4	4
Interesting Information but not Immediately Useful	-	1	1
Not Useful	-	-	-
	7	17	24

TABLE JJ

	Legal Proceedings Form 10-K - Item 5		
	Number of Respondents		
	Sell-Side	Buy-Side	Total
Vital Information	2	1	3
Confirmatory Information	5	11	16
Interesting Information but not Immediately Useful	2	2	4
Not Useful	1	2	3
	10	16	26

TABLE KK

Increases and Decreases in Securities
Form 10-K - Item 6

	Number of Respondents		
	Sell-Side	Buy-Side	Total
Vital Information	3	3	6
Confirmatory Information	6	5	11
Interesting Information but not Immediately Useful	2	7	9
Not Useful	3	2	5
	14	12	31

TABLE LL

	Competition Form 10-K - Item 1(b)(1) Number of Respondents		
	Sell-Side	Buy-Side	Total
Vital Information	3	5	8
Confirmatory Information	1	3	4
Interesting Information but not Immediately Useful	3	3	6
Not Useful	2	3	5
	9	14	23

TABLE MM

	Backlog Disclosure* Form 10-K - Item 1(b)(3) Buy-Side Analysts Number of Respondents
Vital Information	4
Confirmatory Information	1
Interesting Information but not Immediately	-
Not Useful	-
	5

* No Sell-Side Analysts responded to this item.

TABLE NN

	Research and Development Form 10-K - Item 1(b)(6)		
	Number of Respondents		
	Sell-Side	Buy-Side	Total
Vital Information	2	5	7
Confirmatory Information	-	3	3
Interesting Information but not Immediately Useful	2	1	3
Not Useful	-	-	-
	4	9	13

TABLE OO

	Management Analysis of Summary of Earnings Guide 22		
	Number of Respondents		
	Sell-Side	Buy-Side	Total
Vital Information	3	10	13
Supplementary or Confirmatory Information	5	2	7
Interesting Information but Not Immediately Useful	1	2	3
Not Useful	1	1	2
	10	15	25

TABLE PP

SECURITY ANALYSTS' QUESTIONNAIRE

QUESTION VIII

AVAILABILITY OF CERTAIN INFORMATION PRIOR TO SEC REQUIREMENTS

	Yes	No	Don't Know
A. Management Discussion and Analysis	28	14	
1. Mode of Disclosure			
. Annual Fact Book	1		
. Speeches and Personal Contact	8		
. Annual Report	21		
B. Line of Business	14	7	6
1. Mode of Disclosure			
. Annual Report	13		
. Personal Contact	1		

QUESTION IX

PROJECTIONS

A. Analyst Projections		
1. Regarding *any* company	50	2
2. Regarding *this* company	45	3
B. Access to Company Projections	18	29
1. If Yes -		
a. Form of Projection		
. Public statement concerning economic outlook	4	
. Public statement regarding company goals	1	

C. Legal liability associated with analyst projections

Very Great	Moderate Amount	Hardly Any	None
	2	12	14

TABLE QQ

EVALUATION OF FINANCIAL STATEMENTS

Number of Respondents

	Vital Info.	Supplementary or Confirmatory Information	Interesting But no Immediate Use	Not Useful	Total
Balance Sheets	25	2	-	1	28
Income Statements	24	1	-	1	26
Statements of Changes in Financial Positions	17	6	2	2	27
Statements of Share-holders Equity	11	5	2	2	20

TABLE RR

Footnotes to the Financial Statements

Regulation S-X Rule No.	Description	Vital Info.	Supplementary or Confirmatory	Interesting but No Immediate Use	Not Useful	Total
-	All Footnotes as a Whole	9	-	-	-	9
	Specific Footnotes					
3-6 (a)	Principles of Consolidation	12	2	-	2	16
(b)	Principles of Translation of Foreign Currency	2	-	-	-	2
(c)	Assets Subject to Lien	5	-	1	1	7
(d)	Intercompany Profits or Losses	1	-	1	1	3
(e)	Defaults	2	-	-	-	2
(f)	Preferred Shares	-	-	-	-	-
(g)	Pension and Retirement Plans	5	2	3	1	11
(h)	Restrictions on Retained Earnings	3	-	-	1	4
(i)	Commitments and Contingent Liabilities	9	2	1	1	13
(j)	Bonus, Profit Sharing and Similar Plans	1	1	2	1	5
(k)	Long Term Debt	7	1	1	-	9
(l)	Bases of Revenue Recognition	2	-	-	-	2

TABLE RR

Footnotes to the Financial Statements

Regulation S-X Rule No.	Description	Vital Info.	Supplementary or Confirmatory	Interesting but No Immediate Use	Not Useful	Total
(m)	Depreciation, Depletion and Amortization	5	-	-	-	5
(n)	Stock Options	-	4	5	2	11
(o)	Income Tax Expense	16	2	-	-	18
(p)	Warrants and Rights	-	1	1	-	2
(q)	Leased Assets and Lease Commitments	5	1	1	-	7
(r)	Interest Capitalized	2	-	1	-	3
	Other					
	. Earnings Per Share	6	5	2	1	14
	Other Footnotes					
	. Inventory	6	6	1	-	13
	. Capital Stock	4	2	2	2	10
	. Foreign Operations	2	-	-	-	2
	. Subsequent Events	3	-	-	-	3
	. Franchises	1	-	-	-	1
	. Reconciliation From Statutory to GAAP Accounting (Insurance Company)	1	-	-	-	1
	Supplementary Income Statement Information	5	3	4	4	1

TABLE SS

COMPARISONS OF IMPORTANT ACCOUNTING DISCLOSURES

Rule	Description	ACCD ANALYSIS: No. Vital or Confirmatory	ACCD ANALYSIS: No. Responding	F.A.F. EVALUATION: No. Positive	F.A.F. EVALUATION: No. Industries	INTERPRETATION AND COMMENT
3-6	Footnotes					
(a)	Principles of Consolidation	14	16	10	17	Presumed important
(b)	Translation of Foreign Currencies	2	2	12	17	Presumed important
(c)	Assets subject to Lien	5	6	-	-	Bond analysts consider vital
(d)	Interco. Profit and Loss	1	3	-	-	Presumed not important
(e)	Defaults	2	2	8	17	Presumed important (bond analysts also consider vital)
(f)	Preferred Shares (callable, etc.)	-	-	-	-	Included in balance sheet
(g)	Pension & Retirement Plans	7	11	15	17	Presumed important
(h)	Restrictions on Retained Earnings	3	4	1	17	Data appears to conflict but bond analysts consider vital
(i)	Commitments and Contingencies	11	13	6	17	Presumed important
(j)	Bonus, Profit Sharing & Similar Plans	2	5	-	-	Presumed not important
(k)	Long Term Debt	7	9	11	17	Presumed important
(l)	Bases of Revenue Recognition	2	2	5	17	Presumed important to specialized industries

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COMPARISONS OF IMPORTANT ACCOUNTING DISCLOSURES

		ACCD ANALYSIS		F.A.F. EVALUATION		INTERPRETATION AND COMMENT
Rule	Description	No. Vital or Confirmatory	No. Responding	No. Positive	No. Industries	
(m)	Dep'n., depletion and amortization	5	5	13	17	Presumed important
(n)	Stock options	4	11	1	17	Presumed not important
(o)	Income tax expense	18	18	17	17	Presumed important
(p)	Warrants and rights	1	2	1	17	Presumed not important
(q)	Leases	6	7	10	17	Presumed important
(r)	Interest Capitalized	2	3	1	17	Presumed not important
-	Earnings per share	11	14	4	17	Presumed important
(t)	Quarterly data	-	-	3	17	Presumed not important
-	Inventory	12	13	8	17	Presumed important
-	Capital stock	4	10	-	-	Presumed not important

TABLE TT

SECURITY ANALYSTS EVALUATION FORM 10-K SCHEDULES AND PARENT COMPANY FINANCIAL STATEMENTS

Schedule No.	Schedule Description	Vital Information	Supplementary or Confirmatory	Interesting But No Immediate Use	Never Use	Total
I	Marketable Securities	1	2	-	-	3
II	Accounts Receivable	-	-	-	-	-
	from Officers, etc.		1	1	1	3
III	Investments in Earnings	-	-	-	-	-
	of Affiliates	1	3	3	1	8
IV	Indebtedness of	-	3	2	2	7
	Affiliates					
V	Property, Plant, and	-	-	-	-	-
	Equipment	8	5	4	6	23
VI	Acc. Depreciation of	8	5	4	6	23
	Property, Plant and					
	Equipment					
VII	Intangible Assets	2	-	1	1	4
VIII	Acc. Amortization of	-	-	-	-	-
	Intangible Assets	1	-	1	1	3
IX	Bonds, Mortgages, etc.	-	2	-	1	3
X	Indebtedness to Affiliates	-	-	-	-	-
	(not current)					
XI	Guarantees of Securities	1	-	-	-	1
XII	Valuation Reserves	4	8	3	5	20
XIII	Capital Shares	1	1	1	4	7
XIV	Warrants or Rights	-	-	-	-	-
XV	Other Securities	-	-	-	-	-
XVII	Real Estate and Accumu-	-	-	-	-	-
	lated Depreciation	-	-	-	-	-
XVIII	Mortgage Loans on Real	-	-	-	-	-
	Estate	-	-	-	-	-
XIX	Other Investments	-	-	-	-	-
Other						
1.	Parent Company Financial Statements	3	-	2	-	5

TABLE UU

SECURITY ANALYSTS' - ITEM IMPORTANCE
FROM MARKED-UP FORM 10-Q'S

Item No.	Item Description	Vital Info.	Supplementary or Confirmatory	Interesting But No Immediate Use	Never Use	Total
1.	Balance Sheets	25	2	-	1	28
2.	Income Statements	24	1	-	1	26
3.	Changes in Financial Statements					
4.	Footnotes to Financial Statements	15	3	2	2	22
5.	Management Analysis of Earnings	15	7	1	2	25
6.	Sale of Unregistered Securities	-	6	2	6	14
7.	Other Information					
	Statement of Shareholder's Equity	-	-	4	1	5
	Computation of Earnings per Share	1	-	-	2	3
	Litigation	-	2	-	-	2

TABLE VV

SECURITY ANALYSTS' DESIRES FOR ADDITIONAL INFORMATION

Item of Information	Importance: Vital	Supplementary or Confirmatory	No Immediate Use
. Earlier issuance of Form 10-Q's	1		
. For Retailers:			
a. Sales and profits differentiated between old and new stores	2		
b. Disclosure of monthly average store volumes-price indexed	2		
c. Better information concerning franchising network	1		
. For banks:			
a. Synopsis of Federal Bank Examiners' Reports	1		
b. Better breakdown of loans and loan losses	3		
c. Better disclosure of loan commitments	1		
. More detailed quarterly information	2		
. Disclosure in financial statements of impact on earnings of alternative accounting for inventory, depreciation, pensions, etc. to permit comparison with others in industry	3	1	
. Contribution to earnings from acquired companies	1		
. Capitalization of all loans	1		
. Better disclosure of valuation reserves and drawdown on reserves	1	1	

TABLE VV
(Continued)

SECURITY ANALYSTS' DESIRES FOR ADDITIONAL INFORMATION

Item of Information	Importance: Vital	Supplementary or Confirmatory	No Immediate Use
. Disclosure of only fully diluted earnings per share (warrants should be excluded)	1		
. Financial statement footnotes written in plain English using 8-point type	2		
. Filing of management letters on internal controls from auditors	1		
. More disclosure of security price movements			
. PLEASE NO MORE REQUIRED DISCLOSURES	2		

TABLE NN

FINANCIAL ANALYST QUESTIONNAIRE

QUESTION VII — COMPANY DISCLOSURE POLICY

(only items about which more than one respondent commented are included)

	General Comment	No. of Respondents
1.	No comment	3
2.	Prompt effective disclosure — good detail on request	31
3.	Company should give more information on both favorable and unfavorable developments	10
4.	Company will not consider all questions during registration periods	7
5.	Company is reluctant to give guidance on projections	2
	a. projections should be in greater detail b. company slow in correcting projections c. projections should be disseminated more fairly	
6.	Company's Annual Fact Book discloses more than SEC filings	2
7.	A bit more detail would be helpful — particularly with regard to Line of Business, major cost items for each line	2
8.	Worried about effects upon company's willingness to talk freely to analysts of having to make analysts' disclosures public	2

TABLE XX

QUESTION X — SHAREHOLDER VOTING MATTERS

(only items about which more than one respondent commented are included)

A. Additions to Proxy Statement for Voting

General Comment	Number of Respondents
1. No comment	20
2. Not interested in the problem	14
3. Current disclosure adequate	5
4. Officers and directors disclosure	
a. stock holdings of directors and officers as well as of customers, banks, etc.	5
b. purchases and sales of company's stock	4
5. Full disclosure of management compensation, bonuses, etc.	5
6. Proxy should disclose growth plan — major opportunities	2

B. Additions to Proxy Statement for Shareholder Democracy

General Comment	
1. No comment	34
2. No interest in problem	3
3. "Shaeholder democracy" has gone too far	4

TABLE YY

XIII. GENERAL COMMENTS

In your opinion, what could be done by the SEC to improve the corporate disclosure system? Describe both the change and the intended effect. Please be as specific as possible. Use additional pages if necessary.

(only items about which more than one respondent commented are included)

General Comment	Number of Respondents
1. No comment	14
2. Should be more detailed segment disclosure (including quarterly reporting) -- perhaps a 10 year analysis	10
3. Should be better disclosure of foreign operations	5
4. No more disclosures; there is already enough information. Rather enforce existing rules better.	6
5. There should be more uniformity of accounting among companies in the same industry. Companies differing should disclose why they chose different accounting policies and what the impact on earnings would have been under "industry method."	4
6. Form 10-Q's shoujld more more detailed, including segment disclosure and discussion of long-term prospects.	4
7. There should be better Guide 22 disclosure including segregation of dollars and units sold.	4
8. There should be less emphasis by SEC on projections and other disclosures requiring subjective estimates. Companies should not be forced to make earnings estimates.	3
9. SEC should provide more guidance on projections.	2
10. Filing deadlines should be more strictly enforced.	2
11. There should be less duplication of information already on file or in the market place.	2
12. There should be more complete information on income tax expense.	2
13. More information should be required about the industry.	2

CHAPTER III

THE ROLE OF THE PORTFOLIO MANAGER

A. Introduction

Chapter II explains in some detail the process by which security analysts obtain and use information relevant to their investment recommendations. Because the nature of security analysis as performed by both buy-side and sell-side analysts is determined in part by the needs of the portfolio management decision-making process, the Advisory Committee attempted, through interviews of portfolio managers, to learn how they use information in making their investment decisions. The Advisory Committee also attempted to ascertain the extent to which modern theories of portfolio management have influenced the way portfolio managers make their investment decisions and the types of information which are required for such decisions.

B. Methodology of Study

As stated in Chapter II, the Advisory Committee asked each of the buy-side analysts who agreed to participate in the case study to contact a portfolio manager in their firm who had purchased or sold the securities of the case-study company during the past year. Of 52 portfolio managers requested to participate in the study, interviews were obtained with twelve.[1/]

The twelve portfolio managers were distributed among the categories of institutional investors as follows:

Category	Number Interviewed
Bank Trust	3
Mutual Fund Management Company[2/]	4
Investment Counsel	2
Insurance Company	3
	12

1/ Clearly this introduces biases into the survey results, particularly because participating portfolio managers were all employed by large institutional investors which, because of their size, had a more structured approach to decision-making and, accordingly, permitted less individual leeway to portfolio managers than a small institution might. The guide used by the staff in conducting the interviews with portfolio managers appears as Appendix III-A.

2/ No distinction is made here among the categories of portfolios managed by the mutual fund management company (for example, mutual, pension, or endowment fund, etc.).

C. Survey Results

The primary objective of the interviews with portfolio managers was to gain an understanding of the specific factors which they consider in their decisions to include (exclude) a particular company's security in (from) a particular portfolio. Accordingly, the interviews were focused on the following considerations:

1. The extent of autonomy in investment decision-making permitted the portfolio manager;

2. The most important macroeconomic factors considered in formulating portfolio strategy;

3. The characteristics of one of the portfolios containing the company's common stock;

4. The most important factors considered in translating a macroeconomic scenario into appropriate diversification among risk categories of industries and/or securities in the portfolio;

5. The most important factors considered in deciding the timing and amount of this company's common stock for the most recent PURCHASE for this portfolio;

6. The most important factors considered in deciding the timing and amount of this company's common stock for the most recent SALE from this portfolio; and

7. Recommendations for modifications to SEC disclosure rules.

Each of the above considerations will be dealt with individually on the following pages.

Extent of Autonomy Permitted the Portfolio Manager. The responses indicate that most institutions interviewed have an investment committee which makes many of the key decisions relating to investment and portfolio strategy. The policy determinations made by these committees include the rate of return objective for the portfolio; the sector of the economy for investment; the percentage of investment to be allocated to each industry and the review and appraisal of new ideas for investment.

The portfolio manager is generally not expected to develop an expected scenario for the overall economy. Most institutions use a staff and/or consulting economist and the investment committee to provide information as to the direction of the economy.

In most cases the investment committee establishes guidelines concerning the distribution of the portfolio assets among securities in various industries and the portfolio manager has discretion only within these guidelines.

Important Macroeconomic Factors. The preceding discussion indicated that for most institutions surveyed, the projections comprising the economy outlook were developed jointly by a consulting or staff economist and an investment committee within the institution. Although portfolio managers are frequently members of the investment committee and may have significant influence on the policies of the committee, a single portfolio manager will usually not depart from the recommendations of that committee.

Portfolio managers were asked to identify the major factors considered by the institution at which they worked in determining the overall direction of the market.

The responses tabulated below indicate that Federal Reserve monetary policy, short and long term interest rates and overall market indicators are the leading factors used to predict future economic conditions. Breadth of the market and volume of trading are considered key factors in determining market trends.

Macroeconomic Factors Considered By Institutions in Determining Direction of the Market

	No. of Respondents			
	Vital Information	Useful Information	Interesting Information	Total
a. Leading Economic Indicators				
Federal Reserve Monetary Policy	10	1	-	11
Short Term Interest Rates	8	3	1	12
Overall Market Indicators (i.e.,S&P 500)	7	2	2	11
Long Term Interest Rates	6	6	-	12
Federal Reserve Index of Industrial Production	5	6	-	11
Corporate Profits After Tax	5	5	-	10
Percentage Change in Money Supply	5	5	-	10
Gross National Product	5	3	2	10
Level of Government Spending	4	6	1	11
Aggregate Inventory Level	4	5	1	10
Personal Consumption Expenditures	4	5	-	9
New Orders for Durable Goods	3	7	-	10
Price of Industrial Raw Materials	3	7	1	11
Level of Housing Starts	2	9	-	11

	No. of Respondents			
	Vital Information	Useful Information	Interesting Information	Total
b. Market Factors				
Breadth of the Market	7	4	-	11
Volume of Trading	4	6	1	11
Level of Short Sales	-	6	2	8
Odd-lot Trading	-	6	1	7

Characteristics of Portfolios in the Survey. In order to put the survey results in perspective, portfolio managers were asked what the objectives of the portfolios which contained case study securities were. The responses indicate that for a majority of the 14 portfolios considered, the principal objective was long term growth of capital. The next two most frequently cited objectives were dividend income and growth consistent with the national economy.

The asset size, asset turnover, number of different companies whose securities were held in a portfolio and the percentage of assets of a portfolio in common stock varied widely among the portfolios studied. The asset size ranged from a low of $800 to a high of $1,408,000; the asset turnover rate ranged from 6% to 123%; the number of different companies whose securities were held in a portfolio ranged from 18 to 121; and the percentage of assets invested in common stock from 15% to 97%.

Because of this wide variation, the only other attribute (in addition to investment objective) that most of the portfolios shared was that in the overwhelming majority of portfolios, at least 85% of the common stocks held were listed on the New York Stock Exchange. This is not particularly surprising in view of portfolio managers' preference for companies with large market capitalization.

Translation of Macroeconomic Forecast into Industry Selection. For most participating institutions, the translation of the macroeconomic forecast into an industry selection is the responsibility of an investment committee which may or may not include the portfolio manager. All institutions attempt to identify industries which, given the institution's investment objectives and risk preferences, will perform best in the predicted economic scenario.

Thus, the investment committee extrapolates from historical relationships between certain economic variables and aggregate industry demand in the industries being considered, 3/ and attempts to identify those industries which are most likely to prosper in the predicted scenario.

3/ Components of aggregate demand will vary from industry to industry, for example, from an index of aggregate hospital expenditures for a hospital supply company to an index of aggregate loan demand for a bank.

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The following tabulation lists the macroeconomic factors mentioned most frequently as being important to selection of an industry:

Important Macroeconomic Factors In Selection of Industry

Factor	No. of Respondents
1. Federal Reserve Index of Industrial Production	6
2. Level of personal consumption expenditures	4
3. Level of housing starts	3
4. Level of capital spending	2
5. Gross national product	2
6. Federal Reserve monetary policy	2
7. Level of short-term interest rates	2
8. Level of capital spending	2

A majority of portfolio managers interviewed believed that there was a strong relationship between the demand for the product of a particular industry and macroeconomic variables.

The staff also attempted to determine whether portfolio managers believe that there is a relationship between an increase or decrease in demand of an industry and the movement of the stock price of a particular company and, if so, the extent to which this relationship influences a buy or sell decision. The portfolio managers indicated that a

change in the demand for the product(s) of an industry will have a moderate effect on the price of a particular stock and a moderate effect on their decision to buy or sell stocks from these portfolios.

The portfolio managers were asked where they obtained information about the relationship between the demand for industry products and the movement of the stock price and the majority indicated that the information was obtained from their internal research departments.

Timing the Amount of Purchase for a Portfolio. To this point the decisions described have not been made solely by the portfolio manager. However, once the decision regarding the industry mix has been made, the portfolio manager usually has discretion to select stocks of companies within those industries which meet the market capitalization requirement. 4/ It appears that from a practical point of view, this frequently limits him to the top companies in an industry. Nevertheless, nominally at any rate, the decision is his. His major decision relates to the timing and amount of purchases (sales) of a security for (and from) his portfolio. This decision often involves considerations other than the merits of the security, such as the liquidity needs of the portfolio and the subjective desires of the client for whom the portfolio is being managed.

Portfolio managers were asked the importance of various sources of information to their investment decisions.

4/ On the other hand, some portfolio managers interviewed had very little discretion in this regard.

The responses indicate that the buy-side analyst's research provides by far the most important input into the portfolio manager's investment decisions. Company annual and quarterly reports rank second and sell-side research and SEC reports serve as confirmatory information. The volatility of the stock price relative to the market (otherwise known as beta) seems to be more important in a purchase decision than in a sell decision, although this disparity might be attributable to the small sample size. Several portfolio managers indicated that they do not become too concerned with portfolio betas because they believe that portfolio betas can be changed by varying the cash position of the portfolio. They emphasized that purchase and sale decisions are made on the buy-side analyst's recommendations - not on the desire to maintain a specific level of beta in the portfolio.

In discussing the relative strength of the stock price, some portfolio managers explained that they trace the five-year price-earnings multiple relative to some market index and from that determine whether the stock is over or under-valued in the current market.

The portfolio managers stated that the most important information they obtain from the buy-side analyst is the earnings forecast, both short-term and long-term, and the most important information which they acquire from company annual and quarterly reports is the financial statements.

Generally the SEC documents are used to corroborate certain information (e.g., product-line information) contained in the annual reports. Sell-side analyst's forecasts tend to be used as benchmarks against which to compare the buy-side analyst's forecast.

For a sell decision, the portfolio managers surveyed look for signals of signficant negative changes in the key factors mentioned above as vital information for a purchase decision. They look to the sell-side analysts to corroborate the buy-side analyst's opinion.

Suggestions for Modifications to SEC Disclosure. Portfolio managers were asked what modifications to SEC disclosure requirements they would like to see. Several responded that they would like the following:

1. More standardization of accounting requirements;
2. More industry overview data including:
   a. production levels
   b. foreign trade activity
   c. pricing
   d. growth rates of major markets
   e. information regarding the effects of government regulation;
3. More complete information on earnings contributions by major products areas;
4. More disclosure of foreign operations;
5. Better management discussion of operations by each line of business.

D. Conclusion

Based upon interviews, it appears that the portfolio manager provides the impetus for much of the buy-side analyst's research and, therefore, indirectly for the sell-side research. He appears to rely heavily upon his buy-side analyst to supply him with much of the company-related information, and he seems to concentrate more heavily upon analysis of specific companies than would be expected if he were concentrating upon total portfolio performance using modern portfolio theories rather than concentrating on picking stocks.

The institutions themselves seem to make the key decisions for the portfolio managers regarding the forecast of the direction of the economy and the representation in portfolios of securities of companies from various sectors of the economy. However, these decisions are usually made by investment committees on which the portfolio manager often serves. In addition, the portfolio manager fulfills a special role in matching client preferences for liquidity and risk to the objectives of the portfolio.

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CHAPTER IV

THE ROLE OF THE INFORMATION DISSEMINATOR

A. Introduction and Background

No segment of the corporate disclosure system is able to directly identify and process all of the information it requires in order to evaluate investment opportunities or make investment decisions. As should be clear from previous chapters of this Report [1/], information used in the investment decision-making process is of considerable quantity and is divided among numerous categories.

Before information can be effectively utilized by the various participants in the disclosure system it must be collected, and some degree of processing must occur: The information, or data, must either be reduced in quantity

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1/ See especially Chapter II - "The Role of the Security Analyst."

or it must be presented in a format suitable to the needs of the users and it must be communicated to them.

These three functions -- information collection, initial processing, and communication to users -- are the function of that segment of the corporate disclosure system which the Advisory Committee has denominated "information disseminators."

In order to understand the process by which information is collected, organized, edited, and transmitted to users, the Advisory Committee undertook to review a representative number of organizations whose p imary purpose is the collection and communication of raw or merely aggregated information for use by the investment community and the general public in the making of investment decisions -- organizations commonly thought of as the financial press.

Empirical data for the study of information disseminators was gathered by submitting a questionnaire developed by the staff to selected disseminators.[2/] Of special interest to the Committee were the sources from which disseminators obtained their information, the criteria for determining which items of information would be disseminated, the formats utilized to enhance

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2/ The questionnaire submitted to information disseminators appears as Appendix IV-A to this chapter.

the utility of the information content, and the classification methods used by disseminators in determining which companies' current developments they would follow and report.

Respondents were also asked to describe freely why they believed their publications to be more useful to investors than the information contained in SEC public files.

In the course of its review, the Committee concluded that it would also be desirable to briefly focus on the information content of a small number of organizations which, while chiefly performing traditional research functions, have no direct brokerage affiliation and are commonly perceived by the general investing public as important investment information sources.

For those organizations conducting chiefly a research function, a hybrid questionnaire was developed. The major portion of the questionnaire consisted of questions contained in the questionnaire developed for security analysts; 3/ in addition, these organizations were requested to respond to a number of the questions contained in the disseminators' questionnaire.

3/ The hybrid questionnaire appears as Appendix IV-B of this chapter.

As occurred with other case studies conducted by the staff, respondents who completed questionnaires were also interviewed in person or by telephone in order to flesh out the information provided and to ensure that the staff properly interpreted the data.

The final pre-case study decision concerned which information disseminators would be requested to participate in the study. A chief consideration was that the disseminator be considered a major source of investment information; however, in order to minimize undue bias, some very small organizations were also selected. The disseminators also had to be concerned with the broad spectrum of information content sought by users, reporting national economic and regulatory developments as well as more traditional business and financial information. In addition, it was hoped to obtain data from organizations located in different parts of the country, in order to determine what effect, if any, geographic location had upon operations. The Committee also wished to know whether dissemination utilizing various forms of media -- wire services, newspapers, periodicals, books, computer format -- significantly affected either the quality or quantity of information content.

With these criteria in mind, the following disseminators were selected and placed in the categories noted:

(a) General economic and business information

(1) The New York Times Company

(2) Dow Jones & Co.

(3) Kentucky Business Ledger

(b) Reference and statistical information

(1) Media General

(2) Standard & Poor's

(3) Moody's

(4) Fitch Investors Services

(c) Analytical and advisory information

(1) Arnold Bernhard & Co.

(2) Argus Research

(3) Duff & Phelps, Inc.

(4) Wright Investors Service

The case study results reveal extreme diversity of method of operation among disseminators. Further, no organization, even an "information disseminator," can or expects to collect all the information desired or even required for investment decision-making. Even the most broadly based "information disseminator" necessarily makes decisions as to which specific items of information will be collected, processed and communicated to users. This is not an objective process; it is judgmental and evaluative. This chapter will present general conclusions about the disseminator's role to the extent that is possible. In order to convey some sense of the diversity of practice, and to describe in more detail how particular disseminators work, the chapter includes descriptive

summaries of five different disseminators. Because the staff found that the role of the analytical and advisory information services in the disclosure system closely resembles the role of the financial analyst, summaries are not provided for any of these organizations.

B. Sources of Information for Disseminators

Governmental Sources. Among the most important sources of information for virtually all disseminators is the government. This is so for three specific reasons. First, there are some types of information to which only the government has access, an example being the line of business data collected from individual companies and disclosed in the aggregate by the Federal Trade Commission. Second, there are some types of information which, because of the expense of identifying and collating it, only the government can afford to monitor, an example being census data collected by the Department of Commerce but extensively analyzed and broken down essentially to assist private enterprise. Finally, there is a third type of information obtainable only from the government, but for a different reason: This is information reporting developments in government fiscal, monetary, regulatory and other policies which, either directly or indirectly, will affect the environment in which all private enterprises operate and, accordingly, influence an investor's evaluation of

investment risk.

With one exception, 4/ all of the information disseminators examined by the staff considered information from government sources to be very important and, on a relative basis, all devoted considerable resources to its identification and collection. The specific types of information and their sources, as well as the resources allocated to collecting it, were usually a function of the space devoted in various publications to reporting that type of information. Timeliness was also an important consideration; that is, where it was unnecessary for the disseminator to report the most timely information, it was more likely that this information would be obtained from secondary sources, such as wire services and service bureaus.

Virtually all of the disseminators are on the distribution or mailing lists of a broad scope of governmental agencies and departments. In addition, where publication requirements demand it, as in the case of The New York Times and Dow Jones, staff personnel make daily visits to government sources in order to obtain desired information on the most timely basis. Moreover, most broad based disseminators are likely to obtain various types of government information from multiple sources - directly from daily

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4/ The exception is Walker's Manual which, by virtue of its product, is concerned only with firm oriented information. Even here, however, some information is obtained from governmental sources when it cannot be readily obtained directly from companies.

pickups, from mailing lists, from wire services, etc.

Use of specific types of information also varies widely, though there is one common theme: Most of the information obtained, whether from governmental or other sources, is not used directly, in the sense that it is reported or reproduced. The overwhelming bulk of the information obtained, if it is retained at all, is merely scanned and filed, where it will be accessible in the event it is needed.[5/] Scanning of the material also serves to update the framework within which the disseminator operates.

Specific publication requirements aside, the selection of those items of information that will be communicated to users is almost invariably a highly subjective process. "News value" is the watchword, though no disseminator is able to define it objectively. As will be discussed below, some disseminators have established basic criteria to identify items that are considered to have "news value," but in all cases these are emphasized to be "guidelines only." In the final analysis, the decision whether to include a specific news item is made by supervisory personnel who, in light of their experience and familiarity with the disseminator, are considered best able to judge what information will prove most valuable to users. Deviations from the normal are most likely to draw the disseminator's interest and be communicated to users.

5/ Dow Jones and The New York Times, to a limited extent, have computerized indices which permit rapid access to previous news stories.

In this respect, information obtained from governmental sources poses special problems for disseminators. For one thing, there is so much information made available that it is simply impossible for any one organization to obtain and realistically evaluate the bulk of it for "news value." On the other hand, and this is especially true for investment oriented information, most disseminators understand that much of the information has value for some highly specialized segment of users, which usually constitutes a small fraction of their users. In addition, a great deal of the information disclosed by the government is highly technical and not susceptible to easy understanding by disseminators, let alone evaluation of its utility to users.

Information disclosed by the government generally falls into one of three categories: (1) statistical and/or periodic; (2) regulatory and/or enforcement; and (3) policy. All of these are of potential interest to information disseminators, although the degree of interest will vary according to specific reader needs. The broader the purported range of the publication, the greater the effort and resources that will be devoted to collecting and, at least, summarily reviewing many of these categories of information. As an example, of the disseminators reviewed by the staff,

The New York Times and Dow Jones have the largest Washington (and other cities in which there are Federal government offices) staffs. Their sole purpose is to collect the information distributed by the government.

Unless a disseminator is highly specialized, it must make drastic and rather arbitrary decisions concerning what types and the amount of government (or any other) information it will follow and report. There appears to be no way to quantify the amount, but by way of illustration, there are at least 320 periodic and subscription services available through the Government Printing Office, which acknowledges that it does not distribute all such government-originated publications (e.g., publications of the Federal Reserve Board).[6/] In addition, the Monthly Catalog of U.S. Government Publications, which purports to index all government publications (except administrative and confidential, or restricted, publications) is usually one-inch thick. Neither of these encompass the many ad hoc releases distributed irregularly by government agencies and departments. Clearly, the quantity of information is staggering.

6/ Government Periodicals and Subscription Services, Price List 36, 165th Edition (May 1977).

In view of the diversity of content among the disseminators examined by the staff and the broad flexibility exercised with respect to content, it is not useful to attempt to identify government sources of information "most important" to a particular publication, disseminator or class of disseminator. Among the more useful, however, are those departments and agencies that are primarily business related. These include most of the Cabinet-level Departments: Agriculture; Commerce; Defense; Health, Education and Welfare; Housing and Urban Development; Interior; Labor; Transportation; and Treasury.[7/] U.S. government agencies described as major sources of information by disseminators are listed alphabetically on the following page.

7/ Obviously, the newly established Department of Energy will be a source of vast amounts of information for disseminators.

Agencies of the U.S. Government Identified as Major Sources of Information by Disseminators

Civil Aeronautics Board
Commodity Futures Trading Commission
Consumer Products Safety Commission
Energy Research and Development Administration
Environmental Protection Agency
Equal Employment Opportunity Commission
Federal Communications Commission
Federal Deposit Insurance Corporation
Federal Energy Administration
Federal Home Loan Bank Board
Federal Maritime Commission
Federal Power Commission
Federal Reserve System
Federal Trade Commission
Interstate Commerce Commission
National Aeronautics and Space Administration
National Credit Union Administration
National Labor Relations Board
Nuclear Regulatory Commission
Occupational Safety and Health Review Commission
Pension Benefit Guaranty Corporation
President's Council of Economic Advisers
Securities and Exchange Commission
Small Business Administration

While the Federal government is not the only governmental authority whose decisions influence business and affect investment decision-making, it is far and away the most important. Unless the information disseminator is particularly concerned with state or regional businesses, there is usually significantly less interest in the activities of state and local governments. Even where some interest may exist, the practical problem of obtaining such information from at least 50 different sources poses major problems for all but the largest disseminators.

A major exception concerns public utility regulation. Because state public utility commissions usually have the final word on the rates that utilities will be permitted to charge customers, their decisions are important to investment decision-makers and, accordingly, to financial information disseminators. For this reason, disseminators are more likely to maintain contact with and seek to obtain information from state public utility commissions -- and invariably do so where their publications are specifically concerned with public utility matters.

Company Sources -- Formal. Companies are also an important source of information for disseminators. However, the company-disseminator relationship is somewhat more complex than the government-disseminator relationship, primarily for the reason that the company, as a private organization, has considerably more discretion than does the government in permitting the disclosure of information and selecting the

information that will be disclosed. Moreover, the relationship of a company to a general economic and business disseminator is substantially different from that of a company to the other types of disseminators examined. This is because the general economic and business disseminator is interested in company information describing not only financial trends and operations, but also company activities in the political, environmental and other social spheres as well. This is particularly so where the disseminator is regional or local in focus, and, therefore, is regarded by users as a prime source of general information concerning the broad scope of the company's activities.

In many cases, the company will be the disseminator's prime source for "hard" information about the company. "Hard" information is defined to include all public documents filed with governmental agencies, annual reports to stockholders, press releases, and supplemental materials prepared for specialized audiences (i.e., supplements for security analysts, public relations materials, etc.). Because of the cost, the degree to which this information is prepared and actively distributed by the company to various disseminators usually is directly related to the company's size. Responsibility for preparation and distribution of these materials is usually located in the "Public Affairs," "Advertising," "Public Relations," "Investor Relations," or another similarly titled office.

Press Releases. The most frequently used and widely distributed company source document is the press release. Press releases are prepared to announce or document the widest variety of company activities, including financial affairs, business developments, personnel changes, construction plans, new products, etc. Initial responsibility for preparation of the press release lies with the company, but many also consult with and/or retain outside advertising and public relations firms. In addition to reviewing the press releases for content and format, these firms frequently undertake distribution to major media services, including newspapers, news wires, periodicals and other information disseminators. Some advertising and public relations firms will also undertake the preparation of "news" stories about the company, subject to review by the company, and attempt to place the story in a newspaper or magazine.

Most of the information disseminators examined by the staff received company press releases, either because they have requested them or because they are automatically included on a company distribution list. The distribution, either by mail or messenger, is undertaken by the company or its public relations firm.

Information disseminators expressed the view that news releases are frequently overdone. Virtually no one quarrels with the basic concept of a press release. It is considered a very efficient technique for drawing

attention to a current development. All also agree, however, that generation of vast numbers of press releases has so diluted the basic technique that a residual unpleasant aroma arises just by the mention of press releases. In addition, there is common agreement that press releases have been relegated too much to public relations firms -- that a "press release" is merely a package for presenting bad news in a good light.

The most frequent financial press release is the earnings announcement. Disseminators' evaluation of the corporate earnings release fairly well reflects their opinion of press releases generally. For example, many felt that earnings releases tended to present those numbers which management believed represented the company in its best light at that time -- and frequently only those numbers. Because these numbers might change, in fact, frequently did, there was little comparability (at least in the press releases) from quarter to quarter. Moreover, many felt that the mere presentation of numbers was inadequate; management should be obliged to discuss the implications of the numbers, but on a realistic basis. Some disseminators also believed that the earnings releases should contain additional information that would assist readers in understanding how the earnings figures

related to the balance of the company's operations. Interestingly, although earnings figures, both actual and estimated, are probably the most widely disseminated item of financial information (aside from stock price), disseminators have a pervasive, if latent, skepticism about their utility. The skepticism is partially due to suspicions that the earnings figures are "massaged"; partially it is due to lack of definition -- i.e., a lack of agreement as to exactly what "earnings" represent. Nevertheless, all but the analytical and advisory services are likely to reproduce earnings figures exactly as provided by the earnings release (except when inconsistencies or obvious errors are noted), primarily because they have no way, and less time, to validate the figures.

Comments made by disseminators to the staff are confirmed in most respects by a survey recently undertaken by a public relations and advertising firm. 8/ The survey was conducted by distribution of two parallel questionnaires to 211 business/financial editors of major U.S. daily newspapers, wire service editors and financial news service editors and to the top corporate public relations executive of each Fortune "500" company. The survey was intended to identify what changes in standard corporate reporting might improve

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8/ Kethchum, MacLeod & Grove, Inc., Corporate Reporting as Economic Education, A Study of Business Media and Corporate Public Relations Executive Attitudes (1976).

the public understanding of business and focused on a denominator common to all publicly-owned companies: the corporate earnings news release.

The majority of editors, 76%, believed that earnings releases should be considerably expanded to include additional information. Of the nine topics of information listed for inclusion on a regular basis, the following were selected by the editors in their order of preference:

(1) Management discussion and analysis of business, by line of business (73%);

(2) Capital spending in relation to earnings (67%);

(3) Projections on next quarter or half (65%);

(4) Return on sales (63%);

(5) Return on shareholders' equity (61%);

(6) Consecutive quarter comparisons (55%);

(7) Environmental spending v. earnings (49%);

(8) Return on assets; tax information (45%).

Over half of the editors, 51%, thought that tables accompanying a corporate earnings release should include complete financial highlights, including net sales, tax on income, capital spending, retained earnings, dividends and outstanding shares. Indeed, 47% wanted the tables to include sales, earnings and earnings per share by line of

business. Only 37% stated that production and sales figures particular to a company's line of business should be included in a table. 9/

For their part, corporate public relations executives, while agreeing that increased information can and should be included in earnings releases, have eschewed significantly expanding their content for a variety of reasons, not the least being that any incremental usage of the data would not justify its costs. While this contention is reluctantly conceded by disseminators to have some merit, they believe that the regular inclusion of additional data would be justified in the long run by an increase in the quality of business and financial reporting.

A point of long-standing friction between disseminators and the corporate side, which reinforces disseminators' skepticism about the function of press releases, concerns corporate policies respecting the issuance of press releases at the time a Form 8-K is filed with the SEC. There is generally acknowledged to be no uniformity in this area--

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9/ By way of comparison, the corporate public relations executives also believed that earnings releases should be expanded, but differed rather decisively on what additional information should be included. While both groups generally favored tables reporting sales, earnings and earnings per share by line of business, as well as financial highlights such as net sales, tax on income, capital spending, retained earnings, dividends and outstanding shares, the corporate side selected increased tax information as the most important addition and were significantly less enthusiastic about management discussion and analysis by line of business and projections. Id. at 8.

a company may or may not issue a press release when an 8-K is filed--and where a press release is not issued, disseminators are likely not to be aware of the 8-K. Disseminators and others have long cited this as an unusually clear case of "burial by disclosure," noting additionally that a press release is far more likely to be issued when the development being reported is favorable to the company. Both groups agree that issuance of a press release concurrent with the filing of every Form 8-K is unnecessary and would be undesirable; as might be expected, however, there is substantial disagreement beyond that point. Disseminators believe that press releases should be issued upon the filing of each "important" 8-K, defining "important" to include at least favorable and adverse developments. Representatives of issuers/registrants, point out that "important" is a highly subjective guide and suspect that, in most cases, disseminators are looking for adverse information. 10/

Annual Report to Shareholders. The second most frequently used company prepared document that is not filed with the SEC is the annual report to shareholders. However, there is a much more distinct bifurcation of users respecting this document than there is with the press release: In most cases, the annual report is seldom used by disseminators of

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10/ Companies in the case study indicate that it is their practice to issue a press release for a material event reported on an 8-K.

general business and economic information, primarily because it is not a timely document when compared to other sources of information. The information most valued by these disseminators, earnings reports, is usually disclosed outside of the annual report and in a different format.

Other information disseminators, however, who do not operate within the same time frame, generally attribute a high degree of importance and utility to the annual report to shareholders. For one thing, the document is perceived as a prime source of statistical and historical data. In addition, where the company may be followed somewhat more closely, as is the case with the advisory and analytical disseminators, the annual report is viewed as providing a window on management. The format of the report and the non-financial information, particularly those portions that may be future-oriented, such as the president's letter, may be carefully reviewed to discern and/or substantiate judgements respecting the character, ability and intentions of management.

Despite their scrutiny of the annual report, and the fact that it is the document most likely to be filed for future reference, most disseminators retain a degree of skepticism about the document. Paradoxically, the skepticism derives from the same basis that makes the document so useful: the fact that it is prepared, in large part, for investor and/or public relations purposes. There is little doubt that the problem of effective communication of information is a

chief priority in the preparation of the annual report, and it is for this reason that the document is so widely used and referenced. However, since the techniques of effective communication are largely a matter of judgment and emphasis, and because the annual report is intended to be used by an extremely diverse user group, the selection of the information to be highlighted, and the method of its presentation, are somewhat less likely to satisfy the requirements of any particular user. While the reasons for emphasis of particular information may be completely and objectively verifiable, they may also reflect the desire of management to put its best foot forward. It is this conflict, plus the experience of many users, that infuses their evaluation of an annual report and predisposes them to skepticism.

On balance, however, all of the disseminators examined by the staff attributed a high degree of usefulness to the annual report and were particularly encouraged about the trend to improvement of the document, with much of the credit for this trend going to the SEC.

Company Supplements, "fact books," etc. A third type of document prepared and distributed by the company, though used only marginally by information disseminators, is special supplements of various types, such as "fact books." In many cases these documents are prepared by investor relations departments or consultants specifically for the use of security analysts, but are available in

varying degrees to other types of users. Since the large majority of these documents are prepared primarily for use by security analysts, they usually contain information more suited to these users' needs: more detailed financial information, such as increased segment data and key ratios; more market data; more emphasis on management goals and strategies.

These documents are least likely to come to the attention of or be used by general business and economic disseminators; they are most likely to be sought by the analytical and advisory services, whose review most closely parallels that of the security analyst. However, because frequently a prime purpose of these documents is to present the company in the most favorable possible light, and because they are not subject to an objective third-party review (as is at least partially the case with the annual report to shareholders), disseminators question their utility.[11/]

Company Sources -- Informal. The importance of informal company sources of information is difficult to specify or evaluate. Part of the reason is due to their very informality -- personal contact by telephone or visit; interview; meetings and/or seminars. Part of the reason is also due to

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11/ Thus, when compared to other documents such as the annual and quarterly reports to shareholders, and the proxy statement, 10-K and 10-Q, "fact books" are considered by financial editors to have significantly less value. See survey by Ketchum, MacLeod & Grove, Inc., supra note 8, at 11.

the objective of the informal contacts, which may not always be to elicit "hard" information. As is the case with security analysts, informal contacts by information disseminators are intended in large part to obtain subjective information that can be used, however nonempirically and however far in the future, to place more formal information in context.

All of the information disseminators contacted by the staff made use of informal company information sources, though their emphasis and frequency varied considerably. Thus, the general business and economic disseminators are far more likely to use telephone contacts and visits, and occasionally an interview, than they are to attend a company sponsored meeting or seminar. Moreover, they are far more likely to initiate the contact since their interest normally does not stem from a posture of continuing review, but because they know or believe (or suspect) that some development has occurred or is about to occur that is of news value. In addition, the general economic and business disseminator finds it far easier to use informal information, either directly or indirectly.

The analytical and advisory disseminators, on the other hand, use informal contacts much as do security analysts. Their contacts tend to be more regular (i.e., just prior to

or after quarterly earnings periods) and the information they seek, aside from predictions of earnings estimates, tends to be more directly related to the financial condition of the company. As an example, advisory and analytical disseminators will informally contact a company after announcement of quarterly earnings in order to obtain an amplification of the earnings announcement. In addition, if the disseminator intends to feature the company in a current article, the company will be contacted to update various financial statistics (as well as personnel changes). These disseminators are also more likely to attend company sponsored seminars, or to visit the company itself, since their basic responsibility differs little from that of a security analyst.

The position of the statistical and reference services contacted by the staff, in this respect, differs substantially and the reason is clear (at least with respect to three such services [12/]): In these cases, because the disseminators also undertook to provide qualitative ratings of the company's debt securities, their relationship to the company had overtones of the relationship between the company

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12/ Standards & Poor's, Inc., Moody's, and Fitch Investors Service.

and its underwriters. By virtue of formal agreement, these disseminators report that they obtain access to a far larger amount of company information not ordinarily made available to other disseminators.

Industry Sources of Information. Most industry sources of information -- such as trade associations, association meetings and trade publications -- are not greatly utilized by information disseminators. In many cases, this is because the disseminator does not report information on an industry basis or, if it does, because the disseminator, itself, undertakes the aggregation of industry information. As always, there are exceptions to the rule. The general business and economic disseminators, for example, will report occasional releases by some trade associations who are viewed by their users as chief souces of industry data. Thus, current traffic and capacity figures as aggregated and disseminated by the Airline Transport Association, or similar figures by the Edison Electric Institute, the Chamber of Commerce of the United States, the Investment Company Institute, etc., are likely to be reported. Some trade associations undertake independent studies or surveys of their members and/or the business community at large, such as the Machinery and Allied Products Institute, and reports of these activities frequently find their way into the business pages of newspapers, magazines, and specialized newsletters.

The resources an information disseminator will allocate

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to collection and aggregation of industry information will usually depend upon the extent to which the publication is utilized by security analysts, brokers, portfolio managers, and similar users. Perhaps the most prominent example of this highly specialized marketing is IndustriScope, a weekly tabloid-sized publication of Media General Financial Services, Inc., listing 50 data items for 1,512 companies on an industry basis. 13/ Media General has also developed a visual display system, utilizing the same data base, which groups the companies on an industry basis for selecting key data items.

Finally, a disseminator's sensitivity to industry data increases as publications become more analytical and advisory in nature -- as opposed to reference and statistical. This is reflected in two ways. The disseminator may prepare and market a newsletter or occasional report analyzing industry trends. In addition, and more frequently, consideration of industry factors is reflected in reports on specific companies, where data respecting industry trends, market share, and other information is more critical. In both of these cases, however, the industry data is more likely to be the result of aggregation of data collected by reference to specific companies, rather than by reference to industry sources.

13/ A list of these data items appears in the appendices as Appendix IV-C.

Other Disseminators as Sources of Information. The use and re-use of information is a characteristic of the corporate disclosure system, and financial disseminators are no exception. For various reasons, disseminators are reluctant to acknowledge their re-use of information, but in a few cases dissemination services exist principally to provide information to other disseminators.

The prime examples of such disseminators are the major wire services. While they have many similarities, they ultimately serve rather distinct functions. All of the major wire services have news gathering bureaus or sources (stringers) in major cities and countries. As a general practice, information originates locally, is fed to a central location, usually New York, edited and placed on the wire for dissemination. News content of the wire is the responsibility of the editor located in the central office. In addition to editing the information submitted, he may initiate coverage of specific developments. The information is distributed to subscribers for direct use or republication by means of terminals. The chief benefit of the wire services is cost savings, for they permit the wide distribution of information from worldwide sources at minimum cost to the subscriber.

With the exception of The New York Times wire service, most of the major general content wire services, i.e., Associated Press, United Press International, Gannett, etc., are not considered major sources of investment information

because their business coverage is neither broad nor detailed enough to be useful to sophisticated investors.[14/] The New York Times service is sought after by companies because appearance in the newspaper is prestigious and more likely to be seen by a nationwide audience. In addition, most of the news carried on the general wire services will not be seen by readers (of the subscribing newspapers) for a period of up to 12 hours.

Dow Jones and Reuters, on the other hand, specialize in business and financial news and are generally considered the primary mechanism for disclosure of current developments. In addition to serving newspapers, these services are subscribed to by almost all segments of the investment community, other disseminators, and corporations. In addition to their timeliness and broad distribution, Dow Jones and Reuters are widely believed to be more sophisticated in their identification and communication of financial and business news.

The content of the Dow Jones and Reuters wires consists of both news items and features and statistical data (stock tables). However, although the operations of both organizations are similar in many aspects, Dow Jones is different because of the existence of the Wall Street Journal and its sister publications; Reuters has no comparable publication.

14/ However, these wire services are frequently the only source of business and financial news for smaller circulation newspapers.

The Dow Jones wire service, the "broad tape," functions essentially as a continuous newspaper. Because it operates throughout the business day and because it carries no advertising, it has virtually limitless space. Ordinarily, therefore, the "broad tape" will carry news items that may not be reprinted in the Wall Street Journal. The most widely-known example of this is the "broad tape" company interview, usually conducted and released immediately before a company's quarterly earnings are expected to be announced. These extensive interviews, frequently the equivalent of four to five columns in the Journal, reflect a concerted effort to obtain specific financial information, including earnings announcements. However, except to the extent that an announcement is obtained, these interviews will not be reprinted in the Journal at all.

Because most statistical information is essentially fungible and need be calculated only once, it is impossible to determine the extent to which information of this type is re-used by disseminators. However, it is obvious that there is extensive borrowing of basic statistical information which, if not encouraged, is at least tolerated for reasons of prestige and public relations. Indeed, certain statistical information is so widely re-used that it has all but entered the public domain. The Dow Jones and S&P averages, as examples, are so frequently cited by disseminators and viewed as benchmarks by investors that it takes a

moment's thought to realize that they are prepared by disseminators. Other, more specific, i.e., firm-related, statistical data calculated by Dow Jones, Standard & Poor's, Moody's, Arnold Bernhard, Media General and other disseminators is no doubt incorporated in the products of many disseminators.

Finally, another disseminator serving primarily other disseminators is the "PR Newswire." This organization transmits press releases to various classes of subscribers, including newspapers, stock exchanges, broker-dealers and investment bankers. The information content of this wire differs substantially from the other wire services because it is specified by newswire clients.

In order to minimize possible misuse of information, securities industry subscribers to the "PR Newswire" receive information 15 minutes after dissemination to the press, a precaution undertaken at the request of the New York Stock Exchange.

Although client control of content apparently limits the utility of the "PR Newswire" as an information source, the service does appear to provide a timely, efficient and relatively low cost means by which information can be distributed to major disseminators and to various segments of the investment community.

C. Products and Services of Information Disseminators

As might be inferred from earlier portions of this chapter, information disseminators seldom market one product or service. While initial entry into a market may consist of a single product or service, frequently second or third products are introduced as soon as a foothold is established and financial conditions permit. Moreover, it is not unusual for subsequent products to have been planned well in advance, with their delayed introduction stemming primarily from financial considerations.

The reasons for this sequential growth pattern have already been alluded to. Primarily, it is because the costs of gathering data and assembling an editorial staff for its processing are relatively high in comparison to the price of the product initially offered. Consequently, there are constant pressures to develop secondary uses for both the data and personnel. Moreover, secondary uses frequently develop as a result of opportunities that are not apparent previous to the introduction of the initial product. User suggestions, accordingly, serve as a frequent source of product and service innovation. Finally, the incremental costs of marketing a secondary product, following establishment of the initial product or service, are minimal, since the disseminator can fairly accurately assess market opportunities with little if any capital expenditure.

Over a course of time, moreover, products and services tend to become highly differentiated. This is a result of

both natural development and marketing efforts. However, because of segmentation of the user market, it becomes increasingly difficult to find commonalities for purposes of general analysis.

For all of these reasons, little useful purpose is served by attempting to compare information disseminators by the content of their products and services. They are simply too diverse. The descriptions of five of the disseminators studied follow below; and their products and are reviewed in great detail.

C-1 Disseminators of General Business and Financial News. The Advisory Committee examined the operations of three disseminators of general business and financial news in order to obtain some understanding of news content, information sources and criteria for coverage. Two of the disseminators, The New York Times and the Wall Street Journal were selected on the basis of their overall importance to the corporate disclosure system generally; the third, the Kentucky Business Journal, was selected as an example of the trend toward development of local and regional business reporting.

The New York Times. The Times is considered one of the two most important outlets for dissemination of current business and financial developments. Its importance derives from its prestige, from the fact that it is

circulated nationally on a daily basis, and because it is read daily by a high percentage of political, business, financial and other leaders. The Times is a general circulation newspaper; it is not a disseminator of solely business and financial news. However, the broad scope of its news coverage provides as good an indication as any of the diversity of information that investment decision-makers and security analysts monitor on a current basis. Especially important are items concerning actions of the Federal government, developments in foreign countries, and trends in economics, demographics, research and development, education, etc. In addition to publication of a daily and Sunday newspaper, the Times operates a wire service by which much of its information is made available to correspondent newspapers throughout the country.

The amount of space which the Times devotes to business and financial news varies daily, but a general breakdown is as follows. Because it is usually the slowest day for business news, Monday papers will have about 17 columns (no stock tables, etc. because the markets are not open on Saturday or Sunday). On Tuesdays through Thursdays, Saturdays and Sundays, the paper will carry about 60 columns of business and financial news, 36 allocated to stock tables, charts and other statistical data and 24 columns for current news items, including "spot news" (current developments) and columns. On Fridays, the paper carries about 34 columns, reflecting a recent expansion,

though the additional space is not primarily for spot news. Most of the increase has been allocated to special columns of analysis and commentary. In addition, the Friday business section is "free standing," i.e., printed as a special section, similar to the Sunday business section. Finally, on any particular day, the business editor can draw on up to ten additional columns of space where developments so warrant.

Within the past two years, the Times has undertaken a broad effort to upgrade the quantity and quality of its business and financial news coverage. In addition to the "free standing" Friday section, additional columns have been added and the display of stock tables has been revamped. With regard to the latter, the most conspicuous change is inclusion of a three column box displaying various market indicators in both graphic and tabular form. Currently, the paper includes a wide variety of stock, bond and other statistical tables, 15/ although the detail of data presented varies widely. For example, the New York and American Stock Exchange consolidated lists include yearly highs and lows, current dividend, price-earnings ratio, volume of daily sales, daily high and low, closing price and net change.

15/ The New York Times contains the following statistical tables on a regular basis: New York Stock Exchange (entire stock and bond list); American Stock Exchange (entire stock and limited bond list); Over-the-Counter Main List; Over-the-Counter Supplementary List; Midwest, Pacific, Philadelphia and Boston Exchanges (limited lists); Major foreign stock exchanges (Toronto, Montreal, Amsterdam, London, Paris, Buenos Aires, Frankfurt, Sydney, Zurich, Tokyo, Milan, Brussels, and Johannesburg); Open and closed-end investment company lists; U.S. Government and Agency bonds; State and public authority bonds; Foreign government bonds; Chicago Board, American, Midwest, Philadelphia and Pacific exchange - listed options; Money market and foreign exchange indicators; and Commodity futures and spot prices.

The main over-the-counter list includes dividend, sales, bid and asked and change in bid, while the supplementary over-the-counter list includes only bid and asked.

Specifically segregated and highlighted tables are provided for dividend announcement and current earnings reports.

The large amount of limited space that must be devoted to these statistical tables has been a cause of continuing concern to the Times, as it has to almost all general circulation daily newspapers. The space problem became critical in 1973-1974 when a shortage in newsprint (paper) required all newspapers to reduce their size; the growth of the listed stock option market also generated severe space problems. The most common general response to this problem, though it did not occur at the Times, was a reduction in the quantity or frequency of the stock tables. For example, some newspapers determined not to include yearly highs and lows; others cut back on the frequency of publication. In many cases, these practices continue to the present day.

In addition, there is a widespread impression among most business and financial editors that the information contained in stock tables is of limited readership interest and utility. Indeed, business and financial news generally is

broadly perceived as being of interest to only a small segment of the readers served by general circulation newspapers.[16/] In addition, editors point out that similar and more timely stock table information can be readily obtained from stockbrokers.

Partly in an effort to broaden readership, a number of general circulation newspapers have attempted to develop columns and features of analysis and opinion. These columns are intended to assist readers in assimilating data and identifying trends in various specialities. The Times has long had columns on labor-management relations, advertising and securities ("Market Place"); recent supplements have included regular columns on management, accounting, technology, and macroeconomic news and analysis.

16/ Readership interest in business and financial news is a subject much discussed but infrequently documented by newspaper executives, editors and reporters. Although statistical data is hard to come by, it is generally agreed that business and financial news in general circulation newspapers increased during the period 1952-1967, primarily in response to economic conditions and resultant readership interest. This increase peaked sometime in the early 1970s and began the decline noted above in 1973. The most severe cutbacks occurred in afternoon papers, primarily because their publication deadlines made it difficult, if not impossible, to obtain closing market prices. Cf. IV News Research for Better Newspapers, Ch. 3, "Content," pp. 24-26 (American Newspaper Publishers Association: 1968); "News and Editorial Content and Readership of the Daily Newspaper," ANPA News Research Bulletin, No. 5 (April 26, 1973).

As it is with most general circulation newspapers, the space allocated by the Times for spot (current) news is variable and the criteria for coverage is subjective. A recent addition to the Times' format is the "Corporation Affairs" column, which provides summary treatment of acquisitions, mergers, new contracts and other similar current developments. A previously existing column provides space for announcements of high level executive changes. The Times attempts to provide spot news coverage on all companies listed on the New York and American Stock Exchanges and in the major over-the-counter list. Most business and financial editors are reluctant to discuss their criteria for selection of spot news items, both because they cannot always adhere to them and because public awareness of the criteria will tend to generate questions as to their implementation. It is understood, however, that the Times will normally carry an earnings report where the quarterly sales volume is at least $5 million and report contract awards where the amount is $10 million for private contracts and $25 million for government contracts.

The most consistent spot news carried is earnings reports. The data provided normally include: name of the company; primary trading market; and, for the current and

previous year, quarterly revenues or sales, net income, earnings per share for the quarter and the year, and 6-month, 9-month or annual earnings. While only selected footnotes are summarized, the earnings figures are republished essentially as received.

The Times maintains an extensive file of annual reports to shareholders and Form 10-Ks and is able to utilize its own data retrieval system (which provides computer accessible references to previous stories concerning a company). It receives a daily "press packet" from the SEC (and other governmental agencies and departments) and makes use of documents maintained in the Commission's New York Regional Office Public Reference Room. Recently, the newspaper sent letters to the presidents of all listed and major over-the-counter companies asking to be placed on the mailing list for all information provided to shareholders.

The major news sources, however, particularly for earnings releases, are the companies themselves, the major newswires (Dow Jones, Reuters, AP, PR Newswire), and Standard & Poor's. Because of the desirability of Times coverage, all of these sources have a thorough understanding of the paper's formats, procedures and time requirements.

Finally, the Times stated that its experience in obtaining news of negotiations about mergers and acquisitions had improved considerably in recent years and attributed this improvement to steps taken by the SEC. However, it was stated that there were still frequent news "blackouts" when companies were in registration. The Times was not enthusiastic about SEC proposals to require earnings projections because it believed that too many opportunities for misuse of the information would have resulted. Had SEC proposals been implemented, they said they would not have reported projections for periods of more than the next 6-9 months.

Dow Jones & Company, Inc. Dow Jones is responsible for a broad range of business and financial publications and services, including the Wall Street Journal, the Dow Jones newswire ("broad tape"), Barron's, and other periodicals and books. The "flagships" of the company, however, are the Journal and the "broad tape." [17/] They are the most widely circulated business and financial news disseminators in the country and are considered an essential medium for current disclosure. The Journal provides next-day daily (Monday through Friday) coverage throughout the country by means of four editions originated in New York, but printed throughout

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17/ The operation of the "broad tape" has been described in a previous section of this chapter.

the country. The major difference among the various editions is not in news content (there are minor differences, to be described below), but in advertising. While this has not always been the case, current practice is to publish most items in all editions subject to overall space available. The space will vary according to how much advertising is carried in each regional edition.

All news stories, wherever developed, are initially sent to New York editorial offices for editing and classification. There a story will be classified as "main tier," which means that it must be carried in all editions, "second tier," that is, stories which should be carried if at all possible, and "if room." There is a correlation between classification and location within the paper: The front and back pages and stock tables are considered "main tier;" all other pages are considered "second tier."

Space available starts with a maximum of 74 columns a day, excluding only the editorial page and paid advertising. Since it includes all stock tables and page headings, considerably less than 74 columns are available for "news" by conventional definitions. The Journal undoubtedly carries a broader and more detailed amount of statistical business and financial information than any other widely circulated

newspaper in the country.[18/] The front page of each day's paper contains a graph displaying the four year trend of a major economic indicator, such as personal income, jobless married men, weekly earnings, consumer prices, hourly earnings, stock and bond yields, construction spending or aluminum output. A major feature of the statistical material is the graphic display, for the previous three months, of the Dow Jones industrial, transportation, and utility averages and the daily volume. As do other newspapers, the Journal

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18/ The Journal carries the following statistical tables on a regular basis:

- New York Stock Exchange (entire stock and bond list)
- American Stock Exchange (entire stock and limited bond list)
- Over-the-Counter Main and Supplementary Lists
- Major U.S. regional and Canadian exchanges (limited lists for Boston, Philadelphia, Pacific and Midwest exchanges in U.S. and for Toronto and Montreal in Canada)
- Major foreign exchanges (limited lists for London, Paris, Frankfurt, Zurich, Basel, Milan, Tokyo, Brussels, Amsterdam and African Mines)
- Open and closed-end investment companies and closed-end bond funds
- Government, agency and miscellaneous securities
- Foreign government securities and bonds (limited list)
- Chicago, American and Philadelphia exchange listed options
- Commodity futures and spot prices
- State revenue and public authority bonds (limited list)
- Detailed foreign exchange rates for bank transfers and foreign banknotes.

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believes that some of its statistical material, particularly price data on infrequently traded securities, take up too much room in the paper.

A prominent reason for the reliance placed upon the Journal is its format which, while modified over time, has retained a remarkable consistency. Its six-column front page contains, in the first and sixth columns, respectively, in-depth stories on business and industry trends and developments and similar stories on government, labor, and macroeconomic conditions. The fifth column contains a summary of developments in five different areas: current trends in business and finance, labor, taxes, Federal government, and industry. The fourth column usually contains a special feature. The second and third columns, called "What's News," contain, respectively, a brief summary of spot developments in business and finance (with references to full stories) and worldwide news. Until recently, the back page contained only an in-depth feature article; within the past year, a column on personal finance, entitled "Your Money Matters," was added.

The Journal carries this consistency over into the interior of the paper. The inside back page, in addition to displaying the Dow Jones averages, contains two columns,

"Abreast of the Market" and "Heard on the Street." The former analyzes the previous day's market activity; the latter usually concentrates on opinions being given on particular stocks and industries by security analysts, portfolio managers and others. Substantial space is allocated on a regular basis to dividend news, stockholder meeting briefs, the new issue market (stocks, bonds and tax exempts), commodities, and management and personnel notes ("Who's News").

Although it is specialized and generally has more space in which to include news items, the Journal must also make decisions as to which stories to run. Also as with other newspapers, this is a subjective judgment. The basic criteria is: Will a proposed item be at least mildly interesting to readership throughout the country? In addition, there are differing criteria for different departments, the most stringent being "Who's News." For this column, the Journal has developed detailed and rigid procedures, essentially to reduce the burden upon editors. For spot news, the Journal regularly follows the events of companies contained on the New York and American Stock Exchanges and the main over-the-counter list. It will request that an item be written on an event concerning these companies if the

transaction involves $3 million or more, although this does not necessarily mean it will be carried in the paper.

Most news information concerning companies is furnished to the Journal by the companies themselves, or by their public relations firms. The paper also has access to other major wire services and maintains an extensive file of corporate literature, including annual reports and 10-Ks.

Earnings releases are processed by a special staff section responsible for maintaining tables on earnings. In many cases, figures received are republished as provided because previous experience has confirmed their reliability. In other cases, the staff makes its own calculations and adjustments if necessary. Reference may also be made to figures contained in annual reports and previously published estimates to see if they are "in the ballpark." A typical earnings digest contains: name of the company, primary trading market, and, for the current and previous years, sales or revenues, net income (or loss), earnings per share and average shares outstanding.

The Journal also reports on a weekly basis changes in insider holdings for selected New York and American Stock Exchange issues. Data for the New York Exchange is obtained from the Exchange; the Journal screens the Amex list itself, although it did not explain the criteria it applied in selecting items.

Kentucky Business Journal. In addition to the general circulation daily newspapers, there are an undetermined number of specialized newspapers which concentrate on business and financial news. Frequently, these newspapers cover two or three "specialized" areas, such as law, banking or local industries; in many cases, these publications appear daily. In other cases, the newspaper focuses only on business and financial news, in which case it is likely to appear less frequently, such as monthly. Because these newspapers are often the only news outlet for local and regional companies, and because they are consulted by regionally based broker-dealer firms and securities analysts, the Advisory Committee believed it appropriate to briefly examine one such publication.

The Kentucky Business Journal ("KBL") is a monthly newspaper having a circulation of approximately 11,000 and specializing in reporting news about companies which are either Kentucky-based or have substantial operations in the state. KBL attempts to obtain information on both public and private Kentucky companies.

The only statistical information consistently published is the Kentucky Stock Index, which monitors 26 Kentucky-based

companies [19/] whose stocks are most actively traded. However, the Index includes some unusual information. In addition to items such as price range (last 15 years and last two years, both highs and lows), current market prices, dividends (how long paid, yield, latest quarter, payment and record date, previous year and total to date of current year), and earnings per share for each of the last five years, the table includes the number of institutions holding stock in the company and their aggregate holdings; and a summary of financial position, listing cash and equivalents, current assets, current liabilities and long term debt (where convertibles are listed, the conversion rate is also indicated). KBL also conducts an annual survey of salaries of officers of indexed companies.

The bulk of KBL regular coverage is devoted to earnings releases, announcements of dividends, a listing of new corporations (with names and addresses of incorporators) and "Taking Note," a potpourri of corporate releases announcing personnel changes, contract awards, construction plans, and

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19/ The companies are: American Air Filter; Ashland Oil; Begley Drug; Belknap; Brown-Forman; Capital Holding; Citizens Fidelity Corporation; Convenient Industries; Dollar General; First Kentucky National; Glenmore; Humana; Jerrico; Kentucky Central Life; Kentucky Utilities; Liquid Transporters; Louisville Cement; Louisville Gas & Electric; National Industries; Reliance Universal; Safetran Systems; Texas Gas Transmission; Thomas Industries; Union Trust; Vermont American; and Western Kentucky Gas.

similar news. The earnings and dividend announcements are reproduced virtually "as received" by companies and their public relations firms. The earnings story, in addition to containing a brief narrative, includes revenues, net income and per share income for the previous year and the year to date with an indication of the percentage change in each. This information is always highlighted in a "box" when the paper does a more extensive article on a particular company. A final regular feature is a report of insider trading, which is obtained from a stringer.

Remaining space in the KBL is devoted to current news, two pages (about 8 columns) of which report general economic and Kentucky industry trends, the balance consisting of feature stories on companies.

Sources for current news are the companies and their public relations firms, although the KBL retains final discretion as to what it will publish. Its limited staff, in addition to conducting personal investigations, makes use of a file of annual and quarterly reports. KBL subscribes to no wire services.

Disseminators of Reference and Statistical Information. A second category of information disseminators examined by the Advisory Committee is concerned primarily, though not exclusively, with reference and statistical data. These disseminators were examined because their services are widely relied upon by virtually all segments of the investment community. In some cases, they are used as information sources of last resort, i.e., where historical information can be found no where else. In others, the data they aggregate and compile is incorporated into the users' own data base primarily as a time-saving procedure. In still others, the services they provide are unique as to format, scope or medium. In all cases, however, as a general matter (and with certain exceptions, to be noted in the discussion that follows), the services they provide are perceived both by the disseminators and the users as being primarily objective information services and are widely distributed and consulted by sophisticated and novice investors alike.

Media General Financial Services, Inc. ("MG"). MG is a wholly owned subsidiary of Media General, Inc., a communications company whose operations include newspapers in Richmond, Virginia; Tampa, Florida; and Winston-Salem, North Carolina; a newsprint recycling plant; a cable television station in

Fredericksburg, Virginia; plus other smaller subsidiary operations. MG, through its predecessor companies, was an early user of high-speed, automated typesetting and its initial product was a daily newspaper, Financial Weekly, providing weekly updating of basic statistical information, including a wide variety of ratios, on over 3,000 stocks. Financial Weekly was disaggregated into three separate products beginning in May, 1976. Since that time, additional products and services utilizing new formats and mediums have been introduced.

Central to MG's operations is a comprehensive data base encompassing approximately 3,600 stocks. The data base includes all New York and American Stock Exchange listed securities, and approximately 600 over-the-counter industrials, with the balance being bank and insurance companies. The data base includes numerous fundamental financial factors and ratios, plus price and volume calculations, mutual fund holdings, short interest, and a number of calculations based on MG's own formulas.

Information for the data base in obtained from company annual reports to shareholders, Form 10-K reports, interim reports, and three wire services - UPI, Reuters and PR Newswire. The information is written on a preprinted and

formatted transactions sheet, keypunched into a computer readable card, and verified by another keypuncher on a verifying machine. A number of different supplemental procedures are utilized to provide further verification and the data is updated on an "as required" basis, that is, as new data becomes available.

The data is recorded or computed within ten basic categories and over 100 sub-categories. The basic categories are listed below, with the number of sub-categories noted in parentheses: 20/

Price (22)

Classification, identification (7)

Volume (10)

Earnings per share (23)

Revenue and total earnings (3)

Dividend factors (6)

Risk factors (5)

Financial position (9)

Financial ratios (18)

Shareholdings (8)

20/ A complete listing of the categories, sub-categories and indices used in compiling the MG data base are included as Appendix IV-C to this chapter.

In addition, the data is retrievable by various commonly used indices, such as the Dow Jones and Standard & Poor's, and by index data items, such as high, low and close for the latest week, 52 week or 5 year high or low, and 200-day moving average, growth and dividend rates and price/earnings ratios.

The data base serves as the core to all MG publications and services. A brief description of these follows.

Market Digest is a weekly 64 page newspaper containing current news and a wide variety of statistical information on all New York and American Stock Exchange listed stocks and bonds and 830 over-the-counter issues -- over 3,450 in all. It is received by somewhat over 2,500 subscribers (60% individual investors, 40% profesionals) and costs $85 per year.

IndustriScope, a tabloid, contains a broader range of price and volume data on 1,512 major NYSE, Amex and OTC issues -- 58 data items in all, including basic balance sheet and income statement and price and volume items, as well as numerous ratios. The stocks are classified into nearly 200 industry subgroups, 60 major industry groups and 10 economic categories. It is received by somewhat over 2,000 subscribers and costs $145 a year if purchased on a weekly basis, $85 a year when purchased on monthly basis.

StockChart, a monthly tabloid, displays semi-log charts on some 3,450 stocks (all NYSE and Amex plus 830 major OTC issues), alphabetically by market, showing price and volume for the last 10 days, last 52 weeks, and last 5 years. It is received by somewhat over 2,000 subscribers and costs $75 per year or $5 per issue.

The publications noted above are essentially specialized newspapers. MG also offers data in modified, specially tailored computer print-out format.

Executive Stock Report is a weekly service allowing the user to choose up to 30 issues for a basic report showing 12 price, volume and balance sheet items on one page. Two additional pages show some of these items ranked, plus ranking of some other key price and volume data. A fourth page shows price change for each issue from the last trading day of 1968 to the latest close. A fifth page shows average daily volume and price action of the stock over the last 35 weeks, and a sixth page shows the price/earnings ratio distribution of all the stocks on the MG data base on a composite basis and broken down by market. This service, which costs $235 per year, is subscribed to by approximately 300 persons, predominantly corporation officers wishing to compare their companies with others in their industry group.

Stock Reference Report is a similar type of service, but intended primarily for institutional investors, which permits users to receive up to 25 data items, selected from a list of more than 140, on any number of stocks desired. The user may also enter his own data, such as earnings estimates. Rankings are provided on various items, along with various listings such as security ratings, weekly changes, etc. The price of this service depends upon the number of securities being monitored, but ranges upward from $2,000 per year.

S&P 500 is a monthly tabloid-sized pamphlet displaying, by industry grouping, basic price, volume and financial data for the S&P 500. It also shows industry summary material and weightings of the stocks and industry groups. Subscription price is $240.

Screen and Rank is a program which permits a user to obtain a screening and ranking of stock according to various criteria levels determined by the user. It is performed on a single report basis for $500.

A final MG service employs still another medium. StockVue is a monthly service consisting of a base grid containing the abbreviations for 1,512 stocks, arranged in economic categories and industry groups, preprinted on stiff

10" x 14" cardboard. Over this is placed a series of plastic screens and, if the user so desires, a second overlay showing the economic categories and industry groupings. The basic service consists of 14 screens showing stocks in upper and lower quartiles of seven basic financial factors, including price/earnings ratio, price, volume, earnings per share, dividends, and other ratios. In addition, users may select from a list of 1,120 additional screens showing upper and lower quartiles of additional financial, price and volume factors, or topical items. The basic services sell for $1,500 annually; additional screens are available at $4 per month down to $2.50 per month, depending upon the number chosen.

As even these brief descriptions should make clear, MG publications are carefully designed to appeal to specific members of the investor community, mostly professionals such as security analysts, portfolio managers, money managers, and corporate financial officers. The Market Digest, which comes closest to being a general financial newspaper, is nevertheless more specialized than the Wall Street Journal. Because it is a weekly, its general news content is oriented toward providing an overview, rather than emphasizing timeliness, in government, economic and industry developments. Columnists provide analysis, which is supplemented by features from regu-

lar staff. But the heart of the publication remains statistical data, liberally sprinkled through the publication in graphic and tabular form and, finally, completely encompassing the final two sections of the four section paper.

In addition to the information sources previously noted, MG uses Standard & Poor's Daily News (most frequently for confirming data) and various SEC sources, such as Disclosure Incorporated and the Official Summary of Security Transactions for insider trading. Bank and mutual fund holdings are obtained, in machine readable form, from an outside source.

Despite the extensive variety of MG data, there is no presentation of management summary and analysis, lines of business breakdown or company earnings forecasts. While management summary and analysis is referred to for background, use of line of business and forecast data are precluded primarily because they are not readily available on a uniform or consistent basis.

Finally, as do most other disseminators, MG reports difficulties in obtaining basic financial data on a regular basis from all the companies it wishes to follow.

Standard & Poor's Corporation ("S&P"). S&P, a subsidiary of McGraw-Hill, Inc., has been collecting, formatting, analyzing and disseminating business and financial information for over 115 years. S&P is the result of a merger in 1941 of Poor's Publishing Company, founded in 1860, and the Standard Statistics Bureau, founded early in this century to collate facts on about 100 large corporations for distribution to subscribers (predominately banks and brokerage houses). 21/ In recent years, S&P has expanded into a variety of product areas including technical charting services (Trendline), mutual fund management (S&P/Inter-Capital) 22/, commercial paper ratings, computerized financial data bases (COMPUSTAT) 23/, uniform security identification numbering system (CUSIP), municipal bond trading service (Blue List), and computerized business information service (COMPMARK).

21/ It is interesting to observe that the value of the service initially provided by the Standard Statistics Bureau was attributable not only to the fact that information not readily available was made more accessible, but also that it was contained in a convenient summarized format -- on separate cards for each company.

22/ This fund was recently sold to Dean Witter & Co.; however S&P has owned a broker-dealer firm, S&P Securities, since 1971.

23/ COMPUSTAT is produced by Investors Management Sciences, Inc., a wholly owned subsidiary of S&P. S&P's other major wholly owned subsidiary is its Government Services Corporation, which applies statistical, financial and related expertise to the needs of government and governmental agencies.

While S&P is undoubtedly best known for its composite stock market averages , "yellow sheets," and bond ratings, the company currently produces 30 different services. Following is a brief description of each, in alphabetical order.

American Stock Exchange, New York Stock Exchange and Over-the-Counter Stock Reports */ consist of two-page "yellow sheet" reports, available in loose-leaf ring binders or in three permanently bound volumes issued quarterly. Revisions to the loose-leaf service are issued two days a week. Each report consists of a summary analysis of the company's activities and its financial results, including extensive statistics on earnings and dividends records, history and capitalization, and S&P's assessment of its position. Reports are revised approximately quarterly, or more often as required by significant changes. Cost: Amex and OTC - $410; NYSE - $485.

Analysts Handbook provides composite corporate per share data for the S&P 425 Industrials and 78 industries, 1946 to date. The book is published annually with monthly supplements. Cost: $250.

Blue List reports every business day (approximately 250 issues per year) information concerning publicly-offered municipal and corporate bonds and contains the offerings of

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*/ Indicates publication(s) will be discussed in more detail below.

approximately 750 advertisers. Copies of the Blue List are printed each night in New York City and distributed by mail and courier delivery services throughout the United States. The service is also available in machine-readable mode. Available on daily or weekly basis.

Bond Guide is a 192-page monthly pocket guide containing comprehensive data on over 4,500 domestic and Canadian corporate bonds, 620 convertibles, 200 foreign bonds, and S&P quality ratings on 5,000 state, municipal, general obligation and revenue bonds. Cost: $58 per year. Similar publications exist for municipal bonds and stocks (all NYSE and Amex, selected OTC).

Called Bond Record reports bond and preferred stock calls, sinking fund proposals, definitive securities, defaulted bond data, and income bond interest payments, including serial numbers. A calendar shows forthcoming redemptions. Published semi-weekly, with weekly and quarterly cumulative supplements, it is completely indexed. Cost: $115.

Commercial Paper Reports presents two and three page reports on the credit standings of leading issuers on the commercial paper market (most issuers have contracted for inclusion, but some have not). Included are a company description, analysis of current operations and statistical data; important ratios, available bank credit lines, latest balance sheet and a five-year performance record. Cost: $450.

COMPMARK Data Services is a data bank containing the name, address and up to 12 key marketing facts about the organization, including a listing by rank and function of executives responsible for vital areas of the business. The file contains information on 37,000 corporations, 390,000 executives, and includes 75,000 executive profile biographies. Data is retrievable by type of business (S.I.C. Number), by size of business (sales, volume, and number of employees), and by geographic location (national, city, state, zip or telephone codes). Data is made available in a variety of formats, including data sheets, mail promotion labels, cards and magnetic tape. The data is also used for market research surveys and for targeting market promotion programs.

Corporation Records is a basic reference source, in six alphabetically arranged loose-leaf binders. Detailed information is included on about 6,000 of the largest corporations; somewhat less information on about 1,600 corporations; and abbreviated descriptions of about 4,000 smaller companies. Each company report is revised at least once annually, following issuance of the company's annual report, more frequently if circumstances require. In addition, latest developments are reported five days a week in a free-standing Daily News Section which may be purchased separately. Cost for the combined service: $795.

CUSIP Services encompass five products. A two volume Master Directory lists alphanumerically the CUSIP numbers and

descriptions for over one million issues of 55,000 issuers (corporate, U.S. Government, municipalities and foreign government. The Corporate Directory provides similar information for corporate issuers only. A Digest of Changes in CUSIP, issued every 10 days, notifies subscribers of changes in CUSIP since the previous issue. The Directory of User Numbers lists all available CUSIP user numbers, i.e., numbers reserved for assignment by users to securities not qualified for official CUSIP identification. Finally, a Conversion Service Bureau assists users in converting securities files to CUSIP numbers.

Daily Stock Price Records are three sets of volumes published quarterly, one set each for the NYSE, Amex and OTC markets, showing daily prices for a three month period on over 5,600 issues. Each pricing page shows high, low and close of stocks traded; bid and asked prices for non-traded securities; daily and weekly volumes; ticker symbols; shares outstanding; dividend information; earnings for the most recently reported four quarters; short interest position; and insider transactions. Also includes a weekly relative strength ratio and a 30-week moving average price; all S&P averages and Dow Jones averages; advance-decline line; broker balances, and Barron's low price stock index. Cost: NYSE - $100; Amex - $85; OTC - $110.

Directory of Bond Agents identifies the paying agent, registrar, co-registrar, trustee and conversion agent of over 20,000 publicly held bonds. Also included are the full title of each issue, state of incorporation, form of bond and exchange fee. Updated by bi-monthly supplements. Cost: $180.

Dividend Record lists dividend actions, in both cash and stock, on both common and preferred stocks, aggregating over 9,800 issues. Included are: amount of dividend, declaration date, ex-dividend date, stock record date, payment date of rights, advance notice of dividend meetings and tax status of dividends. Available on a (5-day) daily, or cumulative weekly or quarterly basis, and annually. Cost: $180.

Earnings Forecaster, */ published weekly, contains earnings estimates on approximately 1,600 companies prepared by analysts from about 50 brokerage houses (identified only by employer) and about 1,100 S&P estimates (company estimates are included when available, but are rare). The publication is updated weekly and, for each company included, shows source of estimate; per share earnings for past full year and, where possible, for the next year; date of estimate; and price/earnings ratio. Where appropriate, figures are reported in ranges or, by notation, as fully diluted. Cost: $200.

Fixed Income Investor is a weekly market letter of summary and analysis of developments in the debt securities markets (including all types of bonds, commercial paper and preferred stocks). In addition to recommendations, articles include a monthly economic forecast and reviews of U.S. Treasury financings. A monthly convertible bonds statistical analysis provides 22 columns of data for each issue. Cost: $295.

Industry Surveys provides weekly economic and investment analysis of more than 50 industries under 36 headings, together with almost 1,500 of their constituent companies in the U.S. and Canada. Subscribers receive an annual basic survey and three current surveys during the year on each industry, plus a monthly section that forecasts industry and economic trends. Cost: $360.

International Stock Report analyzes and expresses opinions on over 65 foreign securities. Includes Great Britain, Germany, and other European securities, Japan, South Africa, and Australia, but not Canada. Cost: $52.

The Outlook is a weekly market letter containing commentary, industry and company appraisals, a master list of recommended issues and statistical data, including S&P investment policy. Cost: $110.

Poor's Register of Corporations, Directors and Executives is a three-volume, 4,300 page bound set listing executive personnel consisting of: (1) an alphabetical corporate section listing about 37,000 public and privately-owned corporations and containing names of approximately 390,000 corporate officials; (2) an alphabetical listing section containing brief biographies of 75,000 officers and directors of these corporations; and (3) S.I.C. index and codes, geographical index and other data. Cost: $150.

Ratio Index Services are a variety of statistical reports on the S&P indexes broken down by: (1) Industry Group Indexes and relative strength; (2) Industry Group Market Values; and (3) Market Value of the component stocks in the S&P 500.

Registered Bond Interest Record in a weekly record of interest payments on about 5,900 registered corporate bonds, listed U.S. and foreign government registered bonds, and daily registered bond interest calendars showing payment and date payable, city of transfer and advance notice of out-of-town transfers. Cost: $360.

Review of Securities Regulation is a semi-monthly newsletter containing contributed articles analyzing developments in securities regulation. Cost: $140.

Security Dealers of North America lists 9,600 brokers, dealers, investment bankers, including branch offices, operating in the U.S., Canada, Mexico and overseas, including an executive roster of over 45,000 individuals. Cost: $48.

Stock Summary is a monthly digest of information on over 1,920 actively traded stocks, including all NYSE, and selected Amex, regional exchange and OTC issues. Among the 40 columns of information included are S&P earnings and dividend rankings, price/earnings ratio, earnings trend, 5-year growth rate percentage, price change in past 6 months, institutional holdings, earnings per share, dividends and capitalization. Cost: $12.

Transportation Service includes a number of different publications. The Weekly Transportation Outlook covers railroad, airline and trucking securities; Earnings Forecastors for each major railroad; Equipment Trust Bulletins; Freight Commodity Statistics; Guaranteed Stock Bulletins; Airlines, Trucking and Railroad Industry Survey; Railroad Operating Results; Efficiency Factors Bulletin; Wage Statistics; Road and Equipment Bulletin; and Financial Summary Bulletin. Cost: $1,500 complete.

Trendline Publications publishes Daily Basis Stock Charts (market action charts) on 744 NYSE and Amex stocks

plotted daily and issued weekly; Current Market Perspective, a monthly book of charts on 972 issues showing average weekly high, low, close and pertinent statistics; OTC Chart Manual, covering 840 actively traded OTC stocks; and a 202-page book, which describes classic chart patterns and how to interpret them.

The information services produced by S&P have gained acceptance for one of three reasons. First, some of the services are one of the few, if not the only, comprehensive source of information in existence on the subject.[24/] Second, other services provide data for highly specialized users.[25/] Third, still others provide summaries of vast amounts of data in convenient, usable format.[26/]

An excellent example of the last approach, and one of the information sources most frequently seen by investors,

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24/ Cf. Corporation Records; Poor's Register of Corporations, Directors and Executives.

25/ Dividend Record; Registered Bond Interest Record; etc.

26/ Stock Guide; Standard NYSE Stock Reports. To some degree, all disseminators define markets and attempt to fill users' needs in this manner. The extent to which they are able to do so, and, in addition, develop new products using essentially the same data base, is usually a measure of their financial success.

are the stock exchange and over-the-counter stock reports,[27/] the "yellow sheets." While these services were originally intended to provide brief, concise resumes for reference purposes, their widespread use is the result of a practice not foreseen -- the common broker's habit of providing copies to customers.[28/]

The general format of the "yellow sheets," developed informally over a period of years, is rigidly adhered to. It is always two pages and always contains the following information:

A. Front Page

1. Name of the company;

2. Ticker symbol, with footnote reference to trading markets;

3. If options are listed, trading market(s);

4. For each common stock outstanding, a recent price; price/earnings ratio (usually based on the latest

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27/ Standard NYSE Stock Reports; American Exchange Stock Reports; Over-the-Counter Stock Reports.

28/ S&P markets multiple copies of the "yellow sheets" to broker-dealers for distribution by their registered representatives. Their distribution is no doubt facilitated by the fact that the evaluation of the stock is prepared by a firm other than the registered representative's employer.

12 months earnings); annual dividend (actual or indicated rate with reference to any stock dividends); and yield (with footnote reference to any adjustments made in calculation);

5. A summary of 3-5 lines identifying primary industries and short and longer term earnings prospects; 29/

6. A graph charting the stock price against the S&P 500 for the last 5 years (adjusted for stock splits, if any), showing price range for the 5 years previous to that, and showing trading volume for the last 5 years;

7. A table showing common share earnings, by quarter, for the last five years;

8. A two or three paragraph opinion on the near and long term prospects for the company; these attempt to relate the company to its market and industry shares, noting construction plans, etc. where appropriate;

9. A briefer summary of recent developments, usually of recently announced construction plans, contract awards, etc; and

10. Dividend data for the last 12 months showing in tabular form, for each cash and stock dividend (adjusted for splits where necessary), the amount of the dividend, declaration date, ex-dividend date, record date and payment date.

29/ Until recent years, the summary also included statements which could be interpreted as a recommendation.

B. Reverse Page

11. In tabular form, the following income statistics and per share data for the last eleven years: net sales; operating income as a percentage of sales; operating income; depreciation and/or depletion; net income before taxes; net income; earnings per share; dividends per share; price range; and price/earnings ratio calculated on the stock's high and low for the year; */

12. In tabular form, the following selected balance sheet statistics for the past eleven years: gross plant and property; capital expenditures; cash items; inventories; receivables; current assets and liabilities; net working capital; current ratio; long term debt; shareholders' equity; book value per common share; */

13. A 5-8 paragraph description of the company's fundamental position, including major products and percentage of sales accounted for by each with an indication of percentage of foreign sales, capacity for major products, major natural resources, etc. This section concludes with number of employees and shareholders;

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*/ Figures in both of these categories are footnoted for major adjustments such as change of depreciation, stock splits or dividends, change in accounting for receivables, etc.

14. A one or two paragraph description of capital spending and capital raising plans;

15. A description of basic capitalization; and

16. At the bottom of each reverse page: state and year of incorporation; address and telephone number of major office; names of chief executive officer(s) and directors; transfer agent and registrar.

It is difficult to dispute S&P's contention that, while the "yellow sheets" obviously do not provide all the information an investor should have or review prior to making an investment decision, they are remarkably successful in presenting a broad cross-section of basic data that provides the investor with a good "snapshot" of the company, its operations, and overall financial condition.

Although the "yellow sheets" are probably the best known, commonly used S&P product, they are not the most widely distributed. That honor is reserved for the Stock Guide, a monthly handbook of about 300 pages that presents 44 columns of data on over 5,000 common and preferred stocks. The Stock Guide is purchased primarily by broker-dealers for distribution to their registered representatives, for whom it is a ready reference source.

The heart of the Stock Guide is the tables on individual stocks containing data on major trading markets, S&P's

earnings and dividend rankings, institutional holding, description of principal business; price ranges of the stock; yield; price/earnings ratio; dividend information; basic financial position and capitalization; earnings record; and interim earnings or remarks.

Also included as regular features of the Stock Guide are:

1. A two-page summary of economic and market trends, usually focusing on current developments in one industry or segment thereof;

2. Two pages of charts showing price movements of major industry groupings;

3. Two pages of charts and/or tables showing trends in selected leading economic indicators, such as gross national product, corporate profits, industrial production, employment/unemployment, etc.;

4. One page of S&P quality ratings of selected utility preferred stocks;

5. A section summarizing basic data on mutual funds in the same tabular manner as is done for stocks;

6. Four pages of graphs and tables showing 12 years of figures for leading economic indicators; and

7. A one page table showing weekly stock price indices, by major industrial groupings, for each of the last five weeks and the highs and lows for the current year.

Particularly pertinent to the Advisory Committee's work were the methods used by S&P, indeed all disseminators, in selecting the specific date items presented in any particular publication. In virtually all cases, these decisions were represented to be matters of editorial judgment based upon the experience of editors and their staffs and, in some cases, user feedback. In many instances, formats were being used that had been involved with initial creation of the format. Accordingly, no conclusions respecting these questions could be drawn.

A final S&P publication of special interest to the Advisory Committee was the Earnings Forecaster. This publication lists, for the approximately 1,600 companies concerning which an estimate has been made, either by an S&P analyst or an outside, participating analyst:

1. The name of the company and its fiscal year, under which appears the source (by firm) of the estimate (company estimates are included if available);

2. A recent market price;

3. Date as of which the estimate was made;

4. Price/earnings ratio, based on consensus of primary or fully diluted earnings estimates;

5. Actual earnings for the previous year and estimate for the current, and, if available, for the following year.

Despite what would appear to be the apparent value of this publication, S&P stated that they do not consider the

Earnings Forecaster to be particularly successful and were unable to determine why this was so.

As might be expected for an organization publishing such a wide variety of information services S&P's sources of information are extremely diverse. They include most companies' prepared filings; exchange listing applications; press releases; Reuters, Dow Jones and Associated Press wire sevices; The Wall Street Journal and other newspapers, from which an extensive clipping file is maintained; bulletins distributed by the self-regulatory organizations; and, for more specialized information, Vickers Service (mutual funds), A.M. Best Company (insurance), and other S&P publications.

S&P also obtains other information, directly from companies, pursuant to any rating of debt that it may undertake.

D. Constraints Upon Information Dissemination

Aside from the overall limitation of space, most of the constraints operating upon disseminators of information are more or less self-imposed or not relevant to the work of the Commission in administering the corporate disclosure system. This is so because disseminators function in a framework which, while deriving from and overlapping the Commission's disclosure system to a substantial extent, in essence is parallel to, rather than congruent with, that system.

Although the questionnaire for information disseminators did not include a specific question concerning restraints upon dissemination, participants were invited to make suggestions as to how procedures might be improved and, in the course of their interviews, the staff attempted to elicit comments in this area.

The consensus of opinion was that any constraints upon disseminators were not the result of Commission procedures or subject to remedy by the Commission. For example, the most frequently mentioned problem was the growth of publicly available information, a development concerning which disseminators had decidedly mixed feelings. Most believed that the increasing volume of information enhanced the attractiveness of their products, while at the same time making their operations more costly and difficult.

The most commonly cited problem about which the Commission might have some influence was the difficulty many disseminators expressed in obtaining publicly filed documents directly from the entire spectrum of companies they followed. Although they were not able to document the feeling, it was suggested that the largest, most widely held public companies were somewhat more sophisticated in dealing with this problem, but that it was not confined to smaller companies. Accordingly, many disseminators suggested that the Commission adopt a rule or express a policy that registered and reporting companies be required or encouraged to provide public filings

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directly to disseminators on a continuous basis and without cost. This posture was justified, in the disseminators' view, because of the service they fulfill in transmitting information to other, more diverse, users.

No disseminator participating in the case study expressed a concern respecting liability problems.

E. CONCLUSION: The Role of Information Disseminators

The number and variety of services provided by information disseminators make it difficult to pinpoint those functions that are of greater importance than others to the operation of the corporate disclosure system. Indeed, the number and variety constitute one of the more important strengths, permitting diversity of opinion, enhancing competition and contributing to the overall efficiency of the marketplace. 30/

Disseminators of financial information are a distinct, complementary and essential component of the corporate disclosure system, performing two important functions. The first function of information disseminators is to provide a means by which potential investment information can be preliminarily evaluated as to importance. The

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30/ The importance of diversity and competition are most easily seen upon examination of the history of the municipal bond rating organizations. See The Rating Game, Report of the Twentieth Century Task Force on Municipal Bond Credit Ratings (1974), esp. 51-83 and 143-51.

end result is simple: Items considered important are communicated to users; those not considered important are not communicated. However, the ranking or selection of information to be communicated to users is a highly subjective process and occurs on a number of levels. For these reasons, its consequences, both positive and negative, are difficult to evaluate.

Ranking or selection is required essentially because all disseminators obtain or receive far more information than they can communicate to users. Since even highly specialized disseminators operate within a limited space, judgments as to what information shall be communicated are necessary. Some reasonably objective criteria can be established to facilitate the decision-making process. Explicit guidelines on company size may be developed, as is the case with most daily newspapers, although they are always subject to being overridden as circumstances dictate. If there is sufficient information and interest, areas of specialized coverage or development of new publications may occur. One of the consequences of this process which is clearly beneficial is the creation of a wide variety, both as to cost and type, of information sources for users.

The first level of ranking or selection that is most pertinent to the corporate disclosure system concerns the

line that must be drawn concerning the universe of companies to be covered. As was noted initially in this chapter, a chief impetus for interest in financial disseminators has been the reputed inability of smaller companies, i.e., those with smaller market values and, usually, lesser numbers of shareholders, to obtain adequate dissemination of current developments. Because of the lack of empirical data, it is impossible to draw definitive conclusions concerning this problem. Certainly it is true that companies outside the Fortune 500, or the New York and American Stock Exchange lists, in most cases, will not obtain news coverage of current developments in nationally circulated newspapers. However, there are indications that information of this type is disseminated by more specialized financial disseminators, by security analysts and by marketmakers.

However, because each disseminator makes its own judgments as to where the line should be drawn, and because even within predefined categories there is some constant turnover, it appears that, in the aggregate, all but the smallest companies, e.g., those with market values in excess of $75 million, obtain, directly or indirectly, sufficient dissemination of material information.

A second level of selection or ranking performed by disseminators concerns which firm-oriented information shall be communicated by disseminators and which shall not.

The second function of the information disseminators is to develop formats for presentation of data. It appears that, to varying degrees, disseminators have been successful in the communication of information. Thus, without the disseminators, the corporate disclosure system would be meaningless in a practical sense; there is virtually no other means by which the information generated by the SEC could be usefully communicated to users.

The conclusion that formatting, i.e., alternative methods for presentation of information, is a key function of disseminators is confirmed by several different findings, not the least of which is the opinion of the disseminators themselves. In response to the Committee's questionnaire, no disseminator claimed that its product was more useful than others because it contained information that was not otherwise publicly available. All responded that the value of their product rested either on the method of presentation of the data or in the judgments underlying the selection of information presented.

CHAPTER V

THE ROLE OF THE REGISTERED REPRESENTATIVE

A. Introduction and Background

For a significant number of individual investors, much of the information that is produced by and transmitted through the disclosure system is personified in one individual: the registered representative. [1/] According to the most recent Commission estimate, there were approximately 72 thousand full-time registered representatives in the securities industry at the close of 1975, 30 percent of total industry employment. [2/] It appears likely that at least 20 percent of the

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1/ The term "registered representative" is used generically to include "account executives," "brokers," etc.

2/ 42d Annual Report of the Securities and Exchange Commission 180 (1976). It is clear, however, that not all of these are regularly engaged in the sale of securities to individual investors.

expenses incurred by the securities industry consists of compensation to registered representatives. 3/

This is not surprising. As the Report of the Special Study of Securities Markets put it:

> . . . the primary emphasis of the securities business still is, as it historically has been, on selling securities. 4/

The importance of sales, not merely to the industry and individual firms, but to the personal success of individuals within firms, was extensively examined in the Special Study and, in a much more limited context, in the Commission's subsequent Study of Unsafe and Unsound Practices of Brokers

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3/ Id. at 177. The Commission's summary report of revenues and expenses for broker-dealers with total revenue of $500,000 or more (764 firms) shows total expenses (including partners' compensation) of $5,955.3 million, of which $1,274.5 million consists of compensation to registered representatives.

4/ Report of the Special Study of Securities Markets of the Securities and Exchange Commission, H. R. Doc. No. 95, 88th Cong., 1st Sess. Pt. I 242 (1963). More specifically, the selling efforts of the industry are addressed to three basic objectives:

> [F]irst, to attract the funds of a potential investor to securities rather than to other forms of investment; next, to persuade the investor to execute his securities transactions through the facilities of a particular market or firms; and, finally, to induce him to purchase particular securities. Id. at 244.

and Dealers. This report noted that managerial personnel, whether at the branch or home office supervisory level, were selected on the basis of sales performance [5/] rather than on the basis of executive or administrative competence.

While it is clear that the registered representative plays an important role in the securities industry, the predominant purpose of which is to sell securities, it is also clear that the registered representative plays other roles within the industry, although it is substantially less certain what these roles are and how they are performed. For example, as part of, or in addition to, the direct selling process, registered representatives are asked and expected to perform "housekeeping services" such as giving stock quotations and resolving transfer and/or dividend problems, providing written information, recommending (or not recommending) particular securities, suggesting alternative investment vehicles and assisting in portfolio evaluation.

Because the registered representative is "often the customer's only contact with the securities industry," and because even sophisticated investors "may rely heavily on the advice of the securities salesman," [6/] it is appropriate to focus briefly on that portion of the registered representative's role having to do with dissemination of

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5/ Study of Unsafe and Unsound Practices of Brokers and Dealers, Report and Recommendations of the Securities and Exchange Commission (Pursuant to Sectin 11(h) of the Securities Investor Protection Act of 1970), H. R. Doc. No. 92-231, 92d Cong., 1st Sess. 18 (1971).

6/ Special Study, note 4 supra, at 252.

investment information to the public. The objective in this limited inquiry is to identify what types of investment information registered representatives provide to their customers, what the sources of that information are, and whether any conclusions may be drawn as to the relative utility of the information provided.

Preliminary Research Efforts. Preliminary to this effort, the Committee undertook (1) to determine what empirical evidence supported the widely-held belief concerning the dependence of many investors on registered representatives as information sources; (2) to assess generally the breadth of investment information sources consulted by registered representatives and provided to their customers.

With respect to the first matter, one empirical study was located that was directly on point. 7/ This was a 1973 survey of 1,423 common stock investors in the metropolitan Washington, D.C. area selected from the customer lists of five brokerage firms. Approximately half (851) of the questionnaires distributed were completed and returned. The questionnaire listed 33 factors used in investment analysis and selected socio-economic variables. Investors were instructed to indicate the relative importance of each factor on a scale ranging from 1 ("of no importance")

7/ Baker & Haslem, "Information Needs of Individual Investors," J. of Acc. 64 (Nov. 1973).

to 5 ("of maximum importance"). In addition, 12 "investor profile" questions were included to permit cross-correlation of the responses. One of these questions was:

10. In general where do you get the information you use in making investment decisions? (Please select 3 statements and rank the most important with number 1, the next most important number 2, etc.).

_____	Friends and/or relatives	_____	Tips and rumors
_____	Stockbrokers	_____	Financial statements
_____	Advisory services		
_____	Newspapers	_____	Other (please list)
_____	Magazines		

_____

_____

The responses showed the following ranking:

Stockbrokers	46.8%
Advisory Services	15.6
Newspapers	11.3
Friends and/or relatives	9.7
Financial Statements	7.9
Magazines	3.5
Tips and rumors	0.4
Other (annual reports, prospectuses and company management)	4.8
	100.0% 8/

8/ Compare the Advisory Committee's finding that only 15% of the investors it surveyed rely primarily on their broker. Chapter VI, Table 7, at 284.

In order to obtain some indication as to the breadth of informational resources registered representatives provide to their customers, members of the staff visited the offices of four Washington, D.C. brokerage firms. 9/

There were substantial differences among the sampled firms with respect to the amount, frequency and source of investment information provided to retail customers. One firm prepared and provided to its registered representatives for distribution to customers a wide variety of market letters, research reports and other informational services. Another firm reported that it conducted no independent research, and instead purchased research reports on a wholesale basis for distribution to customers. There were also substantial differences among the firms concerning the latitude permitted to registered representatives in pursuing investment information outside the firm and, indeed, the research materials made available within the firm.

In view of the limited nature of the data available, the Committee concluded that a broadly-based survey of registered representatives would be desirable. Inquiry was made of the Securities Industry Association to determine whether it would be willing to conduct a survey for the Committee.

9/ The staff interviewed personnel of the local office of two large, national full-line firms, one regional full-line firm and one commission firm.

B. The Securities Industry Association Survey of Registered Representatives

In discussions with the Securities Industry Association ("SIA"), the objectives of the proposed survey were identified as follows: (1) identification of the types and format of investment information provided by registered representatives to their customers; (2) determination of the sources of investment information provided, i.e., firm-prepared or externally-prepared information and, insofar as possible, determination of the reasons for using various sources of information; (3) candid assessments by registered representatives of the usefulness of the investment information available to them and provided to customers; (4) identification of the range of services provided by registered representatives to their customers; and (5) ascertainment of changes in the disclosure system which the registered representatives believe would improve the system for small, individual investors.

To enhance the overall utility of the survey and to provide maximum incentives for candid replies by the registered representatives, certain precautionary measures were agreed to. Selection of the particular firms through whom questionnaires were distributed was the responsibility of the SIA and names of the particular firms would not be disclosed to the Committee or its staff. The only qualification was that the sample of firms selected be representative of the industry generally with respect to size, geographic

location and range of services provided. Moreover, the questionnaire did not require identification either of the particular respondent or his firm, although the questionnaires were coded to indicate the size of the firm. Finally, although the questionnaires were distributed through supervisory personnel of selected firms, the completed questionnaires were returned directly to the SIA, and only aggregated data was reported to the Committee. The sole exception in this regard concerned Question No. 19, in which registered representatives were invited to list five suggestions for improvement of the disclosure system for small, individual investors; in this case, replies were compiled by the SIA individually, apart from the questionnaires, and provided directly to the Advisory Committee.

Development of the Questionnaire and Sample. The actual questions were developed jointly by the staffs of the Advisory Committee and the SIA. Special efforts were made to draft questions that were objective, required little or no reference to other materials, and could be answered with minimum burden on potential respondents. Moreover, in order to determine whether the actual respondents as a group were representative of other

surveys of registered representatives, three questions [10/] were included that had been developed in connection with a previous

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10/ Technimetrics, Inc., A Study of Registered Representatives' Attitudes Toward Corporate Communications (1975). The specific questions and responses, noted below, indicate that the two groups, though not identical, were remarkably similar.

A Comparison of the Results of Three Test Questions Used in the Survey of Registered Representatives by the Securities Industry Assocation (1976) and in a Survey of Registered Representatives Conducted by Technimetrics, Inc. (1975).

QUESTION	SIA	Technimetrics
1. How long have you been a RR?		
0 - 2 years	9 %	6.8 %
2 - 5 years	12	20.8
5 - 10 years	31	33.4
over 10 years	48	38.8
2. How frequently do you do your own research to help customers arrive at investment decisions:		
often	50 %	59.3 %
occasionally	37	31.7
rarely	12	8.9
never	1	0.1
3. In what percentage of transactions do you actually make a recommendation to the account?		
under 25%	8 %	5.9 %
25 - 50 %	21	18.5
50 - 75%	35	38.2
over 75%	36	37.1

survey. The final questionnaire including tabulated results is included as Appendix V-A.

The questionnaire was distributed through 33 broker-dealer firms and submitted to an average of 21 registered representatives in each firm. Of the firms participating, 10 were national and 23 regional. The regional firms were further classified as large or small; a firm was considered "large" if it had more than $10 million in annual revenue and "small" if it had less than $10 million in annual revenue. The regional firms were also classified geographically: 8 were from the Northeast; 5 from the South; 8 from the Midwest; and 2 from the West. The registered representatives were selected to provide a cross section based on experience, geography, and revenues generated. Of the 697 questionnaires distributed, 495 were returned to the SIA, a response rate of 71 percent.

Summary of Responses to Objective Questions. 11/ The registered representatives ("RRs") who responded to the questionnaire are experienced and well-educated. Over three-quarters (79%) have been RRs for over five years and almost one-half (48%) for over 10 years. (Q. 1) */ Almost half (43%) are college graduates, and a substantial portion of these (59%) have also taken some post-graduate courses. (Q. 2)

11/ A tabulation of the 18 objective questions, by actual number of responses and percentage breakdown, appears as Appendix V-A. The Summary Report of the SIA appears as Appendix V-B.

*/ Denotes question from which data derived.

The RRs believe their customers to be fairly knowledgeable, reporting that more than one-third (35%) have a great amount of knowledge about securities and that almost one-half (49%) have some knowledge. (Q. 16) However, their customer accounts are relatively inactive. More than one-half, (57%) of the accounts, have 10 or fewer transactions per year, while only one-fifth (20%) have more than 20 transactions per year. (Q. 17)

The service most frequently provided by RRs is recommending particular stocks (83% do this most often) although this is closely followed by providing "housekeeping services," such as giving stock quotes, handling dividend or transfer problems, etc. (80%). Next in order of frequency are suggesting alternative investment vehicles (62%) and evaluating clients' portfolios (51%). The least frequently provided service is furnishing written information on how to invest (33%). (Q. 3)

With respect to the frequency of recommendations, the RRs reported that almost three-quarters (71%) make a recommendation at least half the time and virtually all (92%) do so at least one-quarter of the time. (Q. 18)

Surprisingly, more than three-quarters (87%) are permitted by their firms to recommend stocks not carried on their firm's recommended list (Q. 11) and most of their total sales involve securities <u>not</u> carried on their firm's recommended list. (Q. 8) Half (50%) of the RRs said that they often do their own research to help customers arrive at investment decisions. (Q. 13)

Of those firms with recommended lists (92%) (Q. 5), three-quarters (75%) contain 100 or fewer stocks and almost all (90%) contain fewer than 200 stocks. (Q. 7)

Not surprisingly, the surveyed RRs consider their own firm's research reports as the most useful source of information on specific stocks (64% rated them "very useful"), while SEC-filed documents are considered the least useful (42% rated "not useful at all"). (Q. 14) The financial wire services, such as Dow Jones' "broad tape" and Reuters, are considered the most timely source of information (72% rated them "very useful") and the least timely are SEC-filed documents (44% rated them "not useful at all"). (Q. 15)

When a customer inquires about a stock carried on the firm's recommended list, he is most likely to receive a report prepared by the RRs' firm; he is least likely to receive SEC-filed documents. (Q. 6, 9 and 12) A ranking of the use of investment information sources -- for securities on a firm's recommended list, for securities not on the recommended list, and when the inquiry is initiated by the customer -- appears in Table V-B, below.

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HOW OFTEN DO YOU SEND AN ACCOUNT THE FOLLOWING INFORMATION

CHART A

Source: SIA Survey of Registered Representatives

	For securities on your firm's recommended list? (Ques. 6)		For securities not on your firm's recommended list? (Ques. 12)		When an inquiry about a security is initiated by a customer? (Ques. 9)	
	"Often"	"Often" "Occasionally"	"Often"	"Often" "Occasionally"	"Often"	"Often" "Occasionally"
A report prepared by the firm	51%	92%	N/A	N/A	66%	92%
A report prepared by an outside source	17	62	40	88	42	80
An article from the trade and/or financial press	26	79	28	80	28	77
An annual report of the company	5	41	12	56	16	51
SEC filed documents	1	14	2	15	4	18

Slightly more than half of the RRs' accounts request a prospectus prior to indicating interest in a new issue: 54% "often" or "occasionally" do so, while 46% "rarely" or "never" do so.

Summary of Responses to Subjective Question. The final question on the SIA survey, No. 19, invited registered representatives to specify, on a separate sheet of paper and without identifying themselves, the five most important steps that the Securities and Exchange Commission could take to improve disclosure for small, individual investors. The SIA received approximately 280 responses to this invitation, although not all respondents made five suggestions or five different suggestions. 12/

Because of the diversity and generality of the suggestions, it is impossible to precisely tabulate and categorize them. Reproduced below, however, is a ranking of all suggestions and/or comments, by actual number and percentage, that were identified by at least three respondents.

12/ A compilation of the responses to Question No. 19, as retyped by the SIA, appears as Appendix V-C.

Tabulated Responses to SIA Survey of RRs, Question No. 19: "On a separate piece of paper and without in any way identifying yourself or your firm, please specify the five most important steps the Securities and Exchange Commission could take to improve disclosure for small individual investors?" */

SUGGESTION/COMMENT	ACTUAL	PERCENT
1. Simplify disclosure documents	93	33.2 %
2. Faster, more complete disclosure of insider trading	68	24.2
3. Simpler, more uniform accounting information	56	20.0
4. Faster, more equal disclosure and dissemination of company announcements	42	15.0
5. More educational programs and literature from SEC, stock exchanges, NASD, broker-dealers	41	14.9
6. Increased forward-looking information	33	11.7
7. More vigorous enforcement program, including earlier disclosure of investigations	33	11.7
8. Better training of RRs, including change from commission system	29	10.3
9. SEC filings easier to obtain, including mandatory furnishing of 10-Ks to stockholders, others	27	9.6

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*/ Base = 280 responses

Tabulation (cont.)

SUGGESTION/COMMENT	ACTUAL	PERCENT
10. More disclosure of institutional holdings and trading	23	8.2
11. Reduce commission rates for small investors; revive fixed commissions	20	7.1
12. Disclosure adequate; SEC has done a good job	19	6.7
13. Equal, stricter regulation of banks, mutual funds, investment advisers	18	6.4
14. Same quality research to individuals as to institutions	14	5.0
15. More thorough distribution of company reports to nominee accounts	14	5.0
16. Stricter regulation of specialists and disclosure of their trading	11	3.9
17. [Other comments/suggestions with less than 10 actual respondents:]		
More line of business information	9	
More industry data in filings	6	
Better reporting by financial press	5	
SEC done enough damage already	5	
Clarify meaning of composite tape, margin accounts, terminology	4	
Provide more economic incentive (i.e., eliminate double taxation of dividends)	3	
Limit broker-dealer advertising	3	
Greater protection of stockholders' rights by SEC	3	

Analysis of Survey Results. Although the empirical evidence is neither extensive nor conclusive, it does support the widely held belief that the registered representative plays a crucial role in the service of the individual investor. Indeed, one of the more striking findings of the SIA survey is the breadth of services that registered representatives are asked to provide. The constant changing of roles as the representative responds to one customer after another may account for the uneasiness expressed by some in the SIA survey with respect to the overall quality of services provided. 13/

13/ A few of the surveyed representatives expressed harsh criticism about the "professionalism" of their co-workers in the following words:

> Broker professionalism and integrity; i.e., strict criteria for new brokers, qualify old salesmen who have never been upgraded to current standards (there are a lot of them.).
>
> Employment standards and meaningful certification of RR's qualification plus mandatory periodic recertifications. Let's face it, some of us are pretty dumb.
>
> Completely revise the licensing processing for RR's. It is nothing less than a disgrace that those entrusted to act as financial advisors to the public are required to have so little preparation for their profession. New standards of education and training should be adopted. At present the small investor receives completely inadequate information because of low professional standards in the industry.

Despite the [illegible] that registered representatives spend a significant portion of their time servicing accounts (in the narrow sense, i.e., providing "housekeeping" services), it is clear that they consider themselves, and are considered by their customers, to be a major source of investment information.[14/] More specifically, although representatives are occasionally called upon to furnish written information on how to invest, and somewhat more frequently are asked to evaluate portfolios and suggest alternative investment vehicles, their most frequent activity is recommending particular stocks. How well are they equipped to do so?

In making recommendations, the registered representative commonly draws upon all of the many research and information sources available to him. Routinely, this will include more or less formal "research reports," whether pre-

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14/ The feeling was not unanimous, however. One representative felt that brokerage houses should be forced "to justify and stand behind their recommendations." Another thought that brokers should be required to "have available to clients an easily readable research report before recommending a particular issue." Still a third suggested that the initial "buy" recommendation was not enough:

> I think that the most important area is the quality of research by the brokerage firm itself. Initial "buy" recommendations should be thoroughly researched and thoroughly followed up until a change in rating is made. (Emphasis in original.)

A fourth representative noted that "recommended" does not necessarily mean "recommended for all purchasers":

> Need better control over RR as to "suitability" of investment for customer. A firm can have a Recommended List but that does not mean that all the stocks on the list are suitable for all customers.

pared by his employing firm, another brokerage house, or "independent" research sources, as well as current news developments from company materials, trade publications and the news media.

By and large, representatives felt comfortable making recommendations based on reports prepared "in house." But, according to the SIA survey, most of the representatives' total sales do not come from their firms' recommended list. 15/ The survey disclosed that, for 40% of those

15/ This may be because most brokerage firms prepa[illegible] on only a small fraction of the companies hav[illegible] ties outstanding and publicly traded.

In order to place a broad gauge on wh[illegible] fraction might be, the staff of the Ad[illegible] quested that 100 firms doing predom[illegible] securities business forward their r[illegible] distributed closest to the date of ma[illegible] mately 65 firms responded, 20 of [illegible] had no recommended list. The ba[illegible] mmended lists, lists of securities resea[illegible] other written information. Responding firms were classified as New York or non-New York based [illegible] corresponding with the classification made by the Financial Analysts Federation in its survey conducted for the Committee) and the lists were aggregated in order to determine how many companies would be noted and how frequently.

From the data gathered, it appears that no more than 2200 of the 10,000 public companies are noted. It also appears that approximately one-third of these 2200 companies are noted by only one of the respondent firms and approximately an additional one-third by no more than five of the firms. Thus, although more definite conclusions must await a more empirical analysis, preliminary indications are that the best supported representatives will be able to readily obtain research "reports" on a universe of about 700-800 public companies. The tabulation appears as Appendix V-D.

It is important to emphasize that the number "700-800" as an "average" is to some extent arbitrary and misleading. Employees of Merrill Lynch, for example, can obtain current research on far more than this number of securities within minutes. Employees of most other firms, however, would not easily be able to obtain such research on more than a small fraction of this number.

responding, three out of four of their sales were of securities not on the recommended list and for 69% of the respondents, up to one-half were not on the list. The survey also found that 87% of the representatives were permitted to make recommendations of securities not on their firms' recommended list and that 71% of them made recommendations respecting such stocks in at least half of the transactions they placed. 16/

While it was not possible to document how persuasive an RR's recommendation to an individual investor may be, certainly the frequency with which the RR is asked to recommend particular stocks raises the inference that investors believe it to have some value. A critical question, therefore, is how the RR is able to recommend securities not on his firm's list.

One-half of the surveyed RRs reported that they frequently performed their own research to help customers arrive at investment decisions and, presumably, a large portion of this effort was devoted to stocks not on their own firms' recommended list. The suggestions submitted by RRs in response to Question No. 19 of the SIA survey indicate that some undetermined number, while definitely a minority,

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16/ In view of the economic importance of this practice, it is surprising that it drew any adverse comment at all, but it did. One representative said that brokers should be required "to justify substantial purchases of stocks not currently on recommended lists." Another was more blunt: "Investigate pushing of unknown OTC Securities." He also thought that small investors should be educated "on danger of local stocks with no market - no following - no interest."

apparently do consult primary information sources in conducting their research. Moreover, while other RRs strongly indicated that various information sources were too complex and not easily understood, this group of RRs indicated that not enough information was available, that some of it was not sufficiently detailed and that whatever is available is not comparable.

Thus, for example, some of these RRs complained about the lack of comparability of financial information between companies in the same industry, an observation that generally would not likely be made by persons who had not tried to make comparisons. 17/ Other RRs felt that there was insufficient detail concerning lines of business and competition. Still others thought that more of the 10-K information should be required to be included in the annual report to shareholders. Perhaps the most representative single comment of this type was the following:

> Disclosure is adequate now, in my opinion. I hesitate to suggest additional requirements to be placed on corporate executives who are already now spending a large part of their time fulfilling government paperwork requirements. I do like to be able to obtain the following from corporate annual/quarterly reports:
>
> 1) Major lines of business and executive comments, outlook for each one for the foreseeable future;
>
> 2) Major stockholders and significant changes over the reporting period;

17/ This observation is also frequently made by analysts. To what degree the representatives' complaint is merely an echo is, of course, impossible to determine.

3) Five years of financial history -- with chart showing price action (at least by months) of the stock over that period of time;

4) Discussion of corporate direction and philosophy by the chief executive officer(s);

5) Conspicuous reference to accounting practices with regard to R&D expenses, inventory valuation, depreciation, and treatment of installment sales and sales to dealers where the possibility of reversal exists.

In addition, a not insignificant number of RRs suggested that the Commission permit or, in some instances, require future-oriented information, both within and without the context of SEC-filed documents. 18/ The following comments are illustrative:

> Allow a corporate entity to do some restricted forecasting in: 1) Annual reports; 2) Prospectuses; 3) 10-Ks; 4) 10-Qs.
>
> Allow companies to make good faith statements without being subject to liability if future events prove them wrong.
>
> In new offerings prospectuses, the SEC should permit a reasonable earnings projection of a company's five-year sales, profit and capital spending plans. A potential investor is buying a stock on what he expects a company to do and not on past history.

18/ This suggestion was made both by representatives who appeared to conduct their own research and by others who appeared not to do so. The motivation for this latter group, accordingly, may lie in areas other than providing useful investment information to investors.

Require public corporations to realistically make their own earnings forecasts and company projections.

Require that improving or deteriorating fundamentals such as sales trends, be made available to the public as soon as they are evident to management.

Important as these comments may be in evaluating the utility of information available to registered representatives, they should not overshadow the more abundant evidence indicating that RRs usually rely on secondary sources of information. 19/ In this respect it is interesting to note that research reports prepared outside the representatives' employing firms constitute the most useful source of information.

In view of the breadth of services that a registered representative is called upon to perform, and the conflicts of interest inherent in any commission-based-on-sales position, how realistic is it to expect the representative to function efficiently as a "quasi" investment adviser? A large proportion of the representative's time is required for non-"research" activities; he is neither trained to be nor, in many respects, expected to act as an

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19/ See responses to Questions 14 and 15 discussed supra at 251.

"analyst;" his success, both personal and within the firm, is highly dependent upon the volume of business he conducts; and finally, discounting or even disregarding all the previous limitations, it is simply impossible for him to conduct the research necessary to evaluate the merits of more than a very few securities outside of his firm's recommended list. 20/

In view of these limitations, therefore, it is hardly surprising that registered representatives -- called upon, fairly or not, to express opinions concerning large numbers of securities -- tend to rely upon secondary sources of information and, for the most part, secondary sources that are evaluative, i.e., research reports. And while it is true that a number of firms conducting the larger volume of retail business have, in recent years, substantially expanded the

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20/ This may have been what the registered representative who submitted the following comment was driving at:

> I feel strongly that recommendations from brokers to clients should be backed by their firm's research. If a broker recommends a stock to a client and it is not followed by his firm, this should be brought to the attention of the client. Otherwise, the client has every reason to believe it is the firm's research recommendation.

Similarly, another representative suggested that:

> Disclosure could be greatly improved by greater supervision of brokerage firms as to the information and distribution of information that their salesman puts out.

support services provided representatives for customer service, particularly in the area of portfolio evaluation, it must at least be asked whether, as a practical matter, representatives are expected to perform services that are beyond their capacity.

The comments submitted in response to the SIA survey, Question No. 19, provide some indication that registered representatives are not unaware of their situation. The frequency of the suggestion for simpler, more uniform disclosure documents speaks for itself. Moreover, the pressures exerted upon the representatives probably are also reflected in the frequency of their complaints concerning misuse of "inside" information by virtually all other segments of the industry. The position of the small investor, bluntly expressed in the following comment --

> With the domination of the institutions and their research, the little guy is going to continue to get the news when it's already history and there's nothing that can be done about it.

-- perhaps says more about the representative than the "little guy" he serves.

In addition, in view of the question they were asked, a surprising number (somewhat over 10%) suggested that better education and training of representatives would be an important improvement, as witness the following comments:

> Don't believe we need more disclosure. Think we need better educated and more informed RR's. I am a Supervisory Analyst, and think that we should require harder examinations to make sure that RR's are qualified to advise customers (emphasis supplied).
>
> Better qualifications required to become a securities salesman and much stricter supervision of the salesman in the future.

C. Conclusions: The Role of the Registered Representative

Many of the comments made and suggestions noted by the registered representatives in the SIA survey concern matters that, strictly speaking, are outside the scope of this study. They are worth reviewing and highlighting, nonetheless, not to spotlight weaknesses in the roles of the registered representative but to provide a framework within which to evaluate these roles insofar as they have an impact on his function as a source and disseminator of investment information. Because of the complex interrelationship among all of the registered representative's functions, it is impossible and probably undesirable to attempt a clinical isolation of one service he provides. A full understanding of the services provided by the representative can be arrived at only by reference to the entire environment. To a limited extent, such a point of reference was provided by the SIA survey, particularly the final question thereof.

While, as has been repeatedly emphasized, this study of the registered representative was limited in method and scope, some valid conclusions can be drawn. Among these are the following:

The registered representative occupies a unique position in the securities industry and plays an important role in the corporate disclosure system. For many investors, he is the "entry point" to the intricacies and formalities of investing and, in this capacity, performs activities of a general educational nature. More frequently, however, he is called upon to provide opinions as to the investment merits of specific securities or to recommend particular securities for purchase. In this capacity, the registered representative acts as a "quasi" investment adviser, relying upon his general background, training, experience and the support provided by his firm.

The registered representative's contact with original source information concerning securities, such as SEC-filed documents, is limited. However, the survey indicates that representatives find this type of information neither useful nor timely. The overwhelming majority of representatives feel that this type of information is too complicated for use by them or by their customers. A significant number also believe that it does not contain that information which they consider most valuable -- forward-looking information.

Other original source information, such as company annual reports, although somewhat more accessible, and considered somewhat more useful than SEC-filed documents, is also not greatly relied upon by registered representatives. On the basis of the survey, it was not possible to determine more specifically why this is so.

The prime source of investment information for registered representatives is their firm's research reports or, in those cases where the security is not researched by their firm, research reports prepared by competitors or research organizations. Another important source of information is the financial press and wire services. Possibly these information sources are considered most useful and timely because of their format and availability.

The usefulness of a registered representative's assistance to his customer must necessarily decrease substantially when his advice is solicited concerning securities not carried on his firm's recommended lists. In these cases, not only does the registered representative not have support from his firm's research resources, he is also likely to be substantially less able to evaluate the merits of research obtained from outside sources. Although no formal opinion is expressed in this area, it is suggested that the recommendation by registered representatives of securities concerning which the representative has no ready source of research information should be a source of concern to the Commission.

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Finally, because he works at the "cutting edge" of the disclosure system, the registered representative is far more oriented to the market sensitivity of investment information and its short-term implications than are most other participants in the disclosure process. For this reason, the registered representative is greatly concerned about equal disclosure and dissemination of investment information and about the problems of "insider" trading.

While no explicit attempt to evaluate the merits of these particular comments of registered representatives was made, the widespread concern expressed should be considered by the Commission not only in the development of disclosure policy, but in the administration of regulation and enforcement policies. Whether well-founded or not, a widely-held belief by those who maintain closest contact with individual investors that basic "unfairness" exists in the securities markets holds profound implications for the future of those markets.

CHAPTER VI

SURVEY OF INDIVIDUAL INVESTORS

A. Introduction and Overview

One of the central concerns of both the Commission and the Advisory Committee is how well the present disclosure system serves individual investors. Surveys of individual investors are rare in the private sector[1/] and, to

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1/ Private sector surveys which the staff was able to identify included Baker and Haslem, "Information Needs of Individual Investors," J. of Acc. 64 (Nov. 1973); Lewellen, Lease and Schlarbaum, "Patterns of Investment Behavior Among Individual Investors," 50 J. of Bus. 296-333 (July, 1977). The latter article reports the results of analysis of individuals who had accounts open with a large national retail brokerage house over the full period from January 1964 through December 1970 and represents a random selection of approximately 10% of all the individuals who had such a persistent relationship with the firm. Accordingly, it encompassed investors of far larger holdings, etc. than desired for this survey. Also, a 1975 survey of investors was conducted by Marc J. Epstein and reported on in the "Usefulness of Annual Reports to Corporate Shareholders," published by Marc J. Epstein.

the Committee's knowledge, have never been conducted by the Commission. In view of this lack of empirical data, the Advisory Committee determined to conduct its own survey of individual investors.[2/]

With the assistance of survey research specialists of the research division of the New York Stock Exchange, the staff drafted and extensively pretested a detailed questionnaire. The questionnaire was sent to 11,574 investors who were randomly selected from among the shareholders of fifteen case study companies and the customers of two brokerage firms.[3/] A total of 4,922 returned questionnaires were used in the tabulation of information referred to in this summary report. This represents aggregate response rate of 43 percent.[4/]

2/ For reasons of convenience and symmetry, the investors selected were shareholders of those companies which had participated in the Committee's case study of issuers. See Chapter I.

3/ The two cooperating brokerage firms were Bache Halsey Stuart Inc., and Merrill Lynch. Bache Halsey Stuart sampled its customers who held between 50 and 1,000 shares of one case study company and Merrill Lynch sampled its customers who held shares for the same size group, in two other case study companies. For further details see Section C: Survey Sampling Procedures and Questionnaire Design, infra.

4/ Some of the total responses indicated in the statistical tables contained herein do not sum to the total of questionnaires returned because of respondent error. Also, about 500 questionnaires received after tabulation commenced are not included because of time constraints on report preparation.

The objectives of the survey were to determine the following:

1. Method of investment decision-making;

2. Types of information used, including an indication as to its accessibility and utility;

3. Sources of investment information; and

4. Awareness and use of proxy information material.

In addition, other more general information concerning age, education, willingness to assume financial risks and other characteristics were obtained for analytical purposes.

The Advisory Committee was interested in learning what kinds of investment approaches were used by investors so that the Commission could gain insight into information needs of investors. A survey finding, for example, which indicated most of the surveyed investors utilized a technical approach to decision-making would suggest that new directions in corporate disclosure policy which emphasized prospective information may not be beneficial to an investor population largely engaged in analyzing relative share price changes. Or a finding which indicated a large majority of investors relied on brokers or paid investment advisors in arriving at investment decisions would suggest a Commission disclosure policy oriented to the adequacy of information flows between professional advisors and beneficial owners. Similarly, knowledge about the importance or non-importance to investors of a variety of information types could assist the Advisory Committee in its determinations and recommendations concerning

the areas of corporate disclosure which may need emphasis (or de-emphasis). An example of the usefulness of the survey in this respect is the response of surveyed investors to the question on the usefulness to them of corporate projections of company earnings. Half of the surveyed investors thought such information would be useful. General findings from the survey are summarized immediately below. The balance of this chapter discusses: survey sampling procedure; the survey questionnaire; raw data derived from the survey; and an analysis of the data, with emphasis on the implications for the disclosure system generally and the Committee's recommendations.

B. Overview of Survey Findings

The "typical" investor responding to the survey is male, between 55 and 64 years old, affluent and highly educated relative to the general population. The value of his portfolio is about $50,000 consisting of investments in about ten companies and no mutual funds. He is willing to take a moderate risk to achieve more than average financial gains and considers himself a "fundamentalist" in his approach to investment decisions, although he is quite likely to attempt to confirm his investment judgments by reference to other investment techniques such as consultation with a broker.

Information concerning the company's industry, its products and markets and the caliber or quality

of its management, as well as financial statement information, is considered most important in reaching investment decisions. The majority of this information is also considered relatively accessible, with the exception of an objective means of guaging the quality of a company's management. Primary sources of information are company annual reports, daily newspapers and stockbrokers; moreover, the income statement and balance sheet contained in the annual report are the portions read most thoroughly and considered most useful. Almost half of the investors favored disclosure of an earnings projection in the company's annual report, although a large proportion of investors indicated that the necessary uncertainty in the prediction of factors forming a basis for an earnings forecast makes such projections of dubious utility. Finally, proxy solicitation materials are received, read and considered adequate by most shareholders, although a significant number could not recall whether a management proposal appeared in the last such materials they received.

In summary, while survey respondents were atypical in terms of some demographic and financial characteristics, the data on the investment decision-making process obtained for the survey group is similar to the data from the case study of security analysts interviewed and reported in Chapter II. Moreover, the investors surveyed appear to be well-equipped by education and experience to review and understand most types of investment information and to display a healthy skepticism

about earnings projections. Finally, their reliance upon a company's annual report as an information source substantiates the Committee's judgment that improvement of this document can materially enhance the corporate disclosure system.[5/]

C. Survey Sampling Procedures and Questionnaire Design

It was decided that the shareholder population to be surveyed should consist of the shareholders of those issuers who agreed to participate in the Advisory Committee's corporate case study. Use of this sample permitted the Committee to follow and accurately assess the flow of information from issuers through the professional investment community to most classes of users, including individual shareholders. Not all companies in the case study were able to participate in this shareholder survey, however, because of expense, incompatible timetables, and other reasons. For the 15 issuers that participated, detailed sampling procedures were developed to draw a stratified sample of 800 eligible shareholders from each issuer. Additionally, two cooperating brokerage firms, following the same sampling procedures, sampled about 400 customers for each of three case study companies.

Participating issuers and cooperating brokerage firms were asked to develop a computer list which was to be no more than three months old, showing all shareholders

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5/ See Chapter XV, "Reporting Requirements under the 1934 Act."

owning between 50 and 1,000 shares.[6/] From this list were eliminated nominee, and institutional accounts, and all trustee, custodian, guardian and all other fiduciary accounts--except those under the Uniform Gift to Minors Act. This constituted the "basic list."

The basic list was then subdivided as follows into four subgroups:

1. By activity within the past 6-8 months:

A. "Active holders"--shareholders having one or more purchases or sales of the issuer's stock during the past 6 to 8 months;

B. "Inactive holders"--shareholders having no purchases or sales of the issuer's stock in the past 6 to 8 months;

2. By size of holdings:

6/ The restriction of ownership of from 50 to 1,000 shares was to a) improve the sample response rate, b) target shareholders or brokerage customers who had meaningful "stakes" in the case study companies and thus were likely to respond more completely on the questionnaire, and c) to eliminate atypical ownership interests such as would be the case for interests in excess of 1,000 shares. The minimum criterion of 50 shares does introduce a bias in that shareholders with smaller holdings in the selected case study companies were not included in the "basic" list. However, this bias is mitigated to a large extent in that an included shareholder may be a "small" shareholder in other corporations and responses to those questions not case study company specific would not preclude "small" shareholder viewpoints. Moreover, very large shareholders, to the extent the 1,000 share maximum criterion was an effective screen, were not represented in the survey response.

C. "Small holders"--shareholders of 50 to 499 shares; and

D. "Large holders"--shareholders with 500 to 1,000 shares.

The "active-inactive" dichotomy was developed by obtaining a list from each issuer's transfer agent (or brokerage firm customer records) showing all stockholders with any purchases or sales during the past 6 to 8 months.[7/] The resulting "active-inactive" lists were thereafter arrayed by number of shares owned, from smallest to largest and, within size of holdings, by zip code. These were then divided into "small" and "large" shareholders, setting the dividing line between 499 and 500 shares.

Finally, from each of the four sub-groups, 200 names were randomly selected using a different selection interval for each sub-group.[8/]

In order to assure increased survey validity through uniform treatment of those selected and to impress upon the sample the importance placed upon the survey by the company, the Advisory Committee and the Commission, each person

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7/ Shareholders who sold all of their ownership interest or as a consequence of a sale had an ownership interest of less than 50 shares were not retained on the active eligible list.

8/ If the number of names in one or more of the sub-groups consisted of less than 200 persons, the overall sample was reduced accordingly. Where an issuer had no more than 800 eligible shareholders, questionnaires were mailed to all shareholders.

selected was mailed a packet consisting of: a letter from the issuer's chief executive officer and from the Chairman of the Commission; the questionnaire (with pre-addressed, franked return envelopes); and a pre-addressed, franked postcard with boxes permitting the shareholder to indicate whether the survey form had been returned. These postcards, received independently of the returned questionnaire to assure confidentiality of reply, were used to identify shareholders to whom a second mailing was made, three weeks after the first, requesting participation in the survey and return of the questionnaire. The letter from the Chairman of the Commission, in addition, noted that all replies would be treated as strictly confidential, as evidenced by the fact that the questionnaire did not require the shareholder to identify himself. The proposed areas of questioning were pretested twice in informal, though structured, meetings with individual investors. The final questionnaire[9/] consisted of 19 questions. Completed questionnaires were returned directly to staff of the Committee for tabulation and analysis.

D. Characteristics of Survey Participants

Investor Age. Slightly more than three-quarters of the investor survey respondents were men (Figure 1). The median age of the

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9/ The final questionnaire, as mailed to shareholders, is included as Appendix VI-A.

respondents was 61 years compared to the 1975 NYSE census of shareholders' median age of 53 years.[10/] This finding may be explained by the survey's exclusion of very small ownership sizes which owners as a group tend to be younger than more wealthy shareholders.

Figure 1

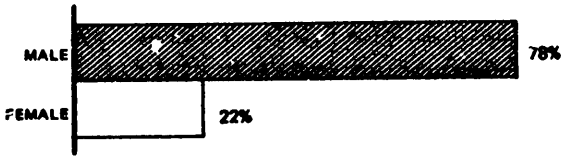


Table 1: Investor Age
All Investors

Age Category	Percent
Under 34	7
35 to 44	10
45 to 54	17
55 to 64	29
65 to 74	25
75 and older	12
Total	100%

10/ 1975 "Census of Shareowners" NYSE Share Ownership Research Section.

Investor Education. Shareholders were well-educated relative to the general population. Twenty-seven percent were college graduates while an additional 30 percent continued on in school doing post graduate work. This 57 percent compares to the 42 percent who were college educated in the 1975 NYSE census. This difference again is attributed to the Advisory Committee's survey design.

Table 2:
Investor Educational Attainment
All Investors

Education Completed	Percent
1. Attended or graduated Elementary School	3
2. 1 to 3 years High School	5
3. High School Graduate	16
4. 1 to 3 years College	19
5. College Graduate	27
6. Some postgraduate work, Master's Degree, PhD. or equivalent, etc.	30
Total	100%

Investor Affluence. The surveyed shareholders were generally more affluent than the population at large (Table 3). The median expected before tax income for 1977 was $30,130. Thus, the expected incomes of more than half the surveyed investors were well over the median family income of $14,960, as estimated by the U.S. Census Bureau[11/] for 1976 as well as the median shareholder before tax income of $19,000 in 1975 as reported in the 1975 NYSE census.

11/ U.S. Department of Commerce news release October 9, 1977, CB 77-188.

Table 3: Family Income, All Investors

Income Bracket	Percent
Under $5,000	1
$5,000-$9,999	4
$10,000-$14,999	9
$15,000-$24,999	23
$25,000-$49,999	38
$50,000-$99,999	18
$100,000 and over	7
Total	100%

The relative affluence of the sample of respondents is demonstrated in the finding that fifty-seven percent of the surveyed investors held portfolios valued at over $50,000. By contrast, based on its survey the New York Stock Exchange survey found that only slightly more than 15 percent of all investors owned portfolios worth more than $50,000 (Figure 2).

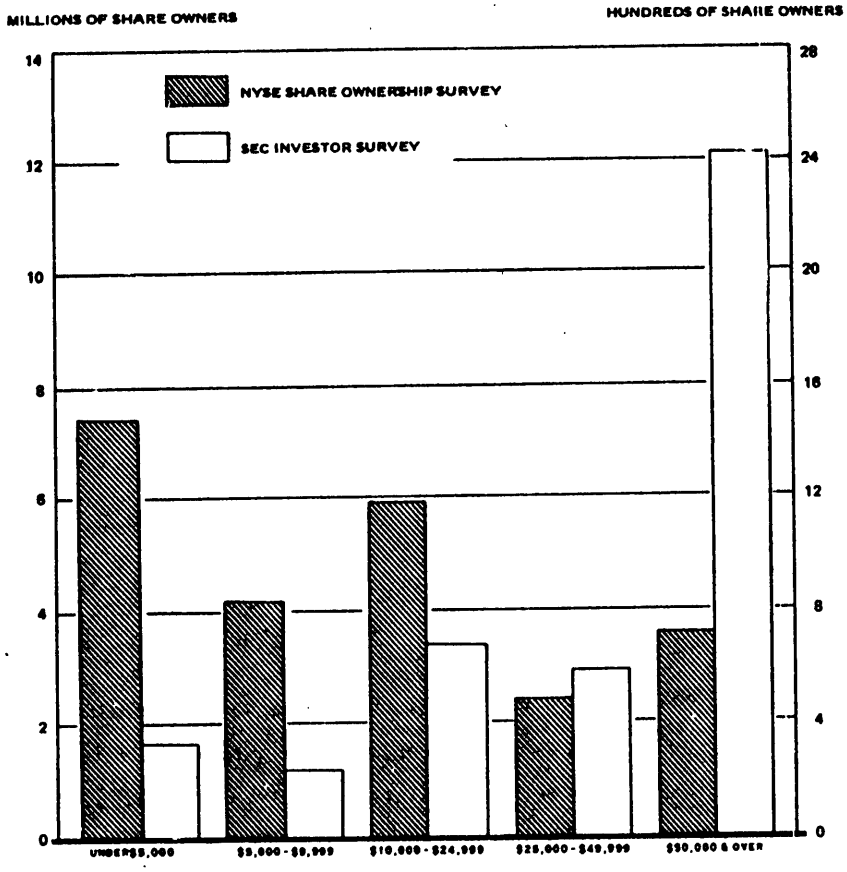
Table 4: Current Market Value of Investor Portfolio, All Investors

	NYSE Estimates		SEC Survey	
Portfolio Value	Number	Percent	Number	Percent
Under $5,000	7,484,000	32	324	8
$5,000-$9,999	4,163,000	18	227	5
$10,000-$24,999	5,832,000	25	697	16
$25,000-$49,999	2,386,000	10	594	14
$50,000 & over	3,523,000	15	2,422	57
Total	23,388,000	100%	4,262	100%

Figure 2

CURRENT MARKET VALUE OF INVESTOR PORTFOLIO

ALL INVESTORS



Portfolio Composition. Almost half of the surveyed investors held ownership in eleven or more corporations. These data suggest that though they were selected to participate because they owned stock in a particular company, they were fairly well-diversified in their holdings of ownership interests.

Table 5:

Portfolio Diversification
All Investors

Number of Corporations	Percent
1 - 5	30
6 - 10	21
11 - 15	16
16 - 20	11
21 - 29	10
30 - 39	6
40 or more	6
Total	100%

An alternative way to broaden ownership interest with a given amount of investment funds is to participate in a mutual fund. However, mutual funds did not appear in the portfolios of most of the investors surveyed as indicated by the very large non-ownership response--sixty-three percent of the respondents (Table 6).

Table 6: Mutual Funds Invested in by Investors
All Investors

Number of Mutual Funds	Percent
0	63
1	16
2	8
3	5
4	2
5-8	2
10 or more	4
Total	100%

Investment Strategy. The "fundamental" approach[11/] was cited most often as the method respondents used when evaluating securities (Table 7). Second in preference was reliance on a broker's advice. The technical approach[12/] trailed a distant third as an investment strategy. However, a sizeable number of investors indicated they combined the fundamental and technical approaches, perhaps using

11/ The "fundamental" approach was defined in the questionnaire as "analysis of such fundamental factors as general business conditions, earnings, dividends, industry outlook, quality of management, etc."

12/ The "technical" approach was defined in the questionnaire as "analysis of market factors such as stock price movements, supply v. demand, amount of odd-lot trading, resistance levels, short interest, charts, etc."

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one approach initially and confirming or disconfirming indicated investment decisions with a second approach.

Table 7: Approach Used in Evaluating Securities Direct and Street Name Investors Compared

Type of Approach	Direct %	Street 13/ %	Total 14/ %
Fundamental Approach	54	42	50
Technical Approach	2	5	3
Combination of Fundamental and Technical Approaches	19	23	21
Rely Primarily on Broker	12	23	15
Uncertain	5	3	4
Passively Acquired: gift, etc.	3	1	3
Miscellaneous	5	3	4
Total	100%	100%	100%

Attitude Toward Risk-Taking. Slightly more than four out of every ten respondents preferred to take moderate risks in order to realize more than average gains (Figure 3). Nearly a quarter of the investors surveyed wished to reduce risks to the barest minimum to maximize long-run financial gains while relatively few--only three percent--indicated a willingness to have substantial financial risks.

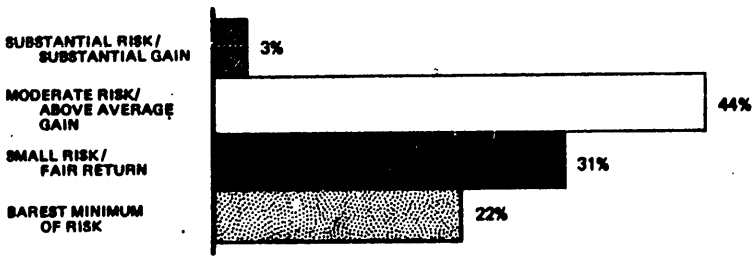
13/ "Street name" is a phrase used to denote investors who choose to hold their ownership interest in the name of a financial institution such as a brokerage firm or the trust department of a commercial bank.

14/ The total response column may be considered biased in that most investors surveyed were selected randomly from shareholder lists. Shareholders who retain ownership in the nominee names of brokerage firms were sampled for only three of the fifteen participating companies.

Figure 3

INVESTOR EXPECTED GAIN AND RISK RELATIONSHIP

ALL INVESTORS



Types of Information Considered Important. Respondents were presented with an array of types of information commonly believed to be used by many investors. Investors were then asked to rate the usefulness of the information types in the context of their decision(s) to buy, sell, or hold shares in a designated participating corporation in which they had an ownership interest. The purpose of this question was to identify among all information types presented those which a large number of investors indicate are important to decision-making, and those which are of minor importance.

Of the twelve listed types of information (Table 8), information about the future business outlook of the company's industry was rated as either "extremely" or "moderately" useful

by 96 percent of surveyed respondents, the highest "usefulness" ranking of all the information types. Second in ranking was corporate financial statement information (86 percent), followed by information about the company's products and markets (85 percent) and information concerning the caliber or quality of management (82 percent), respectively. Information about the trading activity of large institutions such as banks, mutual funds, etc., was the information type ranked least useful. The next lowest ranked information type was charts showing financial ratios of the company.

Information Accessibility. Respondents were asked to indicate the accessibility of the information types they rated as useful. Forty-seven percent of those who believed information about institutional trading activity was important also rated it as largely inaccessible; however, this information type was ranked the least useful by respondents. (The low ranking of institutional trading activity as a useful piece of information should be biased downward because of the indicated relative inaccessibility of the information. Information that is not readily available may not be rated useful by respondents because of an inability to evaluate.) Thirty-three percent of the respondents rated quality of management information relatively inaccessible, although the information type ranked high in terms of usefulness. However, only 15 percent of the surveyed respondents thought information concerning the business outlook of the company's industry to be relatively unavailable,

Table 8: Value Ranking of Information Types; All Investors

Rank	Types of Information	Extremely Useful	Moderately Useful	Not Very Useful	Not at All Useful	No Opinion
1.	Business Outlook - Industry	58	38	4	0	0
2.	Financial Statements	50	36	6	3	5
3.	Company's Products and Markets	44	41	7	3	5
4.	Quality of Management	54	28	9	3	6
5.	Charts/Earnings, Sales	38	43	11	3	5
6.	Business Prospects—Outside Assessment	37	42	9	4	8
7.	Year-to-Year Changes Financial Statements	36	43	12	3	6
8.	Business Outlook—Economy	30	46	15	4	5
9.	Business Prospects—Company Assessment	28	47	15	5	5
10.	Charts/Security Prices	18	41	18	9	14
11.	Charts/Key Ratios	19	39	23	8	11
12.	Knowledge of Large Institutional Trading Activity	14	33	26	14	13

Table 9: Ranking of Information Accessibility, All Investors

Rank	Types of Information	Percent of Investors Who Rated Information As Useful	Percent of Investors Who Rated Information As Useful and Inaccessible
1.	Large Institutional Activity	47	47
2.	Quality of Management	82	33
3.	Business Prospects—Outside Assessment	79	22
4.	Business Outlook—Industry	96	15
5.	Charts/Key Ratios	58	11
6.	Charts/Securities Prices	59	10
7.	Business Prospects—Company's Assessment	75	9
8.	Company's Products and Markets	85	8
9.	Economy Business Outlook	76	7
10.	Charts/Earnings, Sales	81	5
11.	Financial Statements	86	4
12.	Year-to-Year Changes—Financial Statements	79	0

Table 10: Reasons for Information Inaccessibility
All Investors

Types of Information	Available Only to Institutions or Large Investors	Available Only to Insiders	Too Expensive	Broker/Brokerage Firm Refused or Doesn't Provide	Doesn't Know How to Obtain
1. Charts/Security Prices	11	7	32	11	36
2. Financial Statements	14	26	9	14	29
3. Business Prospects-Company's Assessment	16	42	3	5	28
4. Business Prospects-Outside Assessment	17	12	15	7	43
5. Business Outlook-Industry	15	12	11	7	48
6. Charts/Earnings, Sales	8	19	9	17	43
7. Business Outlook-Economy	9	7	21	5	47
8. Year-to-Year Changes, Financial Statements	14	23	3	9	42
9. Quality of Management	12	28	3	4	47
10. Charts/Key Ratios	18	15	10	9	45
11. Company's Products & Markets	15	28	7	9	38
12. Large Institutional Activity	23	13	4	6	50

the information type ranked highest in importance.

Relatively large percentages of shareholders responded that they "Don't Know How to Obtain" many of the information types listed when asked to indicate why a given information type is relatively inaccessible. Interestingly for only one type of information--the company's assessment of its business prospects--did respondents select available only to insiders as the major reason for inaccessibility.

Informational Sources. Surveyed investors indicated that they rely upon three main sources for information they consider useful: stock brokers, company annual reports, and daily newspapers (e.g., Wall Street Journal), the annual report being the most common source referred to. The degree of importance attached to these sources by survey respondents for the array of information types is reflected in Table 11.

Earnings Per Share Forecast. Nearly one out of every two investors surveyed thought it would be a good idea for companies to show a projected earnings per share forecast for a full year in the annual report. Slightly more than one-third disagree and 19 percent were uncertain.

Figure 4

DESIRABILITY OF EARNINGS FORECAST
ALL INVESTORS

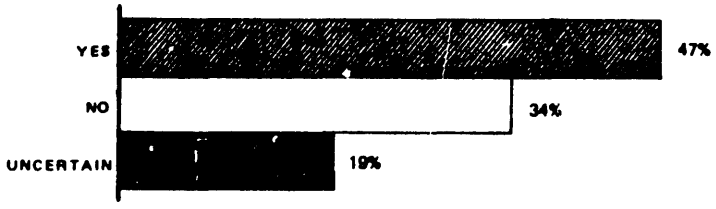


Table 11: Primary and Secondary Sources of Information
All Investors

Types of Information	Primary Source	%	Secondary Source	%
1. Charts/Security Prices	Daily Newspaper	23	Stockbroker	20
2. Financial Statements	Annual Report	42	Quarterly Report	11
3. Business Prospects-Company Assessment	Annual Report	37	Quarterly Report	13
4. Business Prospects-Outside Assessment	Stockbroker	24	Daily Newspaper	17
5. Business Outlook-Industry	Daily Newspaper	23	Financial weekly/magazine	15
6. Charts/Earnings, Sales	Annual Report	49	Subscription, Advisory Services	13
7. Business Outlook-Economy	Daily Newspaper	43	Financial weekly/magazine	19
8. Year-to-Year Changes, Financial Statements	Annual Report	54	Stockbroker	8
9. Quality of Management	Stockbroker	16	Annual Report	14
10. Charts/Key Ratios	Annual Report	40	Subscription, Advisory Services	17
11. Company's Products & Markets	Annual Report	27	Daily Newspaper	11
12. Large Institutional Activity	Daily Newspaper	32	Stockbroker	16

Fifty-two percent of those opposing or uncertain about the value of a company's earnings forecast believed that there are too many variables which enter into the forecast. Another one-fourth indicated that they felt the management would present an overly optimistic forecast (Table 12).

Table 12: Opposition or Uncertainty About Forecasts All Investors

Reason for Opposition	Percent
1. Too many uncertain variables enter into forecasts.	52
2. Think management would tend to present a more optimistic picture than it should.	25
3. Corporations may be subject to lawsuit if projections depart significantly from actual result.	12
4. If all shareholders receive projections at the same time, company's stock price will move too abruptly.	9
5. Company forecast would be too conservative.	1
6. Forecasts would lead to undue pressure and/or unwise business practices.	

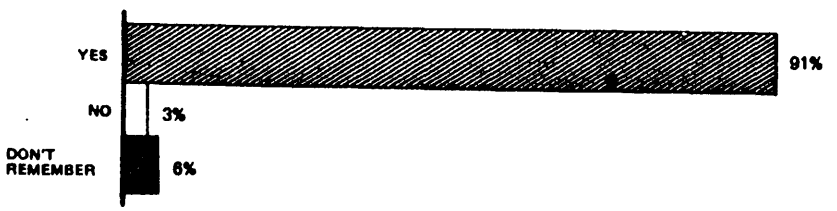
Adequacy of Proxy Materials

Ninety-one percent of the investors in the survey replied that they received proxy solicitation material prior to the most recent shareholders' annual meeting.

Almost half of those receiving solicitation materials said there was a management proposal contained in the proxy. Forty-three percent could not remember. A substantial majority (90 percent) indicated that the proxy material was adequate to some degree[15/] in helping them make an informed voting decision with most of the shareholders rating it as "Reasonably Adequate." Only 3% said that the information was totally inadequate (Figures 5, 6 and 7).

Figure 5

RECEIPT OF PROXY MATERIALS
ALL INVESTORS



15/ Those investors responding indicated that the proxy material was either "extremely" adequate (19%), "reasonably" adequate (60%) or "somewhat" adequate (11%).

Figure 6

MANAGEMENT PROPOSAL IN PROXY MATERIAL
ALL INVESTORS

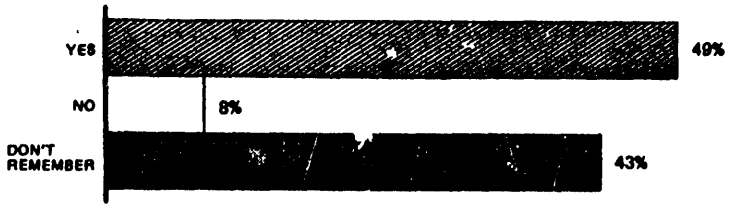
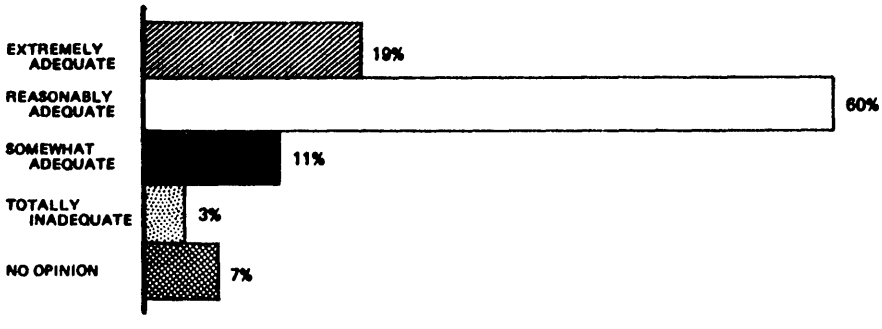


Figure 7

ADEQUACY OF PROXY MATERIAL
ALL INVESTORS



Readership of Annual Report. Investors generally indicated that the company annual report was their chief source of information for making investment decisions. In fact, ninety-one percent of the respondents reported that they read the annual report (Figure 8).

Of those reading the annual report, fifty-two percent indicated that they read the income statement "very thoroughly", while 46 percent said they also read the president's report "very thoroughly." Nearly one-quarter said they did not read the auditor's report at all.

Usefulness of major parts of the company's annual report followed the pattern revealed in the response to the question on thoroughness of review (Table 13). The highest rated part was the income statement section, followed by its companion, the balance sheet.

The reason most cited by those respondents who did not usually read the annual report (35 percent) was difficulty in understanding it (Figure 9). A third said they did not have the time to read the report and a fifth were not interested.

Investor Reasons for Not Reading Parts of Annual Report. Table 14, "Interest in Parts of the Annual Report," indicates that the surveyed investors read or casually "look at" most of the Annual Report. However, a large fraction of investors indicated that they do not

Figure 8

READERSHIP OF ANNUAL REPORT
ALL INVESTORS

Figure 9

REASONS FOR NOT READING ANNUAL REPORT
ALL INVESTORS

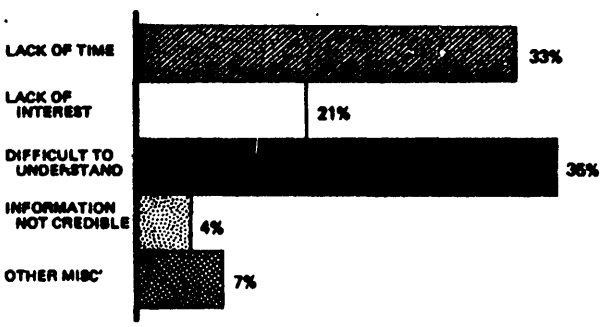


Table 13. Interest in Parts of Annual Report
All Investors

Parts of Company's Annual Report	Read Very Throughly	Read Somewhat Throughly	Read Casually	Do Not Read
1. President's Report	46	31	20	3
2. Management Description Pictorial Presentation	34	39	25	2
3. Income Statement	52	34	13	1
4. Balance Sheet	40	34	22	4
5. Funds Flow Statement	23	29	33	15
6. Footnotes to Financial Statements	26	26	33	15
7. Auditor's Report	19	21	36	24

Table 14: Utility of Parts of Annual Report
All Investors

Parts of Company's Annual Report	Very Useful	Moderately Useful	Not at All Useful	No Opinion
1. President's Report	22	52	17	9
2. Management Description Pictorial Presentation	25	52	16	7
3. Income Statement	55	36	4	5
4. Balance Sheet	45	41	7	7
5. Funds Flow Statement	25	47	16	12
6. Footnotes to Financial Statements	26	46	17	11
7. Auditor's Report	20	41	27	12

read the auditor's report. The reason most frequently cited, as shown on Table 15, was lack of interest. Also, a significant proportion of respondents indicated "they did not read" footnotes to financial statements nor funds flow statements. The preponderant reason seems to be difficulty in understanding these parts of the Annual Report.

E. Analysis and Conclusions

Although substantial precautions were undertaken to guard against possible bias and thereby enhance the reliability of the investor survey, obvious dangers exist in any attempt to draw broad, based conclusions respecting the investment posture and habits of so diverse a population.

For example, the respondents to the survey appear somewhat older than the investor population generally which may account for the relatively large proportion who wish to reduce risks to the barest minimum. In addition, the sample of investors appear to be substantially more affluent than investors generally. It is impossible to determine how this affects the results. Finally, from the survey data respecting education, technique of investment decision-making, diversification and mutual fund holdings, it would appear that the sample population is far more self-reliant and likely to take an active role in the management of its investments than may have been supposed.

Table 15: Reasons for Not Reading Annual Report Parts
All Investors

Parts of Annual Report	Lack of Time	Lack of Interest	Difficult to Understand	Information Not Credible	Boiler-Plate Language	Wasteful Public Relations
1. President's Report	23	47	5	19	1	5
2. Management Description Pictorial Presentation	44	2	21	19	3	11
3. Income Statement	21	25	53	1	0	0
4. Balance Sheet	15	25	57	3	0	0
5. Funds Flow Statement	11	28	57	3	1	0
6. Footnotes to Financial Statements	17	40	40	3	0	0
7. Auditor's Report	12	50	18	11	9	0

Despite these cautionary notes, the survey results are consistent with conclusions derived from case studies conducted of other segments of the corporate disclosure system. This is probably most apparent in comparing the survey findings on individual investors with conclusions drawn by the staff respecting the investment analysis process of security analysts. These two groups of users, commonly believed to be widely divergent in respect to their decision-making methods, sources of information, types of information used and general assessment of corporate disclosure, appear to be substantially similar.

Thus, individual investors and analysts are likely to utilize a fundamental approach in evaluating securities, and to attempt to check and cross-check hypotheses and conclusions through other techniques. Both groups are primarily industry oriented, but attribute high importance to financial statement information, information about a company's products and services, and quality of management. Both groups also look to similar sources for similar information: to newspapers and magazines for macro-economic and industry information and to the company's annual report for firm-oriented information. Despite the importance they attribute to information concerning quality of management, both encounter difficulty in obtaining and assessing such information--although analysts, with their greater access to management and greater resources for company visits, etc., report somewhat more success in this

area. Both groups maintain a healthy skepticism concerning the ability of management to accurately assess future earnings, and for the same reasons: the volatility of factors outside management's control and the temptation to present an overly optimistic forecast. Finally, neither group finds substantial deficiencies in company proxy materials, although neither appears to attribute substantial importance to such materials.

Generally, these findings add confidence to the thrust of the Commission's work and to the substance of the Committee's rec mendations. Although it is unlikely that investors are as sophisticated as professional securities analysts, as suggested by the survey, it nevertheless appears that a substantial number of them engage in the same process, look to the same sources and use the same types of information in their investment decision-making.

The findings of the survey concerning the importance attributed by investors to the annual report is also encouraging. The Committee's recommendations respecting inclusion of 10-K information in the annual report (see Chapter XV) and use of the annual report in exchange offers and business combinations (see Chapter XIV) are both premised on the assumption that the annual report is the most widely used shareholder document.

The survey findings also support an effort to

improve the quality of the management analysis.[16/] Duff and Phelps, Inc., thoughtfully characterized the management discussion as "an island of relative individualism in a sea of regulation," suggesting that it afforded "management the opportunity to show its personality and establish the credibility of the company."[17/] The data from the survey displayed on Tables 14 and 15 indicate that while investors demonstrate high interest in and attribute great utility to the financial statements portion of the annual report, they also consider the president's report and management description to be of significant interest--although of substantially less utility. The reason cited by many was lack of credibility.[18/]

It would appear, therefore, that a substantial effort by management to improve the summary and analysis of earnings

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16/ Duff and Phelps, Inc., A Management Guide to Better Financial Reporting--Ideas for Strengthening Reports to Shareholders and the Financial Analysts' Perspective on Financial Reporting Practices, A Report for Arthur Andersen & Co. (1976).

17/ Id. at 86.

18/ The reasons most cited were, for the president's letter, lack of interest, and, for the management description, lack of time. It is interesting to contrast these results with the reasons submitted for not reading the financial statements portion of the annual report which was usually that the information was difficult to understand. In this respect, surveyed shareholders expressed opinions quite similar to those expressed by registered representatives surveyed for the Committee by the Securities Industry Association. However, shareholders attributed considerably less importance and concern about so-called "inside information" and institutional activity than did the registered representatives. More basically, they indicated considerably less reliance upon their brokers than the brokers believe.

would provide returns to the company in two areas. First, shareholders would obtain a better understanding of the operations and capabilities of their company and management. Second, management could substantially enhance its credibility with both shareholders and the professional investment community which, in the long run, should strengthen the market for the company's products and securities.

It also appears that management and the company's auditors are by-passing an opportunity with respect to the company's financial statements. The survey results indicate that shareholders consider these materials among the most important available to them in the annual report and that they are willing to spend a reasonable amount of time and effort in reviewing them. Shareholders also indicate however, that they have considerable difficulty in understanding the financial statements. Despite all the obvious difficulties in "simplifying" what are inherently complex documents, it nevertheless appears that efforts toward more effectively communicating financial statement information are much desired by shareholders and would be extremely well received.

Also, the importance ascribed by shareholders to information about company products and services and company and industry outlook tend to support the Committee's interest in improving segment reporting and disclosure of forward-looking information.

Finally, the data respecting proxy materials should be noted. While the overwhelming majority of respondent shareholders who reported receiving proxy materials indicated that they read such materials either thoroughly or moderately and that they signed and returned the proxy, a surprisingly large number could not remember whether the proxy materials contained a management proposal. It is difficult to reconcile these two sets of results.

PART II

RECOMMENDATIONS CONCERNING COMMISSION PROCEDURES IN DEVELOPING DISCLOSURE REQUIREMENTS AND STANDARDS

CHAPTER VII

THE OBJECTIVES OF THE SECURITIES AND EXCHANGE COMMISSION IN THE CORPORATE DISCLOSURE SYSTEM

RECOMMENDATION

That the Commission adopt the following statement of objectives:

The Commission's function in the corporate disclosure system is to assure the public availability in an efficient and reasonable manner on a timely basis of reliable, firm-oriented information material to informed investment and corporate suffrage decision-making. The Commission should not adopt disclosure requirements which have as their principal objective the regulation of corporate conduct.

A. Introduction

The Introduction to this report develops the Committee's conclusion that a system for disclosure of firm-specific, investor oriented information is desirable and necessary. It also argues that the system should have a mandatory component in order to provide uniform disclosure, to assure disclosure of information viewed as adverse to management's perception of its

own or the firm's best interest, to provide a standard against which deficient disclosure can be tested, and to establish a mechanism for enforcement.

This chapter reports the Committee's views as to the disclosure objectives which the Commission should pursue in administering this system. It should be noted that the discussion in this chapter is limited to the Commission's objectives as they relate to corporate disclosure. It does not address the Commission's objectives in other areas in which it has jurisdiction such as investment company or stock exchange regulation. Further, the discussion in no way implies that the Commission should not administer a vigorous enforcement program to assure compliance with the Federal securities laws and its rules and regulations thereunder.

B. Adoption of a Statement of Objectives

The Committee recommends that the Commission articulate, adopt, and announce a statement of its objectives. A thoughtfully drafted statement of objectives will assist the Commission's decision-making processes on the complex and difficult matters presented to it for resolution. It will provide a framework for evaluating problems and resolving them in a consistent manner.

Moreover, it appears that other governmental units, the constituencies of the system which the Commission administers, and the general public have varying perceptions of the Commission's role. To the extent these perceptions are

incorrect, they create certain expectations of, and foster demands on, the Commission which are unnecessary or inappropriate and which may result in a Commission response inconsistent with its objectives. The identification and announcement of a statement of objectives will perform an educational function which the Committee hopes will reduce substantially these misapprehensions and minimize the number of inappropriate demands placed on the Commission.

Finally, a statement of objectives will enunciate criteria against which the Congress and the public can monitor the Commission's activities and evaluate on a continuing basis whether its work remains worthwhile. It encourages a thoughtful examination of the Commission's policies. This seems particularly important in view of the current concern with sunset laws and zero-based budgeting.

The Committee recommends the following statement:

> The Commission's function in the corporate disclosure system is to assure the public availability in an efficient and reasonable manner and on a timely basis of reliable, firm-oriented information material to informed investment and corporate suffrage decision-making. The Commission should not adopt disclosure requirements which have as their principal objective the regulation of corporate conduct.

The Committee believes this statement, together with some prefatory remarks and an explication of some terms in the text, will assist the Commission in setting disclosure policy and the public in understanding that policy.

C. The Committee's Perspective

When addressing a question as difficult as what the objectives of a regulatory agency should be, boundaries must be defined. Almost every piece of legislation, including the federal securities laws, can fairly be said to be enacted by the Congress and signed by the President to accomplish a broad range of objectives.

It is fair to conclude, based on the discussion of the background to the adoption of the 1933 and 1934 Acts contained in Chapter XIX of this Report, that the ultimate objective of these statutes was to rebuild this country's economy by facilitating the raising of capital. This was to be done through a restoration of the confidence of investors in the integrity of the capital markets. Disclosure would restore confidence by equalizing access to information, thereby starting everyone at the same place in the competition to find the best investment. Disclosure would, at the same time, hinder fraud and improve the "morals of the market place" without explicit and direct governmental regulation.

There are half a dozen relatively abstract objectives listed above; the problem is to identify those upon which the Commission should focus its resources. The focus is important because the objectives identified may conflict with and counteract one another.

For example, consider a hierarchy of objectives for the Commission arranged as follows:

1. Build a healthy economy.
2. Maintain strong capital markets.
3. Facilitate the raising of capital.
4. Maintain investor confidence.
5. Protect investors through disclosure.
6. Secure disclosure of some piece of information.

If the Commission's objective is to facilitate the raising of capital, it might pursue a program designed to simplify registration procedures for small issuers. However, a simplified registration form might eliminate necessary decision-making information, thereby undercutting an objective of protecting investors through disclosure. If the Commission's objective is the maintenance of investor confidence in the market, it might be argued that the Commission should not require disclosure of adverse situations which management believes are shortterm and will be corrected in the near future. Yet, if the objective is the protection of investors through the provision of necessary information upon which to base investment decisions, the information should be disclosed.

The thrust of the Committee's recommendation is to make clear that in its view, the Commission's objective should be to assure the disclosure of information material to investment and corporate suffrage decisions. The Committee believes this is clear from the legislative history of the federal securities laws described in Chapter XIX. Moreover, the Commission is the only governmental

agency, department or unit which has responsibility for insuring the disclosure of firm-specific, investor-oriented information. If the Commission does not pursue this goal vigorously, there is no assurance that any one else in the government will. The one area that is the Commission's alone is the protection of investors through disclosure. The point of the Committee's statement is to convey its sense that while other objectives in the hierarchy may be laudable, and it does not object to the Commission facilitating their accomplishment, its function is to assure the availability of investor oriented information. To the extent other objectives conflict they must give way.

D. Analysis of Statement of Objectives

By identifying the Commission's function as being "to assure" the availability of information, the Committee intends to suggest that the Commission's administration of the corporate disclosure system should not be limited to the adoption and enforcement of disclosure requirements affecting filed documents. The Commission should recognize that press releases, annual reports, quarterly reports, analyst and investor relations programs are all important components of the corporate disclosure system. If information is available in a reliable and timely manner through this "unfiled" system, it may not be necessary to require the information to be filed.

Further, in some cases, the Commission may want to assure the availability of the information through cooperation with the private sector. Section 503 of the Energy Policy and Conservation Act requires the Commission to "take such steps as may be necessary to assure the development and observance of accounting practices to be followed in the preparation of accounts by persons engaged, in whole or in part, in the production of crude oil or natural gas . . .." It gives the Commission authority to make "effective by recognition, or by other appropriate means indicating a determination to rely on, accounting practices developed by the Financial Accounting Standards Board, if the Securities and Exchange Commission is assured that such practice . . . will be observed . . . to the same extent as would result if the Securities and Exchange Commission had prescribed such practices by rule." 1/

The recognition by the Commission of the various alternatives to rule-making such as those set forth in Section 503 not only gives the Commission access to the resources of the private sector as a supplement to its own, but also minimizes the development of a public-private sector adversary relationship.

The recommended statement of objectives also implies certain characteristics of the information with which the Commission should concern itself. The Committee recognizes

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1/ 42 U.S.C.A. §6383 (1977).

that many competing interests may look to the corporation for information: labor unions, public interest groups, competitors and others. Yet if the Commission attempts to satisfy these groups' needs, it will be placed in the position of arbitrating among these groups and between each group and the corporation. This is a role the Commission is neither authorized nor qualified to fill. If the Commission attempts to satisfy all these groups the materiality threshhold might become so low as to "cause it [the corporation] simply to bury the shareholders in an avalanche of trivial information - a result that is hardly conducive to informed decision making."[2/] By limiting the information to that necessary to investment or corporate suffrage decision-making this would be avoided.

The Committee's second point about the information in the system is that the Commission should not operate from the premise that filings with it must be directly usable by unsophisticated investors. Assumption of such a premise would almost inevitably result in only the most basic information being mandated. There are strong indications that this was not the intention of the Congress. As Justice Douglas incisively stated in 1933:

> The truth about securities having been told, the matter is left to the investor . . .. But

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2/ TSC Industries, Inc. v. Northway, Inc. 426 U.S. 438, 448-493 (1976).

> those needing investment guidance will receive small comfort from the balance sheets, contracts, or compilation of other data revealed in the registration statement. They either lack the training or intelligence to assimilate them and find them useful, or are so concerned with a speculative profit as to consider them irrelevant. And wise and conservative investors will find the Securities Act useful but not necessary and from it will gain but little real protection against an occasional Kreuger or Insull. This means that the results of the Act so far as investors are concerned are primarily two-fold: (1) the requirement that the truth about securities be told will in and of itself prevent some fraudulent transactions which cannot stand the scrutiny of publicity; (2) even though an investor has neither the time, money, nor intelligence to assimilate the mass of information in the registration statement, there will be those who can and who will do so, whenever there is a broad market. The judgment of those experts will be reflected in the market price. Through them investors who seek advice will be able to obtain it. 3/

The Commission's emphasis must be on ensuring the disclosure of that information which will be of use to reasonably knowledgeable or sophisticated investors. Implementation of this emphasis in no way sacrifices the interests of unsophisticated investors. A major implication of the efficient market literature and research is that security prices reflect all information available to the market. All investors benefit from sophisticated information whether they

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3/ Douglas, "Protecting the Investor," 23 Yale Rev. (N.S.) 508, 523-24 (1933). See also Chapter XIX at note 11. Compare Chapter VI where the data from the Advisory Committee's survey of individual investors suggests that a large segment of the investor population is reasonably sophisticated with respect to financial matters.

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can, themselves, understand and use it, or not, because security prices more fully reflect intrinsic values. As a practical matter, all investors have at their disposal the services and advice of sophisticated users - both analysts and disseminators. Here the Commission properly can, and should, recognize this important supplement to the role it performs. The Committee believes it is deceptive even to represent that investors having no familiarity with corporate financial reporting, or experience in investment analysis should make their own investment decisions.

The Committee also considered how the Commission should identify the information necessary for decision-making. Three approaches are suggested. First, the Commission should look to the groups whose needs it is attempting to serve. The Commission should initiate and maintain a consultative dialogue with investment decision-makers and their advisers, and with corporate managers and their independent accountants. This will enable the Commission to identify the needs of users and to establish the limits within which corporations can reasonably provide particular information, and accountants would be willing to associate themselves with such information to lend it credibility. It would then be in a position to identify those areas where a Commission requirement is appropriate and will have been educated as to what form that requirement should take.

This dialogue can take a number of different forms. For example, it might include roundtable discussions, attendance

at meetings of professional societies and organizations, and issuance of releases requesting comments. The only cautionary note is that care must be taken to solicit the individual investor's viewpoint. This may require periodic surveys of the kind the Advisory Committee conducted.

The second valuable source of input for the Commission is academic and professional literature dealing with the questions of financial reporting and investment decision-making, such as the Trueblood Committee Report, or the efficient market literature. Third, on occasion, the members of the Commission will simply have to ask themselves "Am I persuaded that the information secured by the new disclosure requirement is material to informed decision-making?" It may well be that in certain circumstances the Commission will have to lead investors rather than follow them. This would be the case when the Commission recognizes a need for certain information that investors do not yet understand the utility of. If so, the Commission ought to take an activist role in educating the community.

The final comment the Committee would make about the information in the Commission's system is that it should be firm-oriented. The Advisory Committee is aware that much of the information which influences investment decision-making is macroeconomic in nature. Interest rates, inflation, monetary policy, political issues, all influence the decision to buy a particular security.

Yet, for two reasons, little would be gained by requiring Commission disclosure documents to contain this information. First, much of this kind of information is already available on a timely basis, and in a reliable form from other sources. Secondly, the corporation has neither the access to this information nor the expertise in evaluating it to the degree that it materially adds to other sources. It could at most be a disseminator of this information and it is plainly inefficient to have 10,000 companies doing this.

The word "firm-oriented" is included in the statement to reflect the view that the Commission should not expand its mandated disclosure requirements to include all information necessary to an investment decision. This phrasing is intended to be broad enough, however, to encompass disclosure of macroeconomic factors to the extent they have a special impact on a company, without requiring a general discussion of economic conditions.

By the phrase "reasonable and efficient manner," the Committee intends to communicate three different ideas: (1) In setting disclosure policies the Commission should consider the effects disclosure requirements have upon the constituents in the system; (2) the Commission should be aware of the consequences which result from a disclosure policy decision; and (3) the Commission should avoid duplicative, unnecessary, or impractical reporting requirements or those which it is unwilling or unable to enforce.

The last point is self-evident. The first two ideas acknowledge that there are countervailing forces operating which affect the extent to which the objectives in the Committee's statement may be achieved.

The forces divide into two groups: those which the Commission should consider in setting disclosure policy, and those of which the Commission should be aware but which ought not to deter the Commission from a course of action in furtherance of its objectives.

In the former category the Committee would place the costs imposed upon issuers -- both hard dollar costs, and the softer, more difficult to measure, costs -- competition, incentive to innovate and the like. In determining the quality and amount of information to be made available, the Commission must take into account the cost of providing the information. The Commission in setting disclosure policy should apply whatever techniques are available to measure the cost effectiveness (be it cost-benefit analysis or professional judgment) of its proposals.

In the other category -- those matters of which the Commission should be aware -- are certain consequences of disclosure policies, such as the rate of capital formation, confidence of investors in the fairness of the security markets, the allocation of investment among firms, or effects on relationships with foreign countries which may result from the pursuit of the Commission's objectives but which are incidental to the Commission's objectives. The Committee

urges Commission awareness of the consequences because, if the Commission is not aware of and does not report on these matters, those in the government who do have these and related consequences as primary objectives will not be able to respond to correct policy imbalances. In a sense, the Commission is assigned the obligation to alert the rest of the government to important consequences of the pursuit of the objectives which the Congress and President have given it. The Commission should not, however, be deterred from the pursuit of its own objectives because the consequences thereof may be viewed as adverse by others.

The Committee's final observations relate to the last line of the statement: "The Commission should not adopt disclosure requirements which have as their principal objective the regulation of corporate conduct." One of the reasons the technique of disclosure was adopted was that it would inhibit that fraud which depends for its success on non-disclosure or on misleading or false disclosure -- in other words, it would alter and improve the conduct of corporate affairs.

The prevention of fraud and the altering of corporate conduct are necessary consequences of "disclosure" as a regulatory technique. This effect of the disclosure concept is one reason it was chosen as the means to protect investors. Certainly disclosure still has this effect and purpose, and the Committee believes it desirable.

Nonetheless, the Committee does not believe that disclosure requirements should be imposed, regardless of the materiality of the information to be elicted, because of the effect they will have on corporate conduct. If the Commission sees the need to directly regulate corporate conduct, it should request Congress to authorize it to do so and should not do so through requiring disclosure of immaterial information.[4/]

4/ Parenthetically, the Committee would emphasize that a system which provides a sufficient amount of reliable, timely disseminated company-originated information does not alone provide adequate assurance that securities markets will operate in an optimum manner or be characterized by the desired degree of integrity. The achievement of those goals entails more. Among the other factors that affect markets are the integrity of the disseminators of information, the analysts who use it, the broker-dealers and, to a lesser extent, the conduct of investment advisers. To the extent that analysts, for instance, are not competent in assimilating and interpreting the information that is available, investors, particularly less sophisticated ones, will be denied a large measure of the benefits that should flow from the disclosure system. Misconduct by a registered representative may have a similar effect. Distortions or inaccuracies by disseminators can similarly impede the most efficient use of the information available.

It is, then, important that, in addition to addressing the issues discussed in this Report, the Commission also be alert to the adequacy of its regulation of participants in the investment process other than issuers. This Committee has not sought to determine whether the Commission has adequate powers to deal with those problems or whether it has used those it has effectively, but it urges that the Commission address these questions as well as those discussed in this Report.

CHAPTER VIII

MATERIALITY CONSIDERATIONS

A. Introduction

The concept of materiality is the cornerstone of the disclosure system established by the federal securities laws. It serves a variety of functions, operating both as a principle for inclusion and exclusion of information in investor oriented disclosure documents and as a standard for determining whether a communication (filed or otherwise) omits or misstates a fact of sufficient significance that legal consequences should result. Further, the concept functions as a standard for determining in a particular instance whether a person considering a securities transaction has knowledge such that he should

be barred from effecting transactions lest he have an unfair advantage over others.

Although the functions of the materiality concept are clear, its application in any particular instance may not be. Both as articulated by the courts and as set forth in Commission rules,[1/] the definition is not readily translatable into objective criteria. Because of this, there is no certainty that reporting companies, their advisers, the Commission and its staff and the other participants in the securities markets who are continuously making materiality judgments in their different contexts share an understanding of the concept or that their views accord with the perceptions of those who use disclosure documents. The Committee analyzed and reviewed discussions of the materiality concept submitted to it and otherwise available and although no recommendation is forwarded to the Commission the Committee believes a summary of its views may be useful.

1/ In its most recent pronouncement on the issue, the Supreme Court held that the standard for assessing the materiality of a fact omitted from a proxy statement is whether there is "a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote." TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976). Presumably, this general standard carries over to contexts other than proxy solicitation. Rule 405 under the Securities Act of 1933 defines "material" when used to qualify a requirement for the furnishing of information as to any subject, as limiting the information required, "to those matters as to which an average prudent investor ought reasonably to be informed before purchasing the security registered." See also Rule 12b-2 under the 1934 Act.

B. The Committee's Discussion

The Committee is unsure how much uncertainty is associated with the application of the materiality concept. In response to the question "How should the standard of materiality be defined under the federal securities laws?" a number of commentators on Release 5707 stated that existing definitions are adequate. Moreover, with few exceptions, the companies in the Committee's case study indicated both a willingness and an ability to work with the materiality concept as currently formulated.

To the extent there is a problem however, the Committee is of the view that the Commission should not attempt to develop an objective definition of materiality that will have general applicability to all fact situations. In the Committee's opinion the materiality of a particular fact must be determined after evaluating the significance of that fact within the total business and financial circumstances of the company including its impact on future financial performance. Because management has available the information necessary to make this evaluation it has major responsibility for doing so.

Although the initial materiality determination is management's, this judgment is, of course, subject to challenge or question by the Commission or in the courts. The Committee believes that the Commission can pursue

certain policies which will assist both reporting companies and the courts in applying the materiality concept.

First, because materiality, as a general proposition, should reflect the perceptions of both users and preparers as to what is material, consultations with these groups can assist the Commission in identifying new categories of information which are material as well as other disclosure problem areas. This belief underlies the Committee's recommendation that the Commission develop industry guides.

The contribution which preparers of information can make is evidenced by the pattern of disclosure which has developed in the cash tender offer area. The Commission's schedule for disclosure has been a skeleton outline. Moreover, there has been essentially no staff processing of the filed material. Expanded disclosures have resulted primarily from judge-made law and, more importantly, from the views of bidders and their advisers as to what was appropriate.

Secondly, to the extent the Commission deems guidance in the application of the concept of materiality necessary, it should amend its disclosure requirements to reduce uncertainty. Where feasible, the clarification should be effected through rule-making rather than through adjudication or on an ad hoc basis. This is one of the bases of the Committee's recommendations on rule-making and monitoring discussed in Chapter IX.

Schedule A to the 1933 Act represents a Congressional expression of categories of information which are material to investors. The Commission's rules and forms are refinements and elaborations of these categories, and the Commission can adjust them as necessary to clarify problem areas. These adjustments may be through form amendments, adoption of staff guidelines or adoption of new rules.

If the problem is not with a category of information but rather with identifying when an event within a category is significant, the Commission may consider establishing numerical benchmarks for materiality. It has done this in its requirement that a legal proceeding which involves primarily a claim for damages need not be reported if the amount involved exclusive of interest and cost does not exceed 10 percent of the current assets of the registrant and its subsidiaries on a consolidated basis. The definition of "significant subsidiary" in Regulation S-X is another example. This approach may be particularly useful in the case of financial statement disclosures because it is only feasible when the fact in question is readily quantifiable.

Numerical benchmarks can be of several kinds; there are advantages to each. A fixed determinant ("Five percent of revenues is material.") gives the greatest certainty, and provides a safe harbor for companies. Management does not have to guess as to what the SEC and the courts will view as material. However, a fixed determinant also may

result in boilerplate disclosure. The SEC may tend to set percentage levels on the low side, and this can result in a focus on relatively trivial data and a lack of emphasis on key factors. Finally, fixed determinants are somewhat inconsistent with the judgmental nature of materiality.

An alternative to a fixed determinant is a benchmark which operates as a guide or creates a presumption of materiality. Thus, in Guide 22 as presently in effect, fixed percentages are set forth for when a change merits discussion: "The item increased or decreased by more than 10% as compared to the prior period and increased or decreased by more than 2% of average net income or loss." The Guide makes clear, however, that even though an item may meet these standards, if the issuer does not believe the change is material the discussion may be omitted and a supplemental statement of reasons for the omission provided to the staff. A second form of benchmark that the Commission might consider in the future is the identification of ranges which may be material: "Five to ten percent can typically be material." While the benchmark approach is more consistent with the nature of the materiality concept, certainty is sacrificed. It should be noted that the benchmark may be changed if through experience with its operation it appears that the mark is high, low or, in the case of presumptions, too ambiguous.

The Commission will also maximize the effectiveness of the materiality concept if it only asserts as material

information related to its objectives. The Committee recognizes that the different categories of information users--employees, the government, competitors, investors--may have different perceptions of materiality. However, as the Committee views the Commission's objectives, the Commission should only concern itself with information material to investment and corporate suffrage decision-making.[2/] Materiality then, must be determined in this context only. To the extent the Commission asserts as material information not related to its objectives, it confuses those who must make materiality judgments in the investment context.

The Commission has traditionally viewed investors as being motivated by economic concerns and as being interested in information which reflects on the current and future economic performance of their invest-

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2/ See Chapter VII. Although the Advisory Committee discussed the issue of whether the materiality standard is the same for both corporate suffrage and investment decision-making, it was unable to reach a consensus. In the view of some members of the Committee, information relating to the "quality" and "integrity" of management and the directors, its compensation, and the functioning of the board is material on a continuous basis for investment decisions. At the same time, other members of the Committee believe that, in the context of an election of directors, more extensive information is appropriately called for concerning management and the directors than would routinely be provided to the market place for investment judgments.

ment. The Committee concurs in this view.

C. Conclusion

Although the Committee believes that ideally it would be desirable to have absolute certainty in the application of the materiality concept, it is its view that such a goal is illusory and unrealistic. The materiality concept is judgmental in nature and it is not possible to translate this into a numerical formula. The Committee's advice to the Commission is to avoid this quest for certainty and to continue consideration of materiality on a case-by-case basis as disclosure problems are identified.

CHAPTER IX

THE COMMISSION'S RULE-MAKING AND MONITORING PRACTICES

RECOMMENDATIONS

The Commission should initiate the rule-making process promptly after identifying a disclosure issue of general significance rather than proceeding exclusively through administrative or enforcement procedures.

Prior to developing the text of a rule involving a major conceptual issue with which the Commission has had limited experience and concerning which there is limited conceptual literature, the Commission should publish a "concept release" identifying the matter being considered, discussing the issues presented and alternatives available and requesting public comment on the "concept" of the proposed new requirement.

Rules proposed for comment should be deemed withdrawn if not adopted or reproposed for comment in modified form within a specified period of time after the expiration of the most recent comment period. A release should be promptly issued to explain why no action was taken. Similarly, concept releases should be withdrawn if no action is taken after a specified period of time and reasons for the withdrawal should be announced.

The Commission should expand the information content of releases announcing the adoption of a rule to include certain additional information and undertakings related to monitoring of the consequences and costs of new disclosure requirements. (The monitoring undertaken may be informal and non-empirical and need not be limited to economic analysis.)

The Commission should continue to be aware of research that is relevant to its statutory mandate and, if necessary, actively encourage such research.

The Commission's annual report to Congress should reflect the information developed by these recommendations.

Regarding industry guidelines:

The Commission should develop disclosure guides for specific industries to encourage uniform textual and financial statement disclosure of material items which are unique to a particular industry.

A mechanism should be established by the Commission to assure that it receives appropriate input from the users and preparers of information in the specific industry prior to the articulation of guidelines.

A few industries should be selected initially as an experiment for these recommendations.

The effectiveness of this experimental program and the guidelines should be reviewed by the Commission within a reasonable time after adoption.

A. Introduction

In Chapter VII the Committee briefly discussed the process by which the Commission should pursue its objectives. It recommended that they be pursued in a "reasonable and efficient manner," because in the Committee's judgment the process by which disclosure requirements are adopted can be as important to the operation and public acceptance of the Commission's disclosure program as the objectives pursued or the substantive requirements enacted. A well-functioning

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disclosure process includes (1) consideration of the costs imposed by disclosure requirements; (2) an awareness of the consequences which result from a disclosure policy decision; and (3) the avoidance of undesirable, unnecessary, or ineffective reporting requirements. This chapter discusses this area in greater depth.

The Committee presents a series of recommendations to improve the quality and efficiency of the Commission's rule-making activities by increasing the flexibility of that process, by maximizing the input of affected constituencies, and by acknowledging a monitoring obligation on the Commission's part. It also suggests how these recommendations might avoid the criticism that the Commission's disclosure requirements are imposed across the board on all publicly held companies without regard to whether they are relevant to a particular company's situation.

B. The Commission's Rule-Making and Monitoring Process: A Series of Proposals

Section 553 of the Administrative Procedure Act [1/] mandates the procedural pattern for agency rule-making. It provides for general notice of the proposed rule and requires that the agency give interested persons an opportunity to submit written data, views or arguments on the proposed rule. Oral presentations may also be permitted. "After

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1/ 5 U.S.C. §553 (1970).

consideration of the relevant matter presented," the agency is required to incorporate in the rules adopted a concise general statement of their basis and purpose. Except for paragraph (c) of Section 553, which requires the agency to give interested persons the right to petition for repeal of a rule, there is no requirement for any post-adoption monitoring.

The recommendations which the Committee proposes for the Commission's consideration are intended to complement the provisions of Section 553, by maximizing the Commission's own disclosure of its rule-making activities. The Commission should take steps promptly (1) to inform its constituencies of new disclosure policies under consideration; (2) to encourage input into this policy-making at the earliest possible stage; (3) to monitor the consequences of rules after adoption; and (4) to report to the public and the Congress fully and promptly on reasons for Commission action or inaction and on the anticipated and actual consequences of its policies.

The benefits of such an approach are three-fold. First, early input will enhance the flexibility and therefore the quality of the rule-making process; second, the Commission staff and those affected will more clearly understand Commission requirements; third, by undertaking a monitoring program, the Commission will be in a position to eliminate unnecessary, ineffective or obsolete requirements and enforce those which are not being complied with.

Prompt Initiation of the Rule-Making Process. The Commission sometimes establishes disclosure requirements in indirect ways, for example, by commenting on a registration statement or periodic reports, by instituting an enforcement action alleging that the failure to disclose the information in question constitutes a misleading omission, or through announcement of new requirements in a Commissioner's speech.

These indirect methods of setting disclosure policy are sometimes necessary when new problems arise. 2/ Nonetheless, they should only be viewed as temporary techniques to be confirmed promptly by the rule-making process, as soon as the Commission and its staff have identified and understood the issue.

The Committee recommends that when the reporting of information in question is deemed by the Commission to be material or necessary for the protection of investors, with respect to registrants in general or a class thereof, the Commission should with reasonable promptness initiate rule-making 3/ rather than proceed on a continuing basis to

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2/ There is no implication in this recommendation that the Commission should not maintain a vigorous and imaginative enforcement program. In fact, in certain cases an effective enforcement program for existing requirements may be a more desirable alternative than establishing new requirements.

3/ The term "rule-making" is intended to suggest the process described by the Administrative Procedure Act and, accordingly, is directed to the process as opposed to whether a "rule" or "guide" is the output of such process.

administratively set policy through comments on filings, through initiation of enforcement actions, or through other indirect practices.

Unless the Commission proceeds through rule-making, affected parties may not have sufficient notice to plan a course of action to comply with the new requirement. Further, only in rule-making is there provision for general public participation in the setting of agency policy as envisioned by the Administrative Procedure Act. Only the views of the particular registrants who have filed a registration statement or been the subject of an enforcement action are considered if an informal process is pursued. A rule-making proceeding affects all interested parties evenhandedly. It alerts persons concerned to what the Commission is thinking and clarifies the new reporting obligation. When another route is chosen, neither the public nor members of the staff may be able to perceive the scope or applicability of the new requirement.

Issuance of Concept Releases. By first presenting a complete package of rules designed to address a problem, the Commission loses considerable flexibility. The staff tends to be set in its position, having spent long hours drafting a complete package of proposals. Those commenting on the rules suspect that the Commission's basic approach has been set and that only technical changes are likely to be considered. These perceptions limit the usefulness of

the comment process. With a concept release, the interested public's attention will be directed to the major issues rather than toward the specific text of a proposed rule. This should result in a more thoughtful analysis.

Prior to developing the text of a rule involving major conceptual issues with which the Commission has had limited experience, 4/ the Committee recommends that the Commission publish a concept release identifying the matter being considered, discussing the issues presented and alternatives available and requesting public comment on the concept of the proposed new requirement.

The concept release might describe who or what set of circumstances brought the matter to the Commission's attention and why the issue ought to be covered by rule. If the Commission has a strong predisposition toward one course of action, it could so state, indicating reasons for that predisposition. Public comment would then be requested before the staff actually prepared and published the text of a rule. This approach should result in the public becoming aware at an earlier date of what the Commission is considering and why. The second release proposing the rule for comment would respond to the comments made on the concept release

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4/ For example, recent Commission activities in which a "concept release" might have been appropriate include the projections, replacement cost, beneficial ownership, and "going private" issues all of which raise significant conceptual problems.

and would articulate why the Commission was proceeding along its chosen course. It would be evident that the Commission was not proceeding in an arbitrary fashion. Its premises and objectives would be clear, and would provide a basis for post-adoption monitoring.

In most cases the additional step of a concept release will not be necessary. It will usually not be required when existing rules are being modified, or when public hearings have been conducted to solicit input. Only when the Commission proposes to enter a new area would this recommendation be applicable.

Prompt Withdrawal of Proposals Not Acted Upon. An outstanding Commission rule proposal, particularly one concerning a controversial subject, tends to "overhang the market," producing uncertainty and affecting behavior of those who potentially will be subject to the rule. The staff often treats it as in effect when it chooses. This is not equitable. A reasonable time after the proposal is made, the Commission should reach a decision. This is the necessary culmination of a rule proposal. Without it, neither the public nor the staff can be sure what the Commission's policy is. 5/

5/ On February 6, 1975, in Securities Act Release No. 5567 the Commission proposed for comment Rules 13e-3A and 13e-3B. They were issued as part of a notice of public fact-finding and rule-making on "Going Private" transactions. The proposed rules are still outstanding and the Commission's position remains unclear. Similarly, proposed Rule 13e-2 relating to issuer repurchases was announced in Securities Exchange Act Release No. 10539 (Dec. 6, 1973). It also remains outstanding.

The Committee recommends that proposed rules be deemed withdrawn if not adopted or reproposed for comment in modified form within a specified period of time after the expiration of the most recent comment period. A release should be issued to explain why no action was taken. Concept releases should also be withdrawn if no action is taken.

Increased Monitoring Activities. In the discussion of objectives the Committee urged the Commission to consider the costs and to be aware of the consequences of its policies, including those not related to its objectives. The agency has a responsibility to report on these consequences so that the Commission itself can evaluate the effectiveness of its programs and so that those affected by the regulation, political leaders and other policy-makers and the public at large, may be put on notice as to the effects of the Commission's activities.

The Committee recommends that at the time of adoption of a substantive new disclosure rule (or form) [6/] the Commission publicly announce whether it intends to monitor the realization of anticipated benefits and potential adverse consequences. To date, it appears that

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6/ The word "substantive" as used herein is intended to mean any new rule adoption or amendment which calls for disclosure of information which up to the time of the adoption or amendment has not been required in any of the Commission's rules (or forms) and which is perceived by the Commission, based upon comments from preparers, to involve significant costs in preparation of the information or as resulting in significant adverse consequences.

there has been little effort by the SEC to monitor the predicted effects of its rules.

Some disclosure rules affect, among other things, both the resource allocation decisions of companies and individuals and the distribution of wealth. As indicated in Chapter VII, it is not the SEC's function to be concerned with resource allocation and wealth distribution; however, Congress (and the general public) should be aware of the economic effects of disclosure rules in order to consider whether the societal costs of providing useful information to investors have surpassed the potential benefits.

The potential difficulties of establishing a monitoring system do not diminish either its importance or the Commission's responsibility to monitor and report the results of its rule-making to the maximum extent feasible. Therefore, the Committee calls for Commission awareness of potential consequences at the time of rule-making, consideration of whether the rule should be monitored, and, where desirable and feasible, a description of the monitoring program.

Among the different types of monitoring the Commission might consider are reissuing the rule for comment, holding hearings on the operation of the rule, consulting with affected parties, and undertaking empirical studies of the price and volume effects of the rule similar to that which Professor Paul Griffin conducted for the Advisory Com-

mittee.[7/] Whichever method(s) the Commission may experiment with, it will probably want to consider the following in selecting a particular program:

(1) Has the additional information proved useful to investors and, if so, how? If not, why not?

(2) Has the disclosure rule affected the cost of information production and, if so, to what extent?

(3) What has been the impact on costs of dissemination and analysis?

(4) Has the disclosure rule achieved the intended benefits and/or resulted in the negative consequences projected by commentators on the proposed rule?

A monitoring system encompassing these objectives will not be problem-free. However, given the potential economic consequences of SEC disclosure regulation, there is sufficient public interest in the evaluation of SEC regulatory behavior to justify serious consideration of a monitoring program.

Acceptance of a monitoring obligation would also encourage the Commission to re-evaluate periodically all of its outstanding rules. It would keep the disclosure requirements current and effective and prevent the development of an encrusting layer of unnecessary and irrelevant information in disclosure documents.

7/ See Chapter XXII.

The Commission and Academic Research. The Committee believes that the Commission should be aware of the research being conducted in academia and elsewhere in the private sector that is relevant to its statutory mandate or to an evaluation of its effectiveness in fulfilling such mandate. Moreover, where the Commission perceives a substantial deficiency in such research, it should perform its own research or contract with outside parties in order to improve its ability to assess the consequences of its policies and rules or to understand the effects of information on securities markets.

For example, there has been a large amount of academic research relating to the "efficiency" of the securities markets in reflecting the information content of all publicly available information. This research has important implications for policy-making regarding disclosure. However, most of this work has been performed with respect to companies whose securities are actively traded. It may be that the market is not "efficient" with respect to other companies. If so, there may be implications for the Commission in setting disclosure policy different from those contained within the assumption of an "efficient" market. This is an area in which the Commission might encourage additional research.

Reporting to Congress. The Committee also recommends that the Commission report fully to Congress in its annual

report on the results of its monitoring activities and reconcile those results with the objectives the Commission seeks to further.

For rules that have been in place for a reasonable period of time, the discussion could describe why the rule was adopted, how the rule was monitored, and positive and negative consequences of the rule as evidenced by the monitoring. For new rules adopted during the fiscal year being reported on, the Commission could identify the perceived positive and negative consequences and report on whether or not it is going to monitor the rule and if so, how.

It will, of course, not be possible to do this for every new rule or form or amendment to an existing rule or form. The Commission will have to identify those which potentially will have the most impact on the disclosure system.

C. Industry Guides

The Committee would like to apply the foregoing proposals as part of a solution to an often-made criticism of one of the Commission's rule-making practices. It is suggested that sometimes the Commission's disclosure requirements are applicable to registrants for whom they have no meaning, and that disclosures material to one industry should not be required for other industries as to which they are not applicable.

This problem could be substantially alleviated and disclosure documents made far more useful if a different,

more flexible, approach were taken to establishing disclosure requirements. It is proposed that the Commission continue and expand the approach taken in adopting Guide 55, relating to interests in oil and gas programs, Guide 60, relating to preparation of registration statements for interests in real estate limited partnerships, and Guide 61, relating to statistical disclosures for bank holding companies, by adopting additional disclosure guides applicable to particular industries.[8/]

This approach has the following advantages:

1. The extent to which registrants would have to comply with disclosure requirements which are not meaningful to their situation would be minimized;

8/ This recommendation was forwarded to the Commission on November 9, 1976 accompanied by a memorandum from the Division of Corporation Finance, requesting authorization to develop on a limited, experimental basis disclosure guidelines for four industries: Class I railroads, casualty insurance companies, scheduled airlines and one other industry at that time undetermined. The Division requested authorization to obtain input from users and preparers of information. The memorandum was approved. The first step toward implementation occurred on April 28, 1977, when the Commission announced in Securities Act Release No. 5824 that it was coinsidering the formulation of rules and guides with respect to the form and content of railroad industry disclosure requirements and requested public input. Securities Act Release No. 5827 (May 19, 1977) announced that guidelines would be developed for the disclosure to be included in registration statements and reports filed by electric and gas utility companies.

2. Disclosures of vital importance to understanding a company in a particular industry would be secured; and

3. The Commission's staff would have a ready reference for a particular industry, thereby avoiding any charge that the staff had failed to apply uniform disclosure requirements to all registrants in an industry.

Applying some of the recommendations set forth in Section B above, the Committee recommends the following process for affecting this reform.

The Division of Corporation Finance might wish to supplement the Commission's current rule-making practices to secure appropriate input from the users and preparers of information in the specific industry. For example, in addition to issuing a release requesting general comment, the Division might request the Financial Executives Institute and the Financial Analysts Federation (and other representative professional and industry trade associations) to form industry committees to prepare a joint recommendation to the Division. On a continuing basis, these committees might monitor the effectiveness of the industry guides and recommend revisions.

An experimental approach for a few industries would permit the Division to explore which mechanisms for securing input from users and preparers are most successful, thus enabling the Commission to evaluate the results before committing large amounts of resources.

PART III

RECOMMENDATIONS REGARDING SUBSTANTIVE DISCLOSURE REQUIREMENTS

CHAPTER X

SOFT INFORMATION

RECOMMENDATIONS:

Regarding forward looking information:

The Commission should encourage issuers to publish forward-looking and analytical information.

Experimental programs to encourage certain types of information such as projections and future-oriented analysis should be initiated.

Monitoring of these programs is encouraged for the purpose of determining the usefulness of the information to investors, the costs to issuers, and the responsiveness of issuers to user needs.

The SEC staff review process should be coordinated to assure proper implementation of Commission policy and uniform treatment of issuers.

A safe harbor rule should be adopted to provide maximum incentive for disclosure of management projections and other forward-looking information, whether or not filed with the Commission. The purpose of the safe harbor rule would be to place the burden of proof on the person seeking to establish liability for the disclosure of a management projection, management's analysis of financial information, plans and objectives, and other items of forward-looking and analytical information. The safe harbor rule should be applicable to all registrants and should provide protection from li-

ability unless it is proven that the information was prepared without a reasonable basis or was disclosed other than in good faith.

Regarding Projections:

The Commission should develop an experimental program to further encourage the disclosure of information concerning future company economic performance, including the following steps:

A public statement should be issued to encourage public companies to disclose statements of management projections of future company economic performance in their filings with the Commission on a voluntary basis. These disclosures should be subject only to the conditions that the projections be prepared on a reasonable basis, be disclosed in good faith and be accompanied by an appropriate cautionary statement regarding the inherent uncertainty of the information.

The Commission's statement encouraging the voluntary disclosure of management projections should state the following:

a. Disclosure of material underlying assumptions and comparisons of projections with actual results, including management analysis of any significant variance, should be encouraged but not required;

b. The items of information to be forecasted should rest within the discretion of management, but should be those most relevant in evaluating the company's securities and should not be items whose projection would create materially misleading inferences;

c. Third party review of management projections should be permitted but not required;

d. Projections previously issued by management having currency at the time a registration statement is filed should be required to be included in the registration statement in their original form or, where necessary, in modified form;

e. The time period to be covered by the projection should rest within the discretion of management; and

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f. Inclusion of projections in one Commission filing should not "lock" the registrant into including projections in future filings; likewise, registrants should be permitted to resume the inclusion of projections in filings after a prior discontinuance. However, companies should be encouraged not to discontinue or resume projections in filings without good cause.

The statement should remind companies issuing projections of their obligations under the Federal securities laws to keep such information from being or becoming misleading and to disclose projections on an equitable basis.

Regarding management analysis of financial information

(Guide 22 of the Guides for the Preparation and Filing of Registration Statements under the Securities Act of 1933 and Guide 1 of the Guides for Preparation and Filing of Reports and Registration Statements under the Securities Exchange Act of 1934):

The requirement for management analysis should be modified to emphasize that registrants will be given broad latitude as to implementation of the disclosures requested.

It should also be modified to explicitly recognize two separate aspects of management analysis: (1) quantitative analysis (e.g., variance analysis) and (2) discussion of historical facts.

The requirement should be amended to call for a letter, signed by the Chief Financial or Accounting Officer of the registrant and submitted with each appropriate filing, stating that due regard was given to the requirement and in particular to that part which calls for the disclosure of any facts and contingencies known to management which would make the historical record not indicative of the future. This requirement for a letter should terminate three years after its promulgation unless it is expressly extended by the Commission.

Regarding management's plans and objectives:

The Commission should encourage disclosure of planned capital expenditures and methods of financing by business segment for the current fiscal year and the succeeding four fiscal years indicating: (a) amounts thereof related to environmental control facilities; and (b) the expected effects on production capacity.

The Commission should encourage disclosure of management plans and objectives.

Regarding dividend policies and capital structure policies:

The Commission should encourage registrants to publish statements of dividend policies.

The Commission should encourage registrants to publish statements of capital structure policies.

A. Introduction

The traditional disclosure policy of the Commission has been insistent on permitting only "hard" information (i.e. statements concerning objectively verifiable historical facts) as distinguished from "soft" information (i.e. opinions, predictions, analyses and other subjective evaluations) in company registration statements and reports. In excluding soft information, the Commission may have been primarily motivated by a desire to protect unsophisticated investors from being misled by the natural optimism of business enterprises selling their securities to the public.

Disclosure was intended by the framers of the Securities Act and Exchange Act to serve two primary, and correlative, functions. It was believed that disclosure (1) would provide investors with a sound basis for making informed and rational investment decisions; and (2) would deter those in control of public business enterprises from fraudulent and unethical conduct.1/

1/ See Chapter XIX at 560-65.

Although it is at least arguable that the statutory disclosure system created by the 1933 and 1934 Acts was perceived by Congress and commentators as being particularly suited to the interests of sophisticated investors and securities professionals,[2/] for many years the disclosure policy of the Commission was based on the belief that the relevant constitutency was the unsophisticated investor.

The disclosure objective of providing meaningful information to the investment community has, in cases of perceived conflict, been subordinated to the objective of protecting unsophisticated investors from their own ignorance. Thus, for example, the Commission has excluded certain types of information from SEC filings for fear that such information, although useful and important to knowledgeable constituents of the investment community, might be misunderstood and unduly relied upon by unsophisticated investors.

Critics of the exclusionary policy have contended that the Commission has subverted the statutory mandate and the underlying Congressional objectives of disclosure. These critics believe that the interests of all would be better served by a disclosure policy that had as its predominant objective the disclosure of meaningful information to the investment community. It would indirectly benefit un-

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2/ Id. at note 11. See also Douglas, "Protecting the Investor," 23 Yale Rev. (N.S.) 508-24 (1933) quoted at 312-13.

sophisticated investors by promoting the development of more informed investment advisory services and market prices that more accurately and reliably reflect the intrinsic value of securities.

The Commission has exhibited an increasing awareness of the importance of disclosure for informational purposes as opposed to protectionist purposes. Most notable were its 1973 statement that projections of future economic performance would be permitted in company filings under certain conditions, its 1974 requirement for "Management's Discussion and Analysis of the Summary of Earnings," its 1976 replacement cost accounting rules, and its 1976 proposed guides for disclosures of projections of future economic performance. Such information was, until recently, regarded as not sufficiently "hard" to be disclosed in Commission filings.[3/]

Consistent with the objectives the Committee identified for the Commission--that the primary function of the Commission with respect to the corporate disclosure system is to assure the public availability of reliable, firm-oriented information material to informed investment, decision-making--the Committee endorses this departure from the Commission's traditional policy. The investor's task is to assess future earning power of the corporation.

3/ Appendix X-A describes the evolution of Commission policy on disclosure of forecast information.

For many investors and their advisers forward-looking and analytical information are key ingredients to assessments of the future. 4/ Accordingly, the Commission should seek to facilitiate and improve the disclosure of soft information.

This chapter reports specific recommendations for doing so. It is divided into three major sections. The first describes and dicusses the Committee's recommendations on disclosure of management forecasts of company performance. The next section proposes changes designed to improve the quality of the disclosure secured from the Commission's requirement for a management analysis of the summary of earnings (Guide 22 under the 1933 Act, Guide 1 under the 1934 Act, hereinafter referred to as "Guide 22" or "management analysis"). The last section discusses recommendations concerning disclosure of management's plans and objectives, planned capital expenditures and financing, capital structure and dividend policies.

B. Management Projections

Management projections of future company economic performance ("projections") include forecasts of earnings, sales, net income, and other financial statement items. For purposes of the present discussion,

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4/ See Chapter II at 55-57 and Chapter VI at 290.

it excludes statements of management plans and objectives, budgets and other future-oriented data. Projections are deemed important and useful information by many constituents of the investment community,[5/] even though the evidence of accuracy is not encouraging. Recent court decisions have held the omission of management projections, under certain circumstances, to constitute the omission of material information under the federal securities laws.[6/] Further, the importance and usefulness of projections has been recognized by commentators in recent literature; projections being termed "the real key to the present value of securities,"[7/] "among the most significant factors influencing securities prices" and "highly relevant to investors."[8/] Professor Kripke has noted:

5/ See Staff Report "Summary of the Principal Arguments For and Against the Inclusion of Projections in SEC Filings" (hereinafter referred to as "Summary") at 3, 5 and accompanying footnotes. (Appendix X-B)

With regard to the reliability of projection information, Professor Kripke has noted: "Although the research evidence on the accuracy of projections is not encouraging, this seems to me not to be the point. That investors pay attention to projections is conceded." "A Search for a Meaningful Securities Disclosure Policy," 31 Bus. Law. 293, 314 (1975).

6/ See Schneider, "Nits, Grits and Soft Information in SEC Filings," 121 U. Pa. L. Rev. 254, 280 (1972) at 280; Feintuch, "Soft Information; Liability Standards and Safe Harbors (Case Law)," Memorandum to Martin Lipton (June 28, 1976) (Appendix X-C).

7/ Herwitz, "Projections and Forecasts," 4 Ann. Inst. Sec. Reg. 323, 327 (1973).

8/ Schneider, supra note 6, at 280.

> If there is any hope that the public or even the professionals can make an informed investment judgment, it must start with a crystallization of all the plethora of information into a projection for the future. The management is in the best position to make the initial estimate; on the basis of it the professional or investor could then make his own modifications. No other single change could add as much meaning to the unmanageable and unfocused flood of facts in present Commission documents. 9/

Similarly, a prominent securities law practitioner has stated:

> An earnings prediction intelligently arrived at is crucial to investment decisions. It goes to the very heart of security prices. Where the issuer is going, not where he has been, will determine future market prices and the ultimate success of the investment decisions.10/

It has also been pointed out that projection information provides the investment community with a useful standard for evaluating the quality of management:

> It may be time for the securities acts to require the dissemination of information bearing on the competence of management, information which will give the public insight into whether management is doing its job by running the company in a proficient and professional manner. Disclosure of corporate planning processes, budgets and projections may be a step in this direction. The mere disclosure of results of operations is not sufficient to test the quality of management. It is not

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9/ Kripke, "The SEC, The Accountants, Some Myths and Some Realities," 45 N.Y.U. L. Rev. 1151, 1191 (1970).

10/ Mann, "Prospectuses: Policies Against Permitting Projections," 40 Geo. Wash. L. Rev. 222, 224 (1971).

> only important to know what has happened; it is equally or more important to know how it happened and whether it was supposed to happen. A test of management is whether it is realistic about the goals of the company and whether it can orchestrate the dynamic parts of the company to obtain these goals, whether management is efficient at planning and control.11/

The Advisory Committee is of the opinion that the Commission should issue a public statement encouraging companies to disclose voluntarily management projections in their filings with the Commission and elsewhere.12/ In order to maximize the attractiveness of the program to registrants, the Committee's recommendation permits wide latitude to companies issuing projections and the Committee suggests that staff review of forecast information be consistent with this wide latitude. The Committee views this as an experimental program and believes it should be monitored for the purpose of determining the usefulness to investors of the information resulting, and the costs to issuers. The remainder of this section will identify the

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11/ Merrifield, "Projections in SEC Filings: Debate Rages over Worth" SEC 149, 168 (1974).

12/ To date, few companies have voluntarily included projections in their filings with the Commission even though expressly permitted to do so. In September 1976, the Advisory Committee staff sent a memorandum to all chiefs of reviewing branches in the Division of Corporation Finance requesting information on projections included in Commission filings. Responses indicated that the branch chiefs were aware of only 10 companies that had included projection information in their filings with the Commission.

principal features of the program the Committee recommends.

Voluntary Disclosure. The Committee believes a voluntary projection system is more appropriate than a mandatory system for the following reasons:

1. A mandatory system would necessitate the formulation of specific disclosure rules and regulations. The Committee is of the opinion that the Commission does not now have an appropriate basis for formulation of such rules and regulations, and that a period of experimentation is warranted.

2. All public companies should not be required to sustain the expense and other burdens that may be associated with a mandatory program for the public disclosure of projections. In some instances, companies might reasonably find that the burdens of projection disclosure would outweigh any corresponding benefits.

3. Public companies should not be compelled to expose themselves to the potential risks of liability and litigation for inaccurate projections.

4. Many companies would find it difficult, if not impossible to prepare reasonable projections due to a lack of operating history, general economic factors or industry conditions.

One drawback to a voluntary system is that many issuers may choose not to provide any information. But after the Commission's long history of opposition, a reversal must not be too abrupt. If the information is truly valuable to investment decision-makers, then market forces, i.e., demand by investors, may be a strong force to impel such disclosures.

There are indications that good disclosure practices have positive effects. For example, the Financial Analysts Federation Study[13/] (Appendix II-B) indicates that one reason a company may not be closely followed by analysts is that it has poor disclosure policies. Also, several companies that participated in the case study indicated during the interviews that they maintain an analyst relations program because they believe that being followed by well-informed analysts is an important factor in the liquidity and price of the company's stock. Both the analysts and the companies also stated that good disclosure by one company in an industry provides an incentive for other companies in the industry and a lever for the analysts seeking information from those other companies. How strong and effective those market forces are has yet to be measured, but this program may provide insight.

The Commission should, however, remind companies issuing projections of their obligations under the federal securities laws to keep projection information from becoming misleading[14/] and to disclose projections on an equitable basis.[15/]

13/ See Chapter II at 39-42.

14/ See Feintuch, supra note 6.

15/ See Securities Act of 1933 Release No. 5581, (April 28, 1975) at 3. See also 360-61 infra.

Registrant Criteria. In the 1976 proposed guides, it was stated: "Management should have the option to present in Commission filings its good faith assessment of a company's future performance. Management must, however, have a reasonable basis for such an assessment. A history of operations or experience in projecting may be among the factors providing a basis for management's assessment." 16/

Commentators have indicated opposition to the proposed issuer limitations. With regard to the Commission's 1973 statement on projections, one commentator noted:

> There has been no empirical evidence to suggest that the "size" of the company has anything to do with the reliability of its projections. Indeed, there is some limited evidence that there is no positive correlation between size and reliability. Nor, is there any empirical evidence to suggest that a company with established earnings is better able to project than a company without established earnings. Indeed, some companies which have shown yearly reporting losses may be in an ideal position to accurately project revenues--life insurance and leasing companies may be examples. Other companies which have shown a history of earnings may be in a worse position to compute reliable projections.
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> Indeed, by limiting the filing of projections to seasoned reporting companies . . . the Commission may be precluding information from reaching investors in those situations where the information would be the most valuable--with respect to new (unseasoned) and pro-

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16/ Securities Act Release No. 5699 (April 23, 1976) at 5.

> motional companies and companies about which there is no history of public information.
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> It is with respect to such companies that projections may be the most valuable. The nature of the projections and the manner in which they have been calculated will tell the investor a great deal about the venture and also give him insight into the competence and style of management.17/

On balance, the Committee is of the opinion that all public companies should be eligible to participate in the experimental program.

The 1976 proposed guides state that "investors should be cautioned against attributing undue certainty to management's (projection)."18/ Commentators have also recognized the need for appropriate cautionary statements in projection disclosures.19/

17/ Merrifield, supra note 11, at 166-67.

18/ Securities Act of 1933 Release No. 5699, supra note 16, at 6.

19/ See Appendices X-A and X-B, supra notes 3, 5. See also Gray, "Proposal for Systematic Disclosure of Corporate Forecasts," 29 Fin. A.J 64, 68-69 (Jan.-Feb. 1973) Merrifield, supra note 11, at 178-79; Laventhol, Krekstein, Horwath and Horwath, Financial Forecasts: Benefits, Alternatives, Risks 57-58 (1972).

One commentator has stated in this regard:

> An overriding objective in establishing standards of format and content is to clearly differentiate forecast data from historical data. The possibility of confusion between projections is a serious matter. Columnar presentation of the two types of data should be avoided. As a minimum, historical and projected data should be physically separated and clearly identified.

The Committee similarly believes that companies disclosing projections should make a statement clearly indicating the nature of a projection and cautioning investors against attributing undue certainty to it.

Underlying Assumptions. A statement of the material assumptions underlying a management projection is deemed important and useful information by many constituents of the investment community. Disclosure of assumptions provides a framework for analysis of the projection, and further reflects on management's planning capabilities.[20/] Nevertheless, until there is more experience, and to maximize the attractiveness of the program to registrants, the Committee is of the opinion that the disclosure of assumptions should only be encouraged, rather than formally required.

Comparison of Projections with Actual Results. Many investors and securities analysts regard a comparison of projections with actual results, and management analysis of any significant variance, as important and useful information. It is relevant to evaluating the limitations on projection reliabil-

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19/ (con't.) Kell, "The SEC's New Disclosure Rule on Forecasts," Mich. Bus. Rev. 17, 19 (May 1973). See also Reiling and Burton, "Financial Statements: Signposts as Well as Milestones," Harv. Bus. Rev. 45, 52 (Nov.-Dec. 1972).

20/ See Schneider, supra note 6, at 277-78; Merrifield, supra note 11, at 158, 160, 176-77; Gray, supra note 19, at 53.

One commentator has stated: "Disclosure of all assumptions is essential to investors who seek to understand the forecast." Kell, supra note 19, at 18-19.

ity,[21] but also it provides an insight into management planning capabilities and the risk and profit sensitivity of company business operations.[22] The Commission's 1976 proposed disclosure guides[23] state in this regard:

> Management should consider whether disclosure of the accuracy of its previous projections would provide investors with important insights into the limitations of projections. In this regard, consideration should be given to presenting the projections in a format that will facilitate subsequent analysis of the reasons for differences between actual and forecast results. An important benefit may arise from the systematic analysis of variances between projected and actual results on a continuing basis, since such disclosure may highlight for investors the most significant risk and profit-sensitive areas in a business operation.[24]

The Committee is of the opinion that the Commission should encourage, but not require, the disclosure of comparisons of projections with actual results and management analyses of any significant variances.

Projection Revisions. In its 1975 and 1976 statements on projections, the Commission indicated that while companies were not required to update projections on a regular basis, they would be expected to sustain their obligations under

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21/ See Merrifield, supra note 11, at 180; Kell, supra note 19, at 18-19; Schneider, supra note 6, at 279-80; Reiling and Burton, supra note 19, at 52-53.

22/ See Schneider, supra note 6, at 278-279; Merrifield, supra note 11, at 180.

23/ Securities Act Release No. 5699, supra note 16.

24/ Id. at 6.

the federal securities laws to ensure that disclosed projections did not become of a misleading character:[25/]

> The Commission wishes to remind issuers of their responsibility to make full and prompt disclosure of material facts, both favorable and unfavorable, regarding their financial condition, and that this responsibility may extend to situations where management knows its previously disclosed (projections) no longer have a reasonable basis.[26/]

The Committee agrees that periodic updating of projection information should not be required, but believes that the Commission should in any future release again note that public companies disclosing projections have an obligation under the federal securities laws to keep such information from becoming misleading.[27/]

Problems could arise involving the disclosure of revisions while a company is "in registration."[28/] The

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25/ See Securities Act Release No. 5581, supra note 15, at 12.

26/ Securities Act Release No. 5699, supra note 16, at 3. 59 at 3.

27/ See, e.g., Merrifield, supra note 18, at 179-180; Schneider, supra note 6, at 69; Kell, supra note 19, at 19-20.

Some commentators, however, are of the opinion that periodic updating of projection information should be required. See Reiling and Burton, supra note 19, at 52-53; Gray, supra note 19, at 67-68.

28/ See Gillis, "Legal Aspects of Corporate Forecasts," 29 Fin. A. J. 72, 76 (Jan.-Feb. 1973).

Committee believes the Commission should make it clear to public companies that they are permitted to revise their projections while "in registration."[29/]

The Committee is also of the opinion that the Commission should require companies to include such current projections covering the current period in their registration statements (updated as necessary) filed under the Securities Act.

Discontinuance or Resumption of Projection Disclosures. To encourage use of projections, a company should be permitted to subsequently discontinue making projections. An issuer may be in a position to make a projection with relative confidence in one year, but then find it extremely difficult to make a reasonable projection in the following year because of changed business conditions. In later years, more stable conditions may recur such that the registrant finds itself in a sound position to resume making public projections.

The Committee agrees with the 1976 proposed guides[30/] that company management should have the responsibility for selecting the time period to be covered by projections in Commission filings. The appropriate time period for such projections necessarily depends on the circumstances of the disclosing company.

29/ While it certainly could be argued that subsequent Commission actions regarding projections have voided the quoted provision of the 1971 release, it would seem advisable to avoid any possible confusion by clarifying the matter.

30/ Securities Act Release No. 5699, *supra* note 16.

The Committee is also of the opinion, however, that the Commission should encourage companies not to discontinue or resume making projections in Commission filings without a reasonable basis for such action. In any event, the Committee believes that public companies would be reluctant to engage in unreasonable discontinuance and and resumption practices because of the adverse impact such practices would have on a company's credibility in the marketplace.

Items to be Projected. In its 1976 proposed guides the Commission indicated that it would be inappropriate for companies not to project at least three items--revenues or sales, net income and earnings per share.[31/] The Committee is of the opinion there should be no requirement as to the items to be projected; rather, each company management should be given flexibility in determining the appropriate scope of its own projection.

The Commission should remind companies of their obligations under the federal securities laws to ensure that the items projected do not create misleading inferences; i.e., that companies are not permitted to mislead investors by picking and choosing only "favorable" items.

31/ Securities Act Release No. 5581, supra note 15, at 11; Securities Act Release No. 5699, supra note 16, at 5.

Third Party Review. In its April 1976 release, the Commission stated with regard to third party review of projections:

> Additional support may be furnished through an outside review of management's projections. If management decides to include a report of such a review, there should also be disclosure of the qualifications of the reviewer, the extent of the review, and the relationship between the reviewer and the registrant. Moreover, such a reviewer would be deemed an expert and an appropriate consent must be filed with the registration statement. 32/

The Advisory Committee agrees.

Safe Harbor Provision. The Commission, in its 1976 projection statement noted that "although it has withdrawn the safe harbor rule for projections, the Commission is of the view that reasonably based and adequately presented projections should not subject issuers to liability under the federal securities laws, even if the projections prove to be in error. The Commission realizes that even the most carefully prepared and thoroughly documented projections may prove inaccurate." 33/ The Committee agrees with the views of the Commission; however, the law is not conclusively settled and a safe harbor is needed.

Many commentators in recent literature have stated that a safe harbor rule for projections is needed if companies

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32/ Securities Act Release No. 5699, supra note 16, at 5.

33/ Id. at 12.

are to be expected to voluntarily disclose projections in Commission filings.[34/]

The safe harbor rule proposed by the Committee is virtually identical to the Commission's replacement cost safe harbor rule:

> Proposed Safe Harbor Rule
>
> A statement of a management projection of future company economic performance or a statement of management plans and objectives for future company operations shall be deemed not to be an untrue statement of material fact; a statement false or misleading with respect to any material fact; an omission to state a material fact necessary to make a statement not misleading; or the employment of a manipulative, deceptive, or fraudulent device, contrivance, scheme, transaction, act, practice, course of business, or an artifice to defraud; as those terms are used in the Securities Act of 1933, the Securities Exchange Act of 1934, or the Public Utility Holding Company Act of 1935, or rules and regulations thereunder, unless such information:
>
> (1) Was prepared without a reasonable basis; or
> (2) Was disclosed other than in good faith.

This rule, the Committee believes, would provide a a significant impetus to voluntary projection disclosure in a manner consistent with the present state of the law as reflected in recent court decisions.[35/]

34/ See the Summary of Comments on Securities Act of 1933 Release No. 5699.

35/ See Feintuch, supra note 6; Moomjian, "Soft Information; Liability Standards and Safe Harbors (Rule Proposals)," Memorandum to Martin Lipton (June 28, 1976) (Appendix X-D).

Accordingly, the Committee is of the opinion that the Commission, as part of the experimental program for the voluntary disclosure of projections in Commission filings, should adopt a safe harbor provision for projections comparable to the proposed rule. The Committee recommends that this safe harbor provision be available for all management projection information, whether or not included in Commission filings.

C. Management Analysis

"The management discussion of the business and financial results for the year is the section most susceptible to improvement in annual reports."[36/]

This comment articulates a sentiment which was often

35/ (con't.) It is important to note in this regard that should the projection safe harbor provision be voided by the courts, companies relying on that provision would be protected from liability. Section 19(a) of the Securities Act provides in relevant part:

> No provision of this title imposing any liability shall apply to any act done or omitted in good faith in conformity with any rule or regulation of the Commission, notwithstanding that such rule or regulation may, after such act or omission, be amended, or rescinded or be determined by judicial or other authority to be invalid for any reason.

A comparable provision is in Section 23(a) of the Exchange Act.

36/ Duff & Phelps, Inc., A Management Guide for Strenghening Reports to Shareholders and the Financial Analysts' Perspective on Financial Reporting Practices, A Report for Arthur Andersen and Co., 85 (1976).

expressed in the Committee's case study. Several of those interviewed expressed the opinion that the management's analysis of the summary of earnings, is one of the best disclosure concepts the Commission has adopted. It provides the opportunity for those who know the company best--the managers--to explain what lies behind the financial statements. Unfortunately, the implementation of the concept is not always regarded with the same enthusiasm. Both managers and analysts assert that too often the disclosure which results is meaningless boilerplate.

The Advisory Committee believes that the implementation of the management analysis concept can be improved, if (1) the requirement is amended to delete the numeric significance tests and to clarify the matters to be discussed; (2) the staff review of the resulting disclosures is consistent with the spirit of the requirement; and (3) the chief financial or accounting officer is required to submit at the time of each filing a letter stating that due regard has been given to the requirement.

Amended Management Analysis Requirement. The management analysis requirement was adopted in an effort to enable investors to appraise the quality of earnings. As stated in Securities Act Release No. 5520, 37/ additional narrative disclosure resulting from Guide 22 was intended to assist

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37/ This discussion also applies to Guides 1 of the Guides for Preparation and Filing of Reports and Registration Statements under the 1934 Act. It is presented in terms of Guide 22 only as a matter of convenience.

investors in understanding the extent to which "accounting changes, as well as changes in business activity, have affected the comparability of year-to-year data" and permit them to "assess the source and probability of recurrence of net income (or loss)." The intention was to allow investors to get behind the numbers and assist them to an understanding what they meant.

Many registrants, however, applying the materiality tests contained in the Guide produce analyses which are lengthy narratives on obvious matters. Too often the discussions have been boilerplate without information content.

Based upon staff interviews with companies, it appears that there is a general willingness to provide a useful analysis. The problem results from confusion over the subject matter to be discussed and over who has responsibility for making the materiality judgments which the guide requires. It appears that often the numeric significance tests are treated both by registrants and the Commission's staff as absolute materiality criteria, thus removing from management the responsibility for making materiality judgments.

The management analysis concept is a good one. The Committee believes that the disclosure which results will be improved if the requirement is redrafted to delete the numeric significance tests, to more clearly identify the matters to be discussed and to present the analysis on a segment basis.

The Committee recommends the following language.

MANAGEMENT ANALYSIS OF THE FINANCIAL STATEMENTS AND FORWARD LOOKING INFORMATION 38/

Provide an analysis for each business segment of the reported financial statements which (1) will enable investors to understand and evaluate material periodic changes in the various items of the reported financial statements, and (2) will enable investors to relate the reported financial statements to assessments of the amounts, timing and uncertainties of future cash flows for the reporting entity.

Instructions. 1. The analysis of material periodic changes (a) should explain material increases or decreases in discretionary items such as research and development costs, advertising expenses, and maintenance and repair expenses, and (b) should break down variances into components, such as the amounts by which changes in prices and changes in volume resulted in a material change in sales.

2. The analysis should focus on facts and contingencies known to management which would cause reported financial statements to be not indicative of future operating results or of future financial condition. This would include description of and amounts of (a) matters which will have an impact on future operations or financial condition and have not had an impact in the past, and (b) matters which have had an impact on reported financial statements and are not expected to have an impact upon future operations or financial condition.

38/ The Advisory Committee's evaluation of the management analysis reflected thus far in the recommendations and discussions in this chapter was developed originally in the context of revisions to existing Guides 22 and 1. Subsequently, a proposed revision of Form 10-K was developed, and the management analysis requirement was incorporated into that form as Item 9. See Chapter XV at 487-88. Item 9 includes two additional instructions which do not appear in the text above. Instruction 3 relates to disclosure of projections; Instruction 4 relates to disclosure of capital expenditures and financings. See text at 377, 496 infra.

> The form and content of disclosures pursuant to this item will necessarily vary among registrants and will change from period to period for the same registrant as circumstances change. In general, the disclosures should be similar to that which the chief executive officer might prepare for the board of directors of a company. Both quantitative analysis and narrative discussions are important.

By deleting the numeric significance tests, it is hoped that it will be clear that the Commission and investors are relying on management's judgment and giving management responsiblity for a discussion of material periodic changes including those facts which may make the past not indicative of the future. Management has the information available to make such an analysis and has indicated a willingness to make materiality judgments.[39/] Materiality tests interfere with this responsiblity and confuse management as to what exactly is expected. The Committee believes that ~~if~~ the numeric significance tests are deleted, the Commission will make it clear that it is management's responsibility to determine what is material.

The redrafted guide also clearly identifies and explains the two separate aspects of the analysis: (1) quantitative analysis (e.g., variance analysis) and (2) the discussion of historical facts.

Guide 22 now emphasizes quantitative analysis

39/ See Chapter VIII at 321.

by asking registrants to disclose the amount and to discuss any material change between periods of all items of revenue or expense. Registrants are advised that a change should generally be discussed if the item increased or decreased by more than 10% relative to the prior period or by 2% of average net income or loss for the most recent three years presented.

Although this is an appropriate first step, additional quantitative detail may be needed in developing a useful variance analysis of financial statements. This may vary from industry to industry. For example, in the banking industry it is important to know, among other things, the variances in the costs of borrowed funds, but in the steel industry the cost of borrowed funds is usually insignificant relative to variance in the costs of raw materials and labor. The second paragraph of Instruction 2 makes this clear.

Moreover, analysis should not be limited to discussion of material changes of line items between periods. Analysis of internal relationships in the same period is also important. Thus, the statement that the analysis should break down variances into components, such as the amounts by which changes in prices and changes in volume resulted in a material change in sales should add additional clarification and improve

the quality of management discussion.[40/] Security analysts try to relate company results to changes in the industry and in the general economy. Analysts interviewed in the case study said that in evaluating this relationship, they attempt to relate changes in sales volume to changes in costs of sales. However, the traditional disclosures of costs of goods sold, and of selling, general and administrative expenses, are often not useful in this assessment. Many companies provide tables or charts from which the analysts can estimate the major components of costs (e.g., labor, materials, and selling commissions); other companies should be encouraged to do so.

The interrelationship between changes in price and changes in volume is just one of the possible items which might be discussed. Indeed, management should be encouraged to include analysis of any interrelationship within

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40/ See, e.g., Guide 61, Section VII Interest Rates and Interest Differential, Paragraph B:

> B. For the latest two fiscal years and any interim period reported on, present (1) the dollar amount of change in interest income and (2) the dollar amount of change in interest expense. The changes should be segregated for each major category of interest-earning asset and interest-beasring liability into amounts attributable to (a) changes in volume (changes in volume times old rate), (b) changes in rates (change in rate times old volume), and (c) changes in rate/volume (change in rate times the change in volume) . . . .

the financial statements which management believes will contribute to an understanding thereof. Other possible examples include the relationship between cost of goods sold and net sales, the relationship between selling general administrative costs and cost of goods sold, and the profit margin.

A second important aspect of management's discussion is to identify significant facts which will have an impact on future operations and facts which have affected reported results but are not expected to have an impact on future operations. The concept is expressed in the current Guide 22 as follows: "The analysis should include a discussion of material facts . . . which, in the opinion of management, may make historical operations . . . not indicative of future operations . . . ." This kind of information often would not emerge from quantitative analysis. Some members of the Advisory Committee believe that information of this nature is the most important aspect of management's analysis and would recommend that the need for such information be strongly emphasized in Guide 22.

This emphasis is achieved by Instruction 2 of the revised requirement which asks registrants to summarize and comment upon the major events, transactions and facts which, in management's view, had the most significant impact upon the operations of the company during the reported period. Comments should include a quantitative indication, but in

broad terms, of the effect of the matters discussed upon the reported segments of the registrant's business.

The revised language also reflects the Committee's recommendation that narrative discussions in disclosure documents be presented on a segment basis.[41/]

SEC Staff Review and Comments

Potentially the SEC staff review may be the most effective way to improve the analytical information in financial reports. Since many registrants apparently do not understand what kind of information is being sought by Guide 22, staff comments and follow-up telephone conversations can be helpful in communicating and emphasizing the spirit of the guide.

The Committee believes the quality of the management's analysis may also be improved if the Commission staff reviews the analyses in a coordinated and consistent manner. To assure that management analyses continue to receive substantive, constructive comments from reviewers, the Advisory Committee recommends that a review procedure be established by the Division of Corporation Finance to assure that SEC staff comments to registrants are relatively uniform and consistent with the spirit of the requirement.

It would not be reasonable to expect that every filing or every comment would be reviewed by one person. Rather,

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41/ See Chapter XI at 387.

the person responsible might periodically review a sample of filings from each branch and should be available for consultation when disagreements arise between branch personnel and registrants.

Letter Signed by Chief Financial or Accounting Officer

The Advisory Committee recommends that a requirement be added to Guide 22 requiring that a letter signed by the chief financial or accounting officer of the registrant and be submitted with each appropriate filing, stating that due regard was given to the requirement and in particular to that part of the requirement which calls for the disclosure of any known facts which would make the historical record not indicative of the future. This requirement for a letter should terminate three years after its promulgation unless the requirement is expressly extended by the Commission.

The purpose of this recommendation is to emphasize to registrants the importance of Guide 22 disclosures and to focus attention on the "facts which make the historical record not indicative of the future." If Item 9 of the proposed revision of Form 10-K is adopted (see Note 38, supra) this requirement for a letter would not longer be appropriate.

The three year sunset provision was added because the Advisory Committee believes that the letter may serve no useful purpose after it has had the initial impact on registrants.

D. Other Categories of Soft Information

In addition to forecasts and management analysis, the Advisory Committee considered several other categories of soft information which companies also have a reluctance to describe in writing because the information is future-oriented and may be highly uncertain. The disincentives to disclose are the same as with other types of forward-looking information: exposure to legal liability; additional externally applied pressures to perform; and the potential of misleading unsophisticated investors.

Having weighed the importance of this information against the potential costs to the companies, the Advisory Committee recommends that the Commission encourage companies to disclose the information discussed below. The Committee recommends these categories of information also be included within the categories of information covered by the Committee's recommended safe harbor rule.

Planned Capital Expenditures and Financing. The Advisory Committee recommends that the Commission encourage disclosure of planned capital expenditures and financing by business segment for the current fiscal year and the succeeding four fiscal years indicating: (a) amounts thereof related to environmental control facilities;

and (b) the expected effects on production capacity.

Capital expenditure plans are among the most refined of the various budget plans developed by management. Many companies have disciplined procedures for capital budgeting, approval of expenditures, and monitoring progress. Management almost always knows what the capital expenditures budget is for the current year, and often has a fairly good idea what can be expected for the next one to five years. Of course, final budgets and actual expenditures will depend upon financing--raising debt and equity capital and internally generated funds--so any discussion of capital budgets must necessarily be in terms of ranges.

Investors can learn much about management's views of the future and about the direction of the company from capital budget information. If the information is given in enough detail--for example, by business segment and segregated between amounts related to production and amounts related to environmental control--then investors can gain valuable insights about products and productive capacity, future cash flows, and the company's liquidity.

The financial analysts and management representatives that were interviewed in the case study said that companies, for the most part, are willing to give capital budget information to analysts on an informal basis. And several companies disclose some capital budget information in their

annual reports to shareholders. Therefore, the Advisory Committee believes that with proper encouragement more companies would be willing to publish capital expenditure plans and that this would be a positive step in the direction of bringing more forward-looking information into financial reports. As discussed elsewhere in this report, a proposed revision of Form 10-K Instructions has been developed to illustrate some of the recommendations of the Advisory Committee. In particular, Part III, Item 9, Instruction 4, reflects the preceding recommendations:

> PART III
>
> ITEM 9. MANAGEMENT ANALYSIS OF THE FINANCIAL STATEMENTS AND FORWARD LOOKING INFORMATION.
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> Instruction 4. Registrants are encouraged, but not required, to furnish for each business segment a description of planned capital expenditures and financing for (1) the current fiscal year and (2) the succeeding four year period. If this information is furnished, it would be desirable to disclose the amounts related to environmental control facilities and the expected effects upon production capacity, and to furnish an analysis of differences for the most recent fiscal year between previously disclosed budgets and actual capital expenditures.

Plans and Objectives. The Advisory Committee recommends that the Commission encourage disclosure of management's plans and objectives. A discussion of plans and objectives is a natural complement to management's discussion of historical results and discussion of facts which would

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cause historical results not to be indicative of the future: "This is what we've done in the past and why, and this is what we plan to do in the future and how."

Besides capital expenditure plans, companies also have plans--with varying degrees of certainty--covering many other aspects of operations. Most company managements, in the normal course of business and as an integral part of the budgetary process, prepare internal statements regarding plans and objectives for the future business operations of the company, all of which might be useful to investors. They include: (1) plans for product development, marketing programs, methods of financing, personnel, and general business strategy; (2) plans for expansion, contraction or redirection of the business; (3) plans for the acquisition of other companies, which may or may not have been specifically identified; (4) plans involving the disposal of existing assets; and (5) plans regarding distribution of dividends to stockholders.

Dividend Policies. The Advisory Committee recommends that registrants be encouraged to publish statements of dividend policies. Guide 26 of the Commission's Guides for Preparation and Filing of Registration Statements states that objection will be made to a projection of future dividends in the prospectus. This seems obsolete now that the Commission permits projections and is inconsistent with the Advisory Committee's recommendations that the Commission

actively encourage projections.

Guide 26 permits a statement of policy to declare dividends as a percentage of profits, but chills the use of this permission by requiring the usual litany that there is no assurance that there will be any future profits, etc. The net result is that little useful information as to dividend policy is ever offered. In 1974, the Commission proposed to require a statement of dividend policy, but backed away, because the disclosure might involve future-oriented information.

The Advisory Committee recommends that the Commission actively encourage statements of dividend policy. Dividends are becoming increasingly important in the appraisal of common stocks, and figure in many stock valuation models.

Capital Structure. The Advisory Committee recommends that registrants be encouraged to publish statements of capital structure policies. A company's current and future capital structure is an important factor in many security pricing models. Capital structure policies affect future cash flows, dividends, capital expenditure plans, interest expense and income taxes. While not every registrant will have an explicit policy about capital structure, or debt to equity ratio, the Commission should encourage those who do have such policies to describe them.

CHAPTER XI

SEGMENT REPORTING

RECOMMENDATIONS

The Commission should integrate textual disclosures required in Commission forms with segmented financial statement disclosures required by Statement of Financial Accounting Standards No. 14.

In developing the industry guides, the Commission should consider: (1) requiring, as necessary, disclosure of both dollar and, where appropriate, unit sales of each product line within a segment whose total sales comprised a certain pecentage of consolidated sales in the previous fiscal year, and (2) developing on an industry basis the most effective product line breakdown for displaying sales information.

The Commission should require segment data in interim reports (Form 10-Q) filed with the Commission.

A. Introduction

Few issues which the Advisory Committee considered have been as enduring or as controversial as that of segment reporting. On May 24, 1966, Chairman Cohen speaking before the Annual Conference of the Financial Analysts Federation stated that with examples of voluntary reporting already in evidence, the next objective of financial statement disclosure should be "a defined operating profit and loss statement on a divisional basis."

Two major disclosure policy review studies undertaken at the Commission previously have addressed this issue. The Wheat Report stated:

> For many of today's corporate enterprises, the key to an understanding of the business and an appraisal of its future prospects is a breakdown of revenues and, to the extent feasible, of profits by separate lines of business. All those engaged in security analysis to whom the Study spoke referred to this data as of crucial importance. 1/

The Report endorsed a series of outstanding Commission rule proposals affecting registration statements only and recommended that they be extended to cover the annual report on Form 10-K. 2/

The Industrial Issuers Advisory Committee Report, issued on December 22, 1972, recommended that the Commission's Division of Corporation Finance review its experience in disclosure of "lines of business" and "classes of products or services" which had resulted from the line of business reporting requirements imposed in 1969 with a view to providing more specific guidelines for definitions of such lines and classes. In addition, the Industrial Issuers Advisory Committee recommended that the Commission require inclusion of "line of business disclosures consistent with those in Form 10-K" in company annual reports

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1/ SEC, Disclosure to Investors (The Wheat Report) 338 (1969).

2/ Id.

to security holders.[3/]

After full consideration of recent developments, this Committee also has formulated recommendations intended to improve the quality of segment information.

B. The Current Controversy and Committee Recommendations.

Segment reporting first became a major disclosure issue in the mid-1960's when businesses began expanding to an extent probably greater than ever before into diverse industries, product lines, markets, and geographical areas. Users of financial information contended that information with respect to the profitability of significant business segments was necessary to accurately evaluate the business as a whole. Proponents of segment disclosure argued that different industries, product lines, markets and geographical areas may have differing prospects for growth, rates of profitability and degrees of risk and that aggregate data encompassing all of the components for a diversified company is not meaningful.

Many businessmen opposed mandatory segment disclosure, asserting that users would not understand either that the reporting of the profitability of lines of business would require arbitrary allocations of joint costs among different segments or that the reported profitability would vary significantly depending on the company's accounting treatment

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3/ SEC, Report of the Industrial Issuers Advisory Committee, 7,8,15,16 (1972).

of intra-company transfers between product lines. It was suggested that companies ran the risk of being sued by those who with hindsight questioned management's judgment on these issues. Opponents of line of business reporting also argued that comparison of competing product lines among companies is impossible and that management's freedom was infringed by requiring breakdowns that management itself did not make. They believed that management should be measured on the overall result rather than the results of individual lines.

All of the above were important arguments advanced against compulsory reporting; however, opposition to the requirement centered on the competitive costs of such a reporting obligation. It was generally feared that suppliers, employees, customers and foreign governments would use the figures to extract concessions from the company and that competitors would use the information to invade the registrant's profitable markets. Such disclosure would be particularly dangerous for small companies which might have to disclose relatively more information about their operations than their larger competitors since the line in question might not be significant for the larger company. It might also encourage takeovers.

The segment reporting issue was placed on the Committee's agenda in response to the comments of the security analysts who participated in the case study. Approximately

72 percent of the sell-side analysts and 64 percent of the buy-side analysts identified segment information as vital to an analysis of market share and the development of a composite analysis of the profitability of multi-segment enterprises. [4/] Yet, analysts continue to express dissatisfaction with the segment information currently available.

In an effort to further its understanding of this issue, the Committee invited financial analysts and financial executives to participate in a roundtable discussion of the issue at its October, 1976 meeting. This discussion contributed significantly to the Advisory Committee's understanding of this issue and influenced its recommendations.

From the roundtable discussion and the case study it appears that analysts, while not unanimous in their views, generally believe that (a) quarterly information about business segments is needed, (b) market share information is of particular interest, (c) segments should be defined by management rather than by arbitrary categories, and (d) a more detailed segment breakdown than currently provided is necessary. In addition it was indicated that even revenue information on a segment basis is useful although income information is preferable.

It appears that companies are unwilling to provide

4/ See Chapter II at 75-77.

the information in the detail analysts request because management views such information as (a) unnecessary, (b) having significant competitive costs, and (c) not meaningful because of intersegment transfer and joint cost allocation problems. It is also suggested that additional segment information is an unwarranted and unnecessary interference into the organization of the company and its record-keeping because a business normally is not organized or managed along the lines suggested by some analysts and an additional set of records would therefore be required. Further, companies perceive more detailed line of business information as of interest and use primarily to financial analysts who will not be satisfied until there is disclosure of sales and earnings information by product.

It is the Committee's judgment that the quality of segment information can and should be improved. It endorses Statement of Financial Accounting Standards No. 14 ("SFAS No. 14") and forwards to the Commission three recommendations intended to improve the quality of segment reporting.

Endorsement of SFAS No. 14. In December, 1976, the Financial Accounting Standards Board ("FASB") issued SFAS No. 14. Where applicable, it requires companies to prepare financial information by industry and geographical (i.e. foreign/domestic) segments. This information becomes part of the basic financial statements and is subject to auditor

review.

The Committee believes that the promulgation of SFAS No. 14 is a positive step, and endorses the FASB's action. The Committee anticipates that this new approach will improve the overall quality of segment reporting, because segment information will be included in the financial statements and will be subject to auditor review, and because a more precise definition of what constitutes a reportable segment is provided. 5/

SFAS No. 14 also requires disclosure of amounts of revenues, with intersegment sales or transfers shown separately, operating profit and loss, and identifiable assets for each significant industry segment. Information about revenue, profitability, and identifiable assets is to be reconciled to the related amounts in the consolidated financial statements of the enterprise. Finally, it requires substantial information with respect to operations in foreign countries or groups of countries whose business environments differ.

The Committee, of course, cannot predict whether the level of segmentation will improve under SFAS No. 14. Nonetheless, the Committee encourages reporting companies to

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5/ SFAS No. 14 indicates that although certain characteristics can be identified that assist in differentiating among industries, no single set of characteristics is universally applicable. It does, however, list factors to be considered in determining whether products and services are related or unrelated, including markets and marketing methods, the nature of the product and the nature of the production process.

avail themselves of the opportunity presented by SFAS No. 14 for redefinition and recommends that the Commission vigorously review the information resulting from it. The Commission should respond as necessary to reporting it views as inadequate.

Integration of Narrative Disclosures and Segment Reporting in Financial Statements.[6/] Segmented financial information provided pursuant to SFAS No. 14 will be included within the financial statements or the notes thereto or must be referenced in the financial statements if not clearly a part thereof. In the FASB's words, the inclusion of this information reflects "the need for disaggregation of enterprise-wide information expressed by many financial statement users." The Committee believes that the need for disaggregation of enterprise-wide information extends beyond the financial statements to the narrative content of disclosure documents and recommends that disclosure documents filed with the Commission present narrative information on a segment basis.

6/ The Committee's recommendations regarding segment reporting were forwarded to the Commission on February 15, 1977. On May 10, 1977 the Commission in Securities Act Release No. 5826 proposed for comment certain revisions to disclosure forms and rules designed to coordinate the Commission's line of business disclosure requirements with SFAS No. 14. These proposals include amendments to require the textual business discussion in Forms S-1, 10 and 10-K to be presented by industry segment, thereby proposing to partially implement this recommendation. Specific amendments to Guides 22 and 1 were not proposed because additional amendments to those Guides are being contemplated.

Those who perform investment analysis evaluate the different industries, product lines, markets, etc. of an enterprise individually in order to develop an estimate of the future earnings power of the enterprise as a whole. Accordingly, it makes little sense that investment decision-making information--narrative or financial statement--is presented on an enterprise-wide basis. If implemented, this recommendation will improve the format of disclosure documents by presenting information in the way it is used. The content will also be improved because discussion of such items as the description of the business, management analysis, etc. should be much more precise if the presentation is on a segment by segment basis.

Level of Segmentation. Because there is not a standard classification system to which reference can be made in identifying business segments, the level of segmentation has been left largely to the discretion of management. As a result, the information presented has not always been as detailed as users would like. The Committee's second recommendation addresses the almost universal dissatisfaction analysts express with the level of segmentation currently provided by registrants in SEC disclosure documents.

To alleviate this problem somewhat, the Committee recommends that as the industry guides recommended in Chapter IX are developed, consideration be given to whether the disclosure of additional product line and unit sales information beyond the segment information resulting from SFAS No. 14 is necessary for the industry in question. If so, a standardized breakdown which best displays the necessary information should be incorporated into the industry guide.

This approach has decided advantages over Commission imposition of any existing classification system. First, the problem will be approached on an industry by industry basis and an appropriate product classification will be developed for each industry by those most familiar with that industry--including management. Also, by gathering sales information only, the approach avoids the difficult allocation decisions of any kind of income disclosure. This information will be useful since it will enable analysts to develop information with respect to market share for classes of production on a more detailed basis than is currently possible.

Quarterly Segment Data.[7/] SFAS No. 14 is only applicable to a complete set of financial statements or

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7/ The Commission requested public comment on this recommendation in Release No. 5826.

a complete set of interim statements and would have no impact upon Form 10-Q disclosure requirements absent further Commission action.[8/] The Advisory Committee is of the view that segment information on a quarterly basis is important to investment decision-making and should be required in interim reports on Form 10-Q. Analysts place a premium on timely data. This information will permit them to update their earnings forecasts and to assess on a reasonably current basis the impact of economic and political events upon those sectors of the firm which are subject to significantly different economic and political risks. Accordingly, the Advisory Committee recommends that the Commission require the inclusion of segmental financial statement disclosure in interim reports on Form 10-Q on an unaudited basis.

8/ On September 20, 1977 the Financial Accounting Standards Board issued an Exposure Draft proposing to defer any requirement to report the information specified in SFAS No. 14 in interim financial statements until completion of the interim financial reporting project on its agenda. The Board indicated that in reaching this conclusion, it "makes no judgment as to the information that should be presented in interim finacial statements."

CHAPTER XII

DISCLOSURE OF SOCIAL AND ENVIRONMENTAL INFORMATION

RECOMMENDATION:

The Commission should require disclosure of matters of social and environmental significance only when the information in question is material to informed investment or corporate suffrage decision-making or required by laws other than the securities laws. The Advisory Committee endorses the Commission's conclusion that there are no broad categories of social and environmental information, not now covered by mandatory disclosure requirements, that should be made the subject of new requirements.

A. Introduction

As indicated in Chapter VII, The Objectives of the Securities and Exchange Commission in the Disclosure System, the Advisory Committee believes that:

> The Commission's function in the corporate disclosure system is to assure the public availability in

> an efficient and reasonable manner and on a timely basis of reliable, firm-oriented information material to informed investment and corporate suffrage decision-making. The Commission should not adopt disclosure requirements which have as their principal objective the regulation of corporate conduct.

One category of firm-oriented information--that information reflecting on a corporation's performance in areas of significant social concern--has recently received heightened attention from the Commission, a federal district court and certain commentators.

In April 1973 the Commission adopted rules requiring the disclosure, in registration and reporting forms, of the material effects of an issuer's compliance with laws intended to protect the environment, and any administrative or judicial proceeding, pending or known to be contemplated by governmental authorities, arising under federal, state or local provisions relating to the protection of the environment.[1/] The Natural Resources Defense Council ("NRDC") immediately sought judicial review of the Commission's rule-making and the related denial of NRDC's petition for rules requiring registrants to file with the Commission information concerning both the environmental consequences of their activities and statistics and legal proceedings regarding their equal employment practices.

1/ Securities Act Release No. 5386 (April 20, 1973)

In National Resources Defense Council, Inc. v. Securities and Exchange Commission, 389 F. Supp. 689 (D.D.C., 1974), the court held that the Commission's rulemaking failed to satisfy the requirements of the Administrative Procedure Act.

The Commission was ordered to undertake rule-making action to bring the Commission's corporate disclosure regulations into full compliance with the letter and spirit of the National Environmental Policy Act ("NEPA"). The court also suggested that the Commission resolve what it characterized as two overriding factual issues: (1) the extent of interest among "ethical investors" in the disclosure by corporations of the environmental impact of corporate activities and of their equal employment opportunity practices and (2) the avenues open to such investors to eliminate corporate practices inimical to the environment and equal employment opportunity.

In compliance with this order, on February 11, 1975, the Commission issued Securities Act Release No. 5569 announcing further rule-making proceedings. The Commission held 19 days of public hearings in that proceeding and compiled a "record" exceeding 10,000 pages in length. On October 14, 1975, the Commission issued Securities Act Release No. 5627, announcing its final conclusions, proposing certain rules, and inviting further comments. Finally, on May 6, 1976, the Commission issued Securities Act Release No. 5704, announcing its decision to reject the

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additional environmental disclosure rules it had proposed in Securities Act Release No. 5627.

The Commission concluded that it would require the inclusion of information reflecting on social and environmental performance in its disclosure documents "only if such information . . . is important to the reasonable investor--material information."[2/] In its words: "No showing has been made in this proceeding, particularly in light of the more than 100 areas of social information identified by persons responding to our request for comments, that disclosure of information describing corporate social practices should be specifically required of all registrants".[3/]

In view of the specific interest in disclosure of this type of information, the Committee determined to articulate its position regarding whether the Commission ought to require the inclusion of such information in filings made with it, and if so, under what circumstances.

2/ Securities Act Release No. 5627 at 2.

3/ Id. NRDC subsequently sought judicial review of the Commission's decision not to require additional disclosures. On May 19, 1977 the District Court for the District of Columbia held that the SEC's final determinations were marred by serious and fundamental procedural defects and that the rejection of certain specific disclosure alternatives was not rationally based. Natural Resources Defense Council, Inc. v. Securities and Exchange Commission, 432 F. Supp. 1190 (D.D.C. 1977).

B. Discussion and Recommendation

The Advisory Committee believes that the materiality standards for disclosure of social and environmental information should be the same as for other types of information required generally of all registrants. Accordingly, the Committee recommends that the Commission require disclosure of matters of social and environmental significance only when the Commission judges the information in question to be material to informed investment or corporate suffrage decision-making. As indicated in Chapter VIII, "Materiality Considerations," it is the Committee's opinion that investors are motivated by economic concerns and are generally interested in information which reflects on the current and future economic performance of their investment. Consistent with that view, the Committee believes the Commission should classify social and environmental information as material only when it reflects significantly on the economic and financial performance of the Company. The Committee also agreed that disclosure should be required when management is engaged in a consistent pattern of violation of law in the social or environmental areas. The Committee endorses the Commission's conclusion reached after the hearings described above, that there are no broad categories of social and environmental information not now covered by mandatory disclosure requirements which should be the subject of new requirements.

Although this recommendation is a necessary corollary

of the Committee's view of the nature of the materiality concept as it relates to investors, two additional factors influenced the Committee. First, the Commission's expertise is in the area of economic and financial information. Should the Commission decide to require disclosure of information that is socially and environmentally oriented, without reference to the materiality of these disclosures, it would have no standard on which to base its decisions as to what specific additional disclosure should be required. Second, Rule 14a-8 (shareholder proposals) under the 1934 Act provides an appropriate means for shareholders who are interested in social and environmental matters to attempt to obtain information relevant to those matters. If a shareholder can gain the support of a sufficient number other shareholders, he may be able to require a company to disclose the information in which he is interested. Shareholders also have rights under state law to inspect their company's books and records.[4/]

A minority of the Committee disagrees with this position and believes strongly that disclosure of social and environmental information is material to investment and corporate suffrage decision-making regardless of its economic impact on the financial performance of the company. These members

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4/ Committee members are aware that NEPA which applies to all federal agencies, could require the Commission to develop different disclosure rules with respect to environmental matters. Almost all of the members believe, however, that the effect of NEPA on the Commission's rule-making authority primarily raised a legal question which the Committee should not address as it was currently before the Courts.

believe that some shareholders are concerned with their company's social performance as such. They also argue that this kind of information reflects on the quality and character of management, which information clearly plays an important role in both investment and corporate suffrage decision-making.[5/] The minority would urge the Commission to require increased disclosure in the social and environmental area.

c. Conclusion

The Committee's recommendation reflects its view that the SEC is responsible for furnishing information necessary for informed investment and corporate suffrage decision making and that such decisions are influenced primarily by economic considerations. The Committee recognizes, however, that social and environmental issues appear to be having an increasing impact on the economic situation of issuers and may, on occasion, represent information material to an investment or corporate suffrage decision. The Committee urges the Commission to remain sensitive to users' needs in this area so that it may respond promptly if it appears that new categories of social and environmental information have become material.

In adopting this position, the Committee also

5/ This was confirmed by the results of the Individual Investor Study conducted by the Advisory Committee. See Chapter VI at 288.

recognizes that there are other constituencies who look to public corporations for information and find that these information needs are not met by the disclosures required by the SEC for investment and corporate suffrage purposes. Whether, and to what extent, those needs should be met by a mandatory disclosure system supplemental to the SEC's investor oriented disclosure system are questions the Advisory Committee has concluded are beyond the scope of its mandate. It may well be that such socially oriented disclosure, while not material to investors as such, is significant and important to society at large. Some Committee members believe that if this is the case, Congress should establish an appropriate disclosure format, separable and apart from that administered by the SEC, to satisfy this need.

The Committee also notes that an increasing number of corporations have voluntarily made public information about the social and environmental effects of their activities.[6/] While some Committee members expressed skepticism as to the accuracy and balance of some of these disclosures, in general the Committee applauded this trend in corporate reporting practices.

6/ See Ernst & Ernst, Social Respondibility Disclosure (1976).

CHAPTER XIII

PROXY STATEMENT REQUIREMENTS

RECOMMENDATIONS

The Commission should require each registrant to state in its proxy material or in its annual report to shareholders, whether there is a nominating committee of the board and, if so, who the members of the committee are.

The Commission should require registrants to file under cover of Form 8-K a letter of resignation received from a director when the director requests that the registrant file the letter.

The Commission should direct the SEC staff to review intensively proxy materials which contain certain management proposals, with a view to requiring more uniform and adequate disclosure of the advantages and disadvantages of proposals which may substantially affect the interests of shareholders, including disclosure of estimated costs of any option or similar type plan and the possible impact such plan may have on the behavior of management.

The Commission should require issuers to include in their proxy materials a statement of the date by which shareholder proposals must be received by an issuer in order to be eligible for inclusion in the issuer's proxy materials for its next annual meeting.

The following recommendation passed by a slim majority:

The Commission should develop a package of disclosure requirements that, taken as a whole, will strengthen the ability of boards of directors to operate as independent, effective monitors of management performance and that will provide investors with a reasonable understanding of the organization and role of the board.

There are substantial differences of opinion on the Advisory Committee as to exactly what the substance of the new disclosure requirements should be. For that reason, and also because the Advisory Committee has not engaged in any extensive field research relating to these issues, only the disclosure requirements described above are being specifically recommended to the Commission for adoption. Certain additional proposed disclosure requirements are included in the report to illustrate the general approach to the area that the Committee believes the Commission should consider after the completion of its proposed public hearings on corporate suffrage and proxy disclosure issues.

A. Introduction

The proxy statement is unique among 1934 Act filings with the Commission because it is the only filing that is required to be disseminated directly by the corporation to all its shareholders. The legislative history of Section 14(a)[1/] indicates that in adopting the measure, Congress had two goals. One was to promote fair corporate suffrage--

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1/ Section 14(a) reads: "It shall be unlawful for any person, by the use of the mails or by any means or instrumentality of interstate commerce or of any facility of a national securities exchange or otherwise, in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors, to solicit or to permit the use of his name to solicit any proxy or consent or authorization in respect of any security (other than an exempted security) registered pursuant to Section 12 of this title."

reasonable opportunities for shareholders to elect directors and otherwise to participate in corporate governance. The second was to curtail management's dominance of the proxy process so as to enhance the ability of directors to serve as fiduciaries representing the interests of shareholders.

The benefits derived from the disclosures that have been compelled by the Commission's exercise of its power under Section 14(a) may have been more subtle than those foreseen and expected by the authors of the 1934 Act. The usual proxy statement contains information about candidates for the board (age, occupation, etc.), information regarding management compensation and company transactions with management, and details about the mechanics of voting. Sometimes there is a management or a shareholder proposal. However, in the absence of a proxy contest, it is virtually unheard of for shareholders of a company to reject management's nominees for directors. Patently, the "democratic" process has lacked an essential ingredient for it to be truly democratic, namely competing candidates. Similarly, management proposals, are rarely rejected by shareholders. And rounding the circle, in the face of management opposition, shareholder proposals never command a majority vote and rarely receive as much as 5 percent of the shareholder vote, although a significant vote--sometimes as little as 5 percent or 10 percent--will influence management conduct. This may be changing. For the reasons set forth below there has been an increasing

demand for improvements and perhaps radical changes in the proxy solicitation system.

The growth in size and power of corporations[2/] in recent years has generated increasing concern about the widespread impact of corporate behavior on society,[3/] particularly in view of recent disclosures concerning questionable and illegal corporate business and political practices.

2/ "In wide areas of our economy a relatively small number of giant publicly held corporations have become so large, both in absolute size and in relation to their competitors, that they have freed themselves of servitude to the market and have become able to authoritatively determine, within broad limits, matters of such fundamental importance as the rate and direction of capital investment and technological innovation, and even price levels and degree of product differentiation. Such economic power is not only significant in itself, but carries in its train a significant amount of power to control the social order." M. Eisenberg, The Structure of the Corporation: A Legal Analysis 18 (1976)

3/ In "Federalism and Corporate Law: Reflections on Delaware", 83 Yale L.J. 663 (1974), Professor William L. Cary, a former chairman of the Commission, persuasively argued that states', particularly Delaware's, desire for and reliance upon corporate franchise taxes had resulted in such a deterioration of corporation standards and restraints, particularly in the area of fiduciary responsibility and fairness, that it was time to reevaluate the historical circumscription of federal intrusion into corporation law generally. However, he was prepared to go only so far as a proposed Federal Corporate Minimum Standards Act.

Others, picking up a shadowy but consistent thread in the American history of corporate reform, contend that Federal chartering is a more suitable and realistic alternative. Cf. R. Nader, M. Green & J. Seligman, Taming the Giant Corporation (1976), esp. ch. 3, "The Federal Chartering Alternative," 62-71.

In an effort to impose a measure of accountability on the corporation, many observers have directed their attention to defining the obligations of directors of publicly held companies and the appropriate relationship between the board and the management of those corporations.[4/]

Traditional corporate law theory, as expressed in many state corporate law statutes, relates that "The business and affairs of a corporation shall be managed by a board of directors."[5/] In recent years, there has been an increasing recognition that directors cannot and do not "manage" the corporation's business. This changing emphasis is reflected in the Model Business Corporation Act, which states that "the business and affairs of a corporation shall be managed under the direction of, a board of directors . . . ."[6/] To say that directors do not manage the business of the corporation is not to say that the board's role is unimportant. The Corporate Director's Guidebook, recently issued by a subcommittee of the American Bar Association, specifies that the board should establish basic corporate objectives; select competent senior executives; provide the enterprise with other competent

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4/ See Corporate Director's Guidebook, 32 Bus. Law. 5 (1976).

5/ See e.g., N.Y. Bus. Corp. Law §701 (McKinney Supp. 1974) (emphasis supplied).

6/ See Corporate Director's Guidebook, supra note 3, at 20 Model Business Corporation Act §35 (emphasis supplied).

managers and monitor the performance of the managers and the performance of the enterprise.[7/]

The concept of monitoring requires that the board have an adequate flow of objective information and that the directors, or at least a clear majority of them, be independent of the chief executive.[8/] Several commentators also emphasize that to be effective as a monitoring agency, the board must assert control over the process by which its members are selected and renominated.[9/]

Although there are some indications that boards of directors in recent years have begun to behave in a more independent and responsible fashion,[10/] the data now made

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7/ Corporate Director's Guidebook, supra note 3, at 20.

8/ Although the situations are not directly comparable, the importance of independent directors and the possibility that the experience of disinterested directors under the Investment Company Act of 1940 might be instructive was noted by the Committee in the course of its deliberations and has been suggested by former Chairman Roderick M. Hills in an address entitled "The Investment Company Board: Myth vs Reality" delivered November 11, 1976 to an ALI/ABA course on "Investment Companies: The Changing Role of Outside Directors."

9/ Corporate Director's Guidebook, supra note 3 at 35-36; Conrad, "A Behavioral Analysis of Directors' Liability for Negligence," 1972 Duke L.J. 893, 917 (1972); Eisenberg, supra note 1, 112-27.

10/ In addition to anecdotal evidence provided by members of the Advisory Committee, see Investor Responsibility Research Center "Changes in the Corporate Boardroom: What Should be Done? Who Should Do It?" Special Report B, 12-13 (1976); Heidrick and Struggles, The Changing Board: Profile of the Board of Directors (1977).

available to shareholders make it difficult to determine the level of independence or the the nature of the activities of the board of almost any given corporation.

All of this activity has also resulted in increased governmental interest. The Senate Commerce Committee held exploratory hearings in 1976 on the issues raised by one proposal for Federal chartering,[11/] and several congressional committees remain interested in the issue. Also in 1976, the Investigations Subcommittee of the House Commerce Committee issued a report calling on the Commission to issue rules to assure that:

1. A director of a publicly owned corporation receives compensation and independent staff sufficient to perform responsibly his duties;

2. A majority of the board is independent of senior management and operating executives and from any other conflicts of interest;

3. The board reviews and approves the corporation's code of business conduct and system of internal controls;

4. The board's auditing and monitoring committees are comprised of a majority of independent directors;

5. The board's auditing committee has available to it independent expert advisors; and

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11/ Hearings (on the Nader proposal) before the Senate Committee on Corporate Rights and Responsibilities, 94th Cong., 2d Sess. (1976).

6. The board has the authority to hire and fire the independent accountant, legal counsel, the general counsel and senior operating executives. 12/

This increased attention to the operation and responsibilities of boards of directors raises a question as to whether the proxy rules can and/or should be used to facilitate the creation and effective operation of a strong and vigorous board. Such an effort would not appear inconsistent with the purposes of Section 14(a). As indicated previously, the legislative history of that section indicates that in adopting it, Congress had two goals: to promote fair corporate suffrage and to curtail management's dominance of the proxy process. Facilitation of an effective monitoring board would appear consistent with these goals; on the other hand, Section 14-A is generally viewed as a disclosure rather than a regulatory provision. Arguably, an attempt to influence the governance of corporations is regulation not disclosure.

The Advisory Committee spent the better part of two meetings discussing this problem. This

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12/ Subcomm. on Oversight and Investigations of the House Comm. on Interstate and Foreign Commerce, Report on Federal Regulation and Regulatory Reform, H.R. Doc. 95-134, 95th Cong., 2d Sess. 52 (1976).

chapter presents its conclusions on the issue. It also presents recommendations intended to improve the disclosure accompanying management proposals in proxy statements and to reduce the number of shareholder proposals excluded from proxy material for technical rather than substantive reasons.

B. Evidence Gathered by the Advisory Committee.

The Committee undertook a number of steps to determine whether proxy statements are used and whether the information furnished is adequate. The initial release asking for public comments on broad questions of relevance to the Committee's work,[13/] asked for suggestions as to what revisions could be made to the disclosure requirements of the Commission's proxy rules to assist shareholders in making voting decisions,[14/] and how the proxy rules might be revised to improve the process by which shareholders participate in the corporate electoral process.[15/]

13/ Securities Act Release No. 5707 (May 18, 1976).

14/ Question 9(b) read: "What revisions could be made to assist shareholders in making voting decisions?"

15/ Question 10 read: "How could the proxy rules be revised to improve the process by which shareholders participate in the corporate electoral process ('corporate democracy')?"

Neither of the questions drew substantial comment. Of those who did comment, the majority were of the opinion that proxy statements presently contained enough information for shareholders to make well-informed voting decisions. A very small number thought that disclosure of directors' fees might possibly prove useful. Similarly, comments on the "corporate democracy" question were sparse. However, respondents who did comment were more likely to suggest that additional limitations be placed on shareholder participation. Thus, not a few suggested that shareholder proposals be limited as to number, size and proponent; others suggested that a holding period be required before a shareholder be permitted to submit a proposal, or that a shareholder be required to own a minimum number of shares.

In addition, the questionnaire used in the case study of security analysts [16/] included a question on the corporate electoral process and investment decision-makers were asked their opinions on the subject in the course of interviews. Although there were exceptions in both categories, as a general matter, neither of these groups evidenced any par-

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16/ Question X of the security analysts' questionnaire reads as follows:

> "A. What revisions . . . could be made to the disclosure requirements of the SEC proxy and proxy statement form to facilitate or otherwise assist shareholder voting decisions? . . .
>
> "B. What revisions could be made to the SEC proxy rules (other than disclosure requirements) to improve shareholder democracy . . . ."

ticular interest in information respecting this subject.

In the course of the staff interviews, companies were asked for suggestions to improve the corporate electoral process; in addition, they were asked to list the ten most frequently asked questions from shareholders. They indicated their belief that the corporate suffrage process worked satisfactorily. Moreover, none of the questions they listed encompassed corporate democracy. Nor did registered representatives, as a group, indicate that they or their customers considered these questions of substantial importance, although a few registered representatives, in response to Question 19 of the SIA survey, voiced their belief that the Commissin should be more active in protecting shareholders' rights.[17/]

The individual investor questionnaire included several questions concerning the proxy soliciting material, including how thoroughly such material was read and whether it was felt that information on management proposals was reasonably adequate for making an informed voting decision. Results from other questions in that same questionnaire show that shareholders feel that information about the quality of management is important; however, individuals

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17/ Although differences in wording made it difficult to be categorical in evaluating these suggestions, at least three registered representatives made this suggestion. In addition, others suggested that understandable, cogent descriptions of management background and experience would materially assist small investors.

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also frequently found it was not accessible.[18/] More found it inaccessible than any other information. If there was better disclosure in proxy statements, perhaps stockholders would have less difficulty in locating information about the quality of management.

D. Advisory Committee Discussion and Recommendations

In March, 1977 when the Advisory Committee initially began discussing the question of what, if any, changes should be recommended in the area of proxy statement disclosure, the members focused on a report prepared by a task force made up of three Committee members. This report dealt with three broad areas: (1) disclosures about the board of directors -- who the members were, how they were selected, and how they operated; (2) disclosures regarding management proposals in the proxy statements; and (3) revisions in the shareholder proposal rules.

The most controversial area was the first one. It was suggested that the Advisory Committee recommend to the Commission the following specific disclosure requirements:

> 1. Identification of each nominee as "management," "affiliated non-management," or "unaffiliated non-management" and of the factors that have caused each affiliated non-management nominee to be classified as affiliated;
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> 2. Each non-management director's total compensation for the previous fiscal year and whether such compensation is paid on an annual,

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18/ Indeed, securities analysts seem to feel that the only way to obtain information about the quality of management is through company and management interviews. See Chapter VI at 288.

per meeting, or some other basis (including a breakout of compensation paid, if any, by virtue of membership on and attendance of committees of the board);

3. A tabulation of board and committee meetings held the previous year and, for each board member, a tabulation of his record of attendance at said board and committee meetings;

4. A brief description of board policy concerning retirement of directors, including whether there is a mandatory retirement age and, if so, what it is;

Information concerning selection of nominees:

5. A statement of whether there is a nominating committee of the board and, if so, of who the members of that committee are;

6. A brief description of the procedures and criteria used, by the nominating committee or the full board, to select new nominees for election as directors and to determine whether to renominate sitting directors;

Information concerning organization and functioning of the board:

7. A brief description of the authority and responsibilities of each standing committee of the board, including information as to the frequency with which and procedure by which each committee reports to the full board and the procedures used for selecting the members of each committee;

8. A statement of whether members of the board regularly receive, at least 24 hours in advance of board and committee meetings, full information about matters management proposes they pass upon at said meetings, of whether any such matters were passed at such meetings during the previous year without benefit of such advance information, and, if there were such matters and they involved material transactions, what such matters were;

9. A brief description of the systems, procedures, and objective criteria, if any, by which

the board monitored or evaluated the performance of management during the previous year;

10. A brief description of the kinds of matters, if any, which were voted upon only by the unaffiliated non-management directors or by all the non-management directors;

11. A statement as to whether, in the normal course of business, registrant's proxy material is required to be submitted to the board for review prior to its distribution to stockholders; whether the board reviews such material for the fairness of presentation of matters such as directors' and executive officers' compensation and management proposals; and a brief description of the policy followed and criteria used by the board in reviewing or approving management expenditures in connection with proxy solicitation (or, if there are no policies and/or criteria, a statement to that effect); and

12. That the Commission develop a system for requiring registrants and directors of registrants to disclose the circumstances under which directors have resigned, have declined to stand for re-election, or have not been re-nominated. Such a system should be modeled on the Commission's disclosure requirements relating to resignations of registrants' outside auditors.

The argument of the task force and those that supported its recommendations was that in order to arrive at a judgment about the effectiveness of the board and the candidates for which he was requested to vote, a shareholder ought to know, among other things, the percentage of the members who are independent, the organizational structure of the board, how frequently members attended meetings, how well-informed they were and how members were selected. It was acknowledged by many members that this type of disclosure may have a regulatory effect but it was argued that the disclosure itself was necessary for an informed voting

decision.

Those who opposed these recommendations argued that the primary purpose of the proposed disclosure was to regulate; some felt that it was improper for the Commission to require disclosure solely or primarily to regulate; and some suggested the disclosure in this case would not accomplish the regulatory goal. Several members pointed out what they viewed as flaws in specific proposals of the task force. Many members also felt that while reform of the board of directors was a worthy goal, such reform had already begun without disclosure requirements in the proxy statement and the movement was continuing at a satisfactory rate. Further, if the trend for reform did not continue or was reversed, direct regulation such as Federal chartering could be adopted by Congress.

There were two specific recommendations that gained the support of a majority of the members at the March meeting. These were the identification of the nominating committee members and a requirement that if a director resigns and submits a letter stating a reason, that letter should be filed with a Form 8-K if the director so requests.

The support for the first recommendation resulted from the belief that since members of the Executive Committee and the Audit Committee had to be identified, it was reasonable to require identification of the members of the nominating committee. The support for the second recommendation arose from a belief that a director who was resigning for

cause ought to have some forum reasonably available to him if he wanted to convey his concern to the shareholders.

The task force subsequently reviewed and revised its recommendations. Relying in part on the analytic framework provided by Professor Albert O. Hirschman's book, Exit, Voice and Loyalty (1970) the task force concluded that shareholders could not be expected to make demands for new information relevant to the corporate electoral process. It also concluded that the Commission could legitimately use its disclosure authority for the dual purposes of enhancing the ability of boards to operate as independent monitors of management's performance and of providing shareholders with information that should be relevant to their voting decisions in corporate elections. The task force noted that the Commission previously had used its disclosure authority in a similar fashion when it set requrements concerning resignations of auditors.[19/] This issue was again presented to the Committee at its May 1977 meeting. After a considerable discussion a majority of members recommended to the Commission that it develop a package of disclosure requirements that will improve the monitoring functions of the board. Those members did make it clear that although they considered the monitoring functions important, it was not their intention to suggest that management or any other persons not be

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19/ Accounting Series Release No. 165 (Dec. 20, 1974).

permitted to serve on the board. A majority of the Committee's members agreed to include the specific suggestions made by the task force in the report as being illustrative of the kind of disclosure the Commission might want to consider.

The other two broad areas discussed by the Committee were not as controversial. With respect to the proposal that management be required to disclose clearly the unfavorable as well as the favorable aspects of its proposals, many members felt that this was already required and was in fact complied with in most instances. It was pointed out that at least since 1969, the Commission's Division of Corporation Finance has taken the position that when management sponsors anti-takeover proposals to insulate management from removal, such as classifying the board of directors and increasing the percentage of shareholder votes needed to approve a merger not supported by a majority of the board, the issuer's "proxy material should disclose in a prominent place that the over-all effect of the proxy proposal is to render more difficult the accomplishment of mergers or the assumption of control by a principal stockholder, and thus to make difficult removal of management." 20/

However, a review of proxy statements, selected at random, of issuers whose managements proposed adoption of

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20/ Memorandum from Charles E. Shreve, Director, Division of Corporation Finance (July 17, 1969)

anti-takeover measures at their 1975 annual meetings did indicate that there was an obvious lack of uniformity in the manner in which disclosure was made, although there were differences of opinion among Advisory Committee members concerning the overall adequacy of disclosure.

Many members believe that in certain cases, particularly proposals involving compensation such as options, bonus plans and pensions, there might be inadequate disclosure of the potential long term adverse effects these might have on stockholders. It was felt that the existence of such plans might cause management to act in the future in a way that might be more in their interest than in the shareholders'. For example if a large number of options were held by management, dividend policy might be based more on how a particular policy might affect market prices than on broader considerations.

The Committee agreed to recommend that particularly in those areas of possible conflicts of interest, such as anti-takeover proposals and compensation plans, the Commission should attempt to get better, more uniform disclosure in proxy statements of the disadvantages as well as the advantages of management's proposals. The Committee specifically agreed that the disclosure of the cost and other effects of management compensation proposals including a reasonable estimate of current value to management should be required.

The final recommendation of the Committee deals with shareholder proposals. The Committee believes that for the most part the rules governing these proposals are working satisfactorily. However, occasionally, shareholder proposals are excluded from management's proxy material for the wrong reason: procedural technicalities. More specifically, the present provisions of Rule 14a-8(a)(3) [21/] on timeliness of

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21/ Rule 14a-8(a)(3) reads: "Timeliness. The proponent shall submit his proposal sufficiently far in advance of the meeting so that it is received by the management within the following time periods:

> (i) Annual Meetings. A proposal to be presented at an annual meeting shall be received by the management at issuer's principal executive offices not less than 90 days in advance of a date corresponding to the date set forth on the management's proxy statement released to security holders in connection with the previous year's annual meeting of security holders, except that if no annual meeting was held in the previous year or the date of the annual meeting has been changed by more than 30 calendar days from the date of the previous year's annual meeting a proposal shall be received by the management a reasonable time before the solicitation is made.
>
> (ii) Other Meetings. A proposal to be presented at any meeting other than an annual meeting shall be received a reasonable time before the solicitation is made.

This provision of the rule became effective May 1, 1977. The rule also includes the following:

> NOTE: In order to curtail controversy as to the date on which a proposal was received by the management, it is suggested that proponents submit their proposals by Certified Mail-Return Receipt Requested.

proposals is quite difficult for shareholders to interpret and apply, especially since, as the Commission has pointed out, most shareholder proponents "are not sophisticated in matters of securities law such as Rule 14a-8." 22/ The complexity of this part of the rule sometimes operates to deny shareholders reasonable access to issuers' proxy statements. In fact, in fiscal year 1976, of 226 instances in which the staff said it would take no action if a shareholder proposal was omitted from an issuer's proxy statement, 88 (or about 39 percent) involved proposals that were not submitted on a timely basis.

The Committee believes that the Commission could alleviate the problems created by the complexity of the timeliness requirement of Rule 14a-8 by requiring issuers to include in their proxy statements for each year's annual meeting an indication of the date (computed in accordance with Rule 14a-8(a)(3)) by which proposals must be received to be eligible for inclusion in their proxy materials for the following year's annual meeting. The suggested

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22/ Securities Exchange Act Release No. 12999 (November 22, 1976). The quoted language pertains specifically to the flexible posture which the Commission suggests management should retain in permitting shareholders to correct relatively minor defects in proposals otherwise submitted on a timely basis. The observation is nonetheless appropriate in evaluating the entire shareholder proposal process and, particularly, the timeliness requirements.

change[23/] would not provide shareholders with any new rights, nor would it impose any substantial burdens on issuers, but it would correct a troublesome and somewhat unsatisfactory situation.

23/ This change might be accomplished by adding to the Note to Rule 14a-8(a)(3) the following:

> In order to assist shareholders in understanding when shareholder proposals must be received by management to be eligible for inclusion in management's proxy materials for the next subsequent annual meeting, management should compute that date as required by subpart (i), and should specify as a part of the notice of meeting that proposals must be received by management by that date in order to be included in the issuer's proxy materials for the next year's annual meeting.

CHAPTER XIV

FURTHER INTEGRATION OF THE 1933 AND 1934 ACTS

RECOMMENDATIONS

The Commission should adopt a single integrated disclosure form to be used for compliance with the registration, reporting and proxy solicitiation requirements of the Securities Act and the Exchange Act.

Companies should be classified into Levels 1, 2, and 3 (proposed definitions are offered in the text of the report) for purposes of compliance with the Securities Act.

Level 1 companies should be allowed to use a Form S-16 type short form registration statement for primary offerings. Level 2 companies should be allowed to use a short form registration statement containing the disclosures required by current Form S-7.

In any exchange offer or transaction subject to Rule 145(a):

(a) Level 1 companies should be allowed to utilize short form registration statements containing the disclosure currently required by Form S-16 and certain additional information with respect to the nature of the transaction, which incorporates by reference the registrant's most recent proxy or information statement and periodic reports, and which undertakes to furnish such documents and the registrant's annual report to stockholders on request;

(b) Level 2 companies should be allowed to utilize registration statements containing the disclosure currently required by Form S-16 and certain additional information with

respect to the nature of the transaction and which incorporates by reference the registrant's most recent proxy or information statement and periodic reports, provided such reports and the registrant's most recent annual report to stockholders are furnished with the prospectus; and

(c) Level 3 companies should be required to utilize registration statements containing the disclosures currently required by Form S-1.

The following rule should be enacted to clarify the extent of responsibilities of officers, underwriters and others for materials incorporated by reference in a 1933 Act filing:

> In determining what constitutes reasonable investigation or care and reasonable ground for belief under the Securities Act of 1933, of information incorporated by reference into a registration statement or prospectus, the standard of reasonableness is that required by a prudent man under the circumstances, including (1) the type of registrant, (2) the type of particular person, (3) the office held when the person is an officer, (4) the presence or absence of another relationship to the registrant when the person is a director or proposed director, (5) reasonable reliance on officers, employees, and others whose duties should have given them knowledge of the particular facts (in the light of the functions and responsibilities of the particular person with respect to the registrant and the filing), (6) the type of underwriting arrangement, the role of the particular person as an underwriter, and the accessibility to information with respect to the registrant when the person is an underwriter, (7) the type of security, and (8) whether or not, with respect to information or a document incorporated by reference, the particular person had any responsibility for the information or document at the time of the filing from which it was incorporated.

Introduction

Prior to the introduction of Section 12(g) [1/] of the

1/ Section 12(g) of the Securities Exchange Act of 1934 (Exchange Act).

Exchange Act, pursuant to the Securities Act Amendments of 1964 [2/], the Commission essentially administered the Securities Act and the Exchange Act as two separate and distinct statutes. [3/] This was the result of a curious regulatory phenomenon existing in the Exchange Act. Generally, prior to the passage of Section 12(g), issuers who had a class of equity securities listed for trading on a national securities exchange [4/] or who had a registration statement declared effective under the Securities Act [5/] were subject to the continuous disclosure provisions of Section 13 or 15(d) of the Exchange Act. Issuers not falling into these categories, such as those whose securities were traded in the over-the-counter market, were not required to report. Although the Commission recognized that the disclosure principles forming the foundation of the Exchange Act reporting provisions were applicable to both listed securities and securities traded in the over-the-counter market, it found that attempts to improve the quality of 1934 Act disclosure resulted in securities

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2/ Securities Acts Amendments of 1964, Pub.L.No.88-467, 78 Stat. 566 (1964).

3/ For a detailed discussion of the historical evolution of Securities Acts disclosure see Chapter XIX, "The Evolution of the Federal Disclosure System: A Historical Perspective."

4/ Exchange Act §12(b).

5/ Exchange Act §15(d).

being delisted and Exchange Act requirements being circumvented. For this reason and because of the general application and resulting ease of administration of the Securities Act, the Commission concentrated its efforts on improving the quality of 1933 Act disclosure, notwithstanding its episodic application.

The 1964 Amendments eliminated this disparity by extending the continuous reporting provisions to unlisted issuers who have a class of equity securities held of record by at least 500 persons and who have total assets in excess of $1 million. Section 12(g) provided the opportunity for the creation of a significantly more meaningful disclosure system through the coordination of the provisions of the two Acts. Certain commentators suggested that the large reservoir of continuously updated information accumulated under the Exchange Act might be utilized in partial or total substitution for the sporadic, and often duplicative disclosure provided in registration statements under the 1933 Act. 6/

In November 1967 the Commission took initial steps toward a closer integration of the securities acts in adopting Form S-7. 7/ As the Commission noted in proposing Form S-7, 8/ the short form registration statement is available only to issuers with a substantial history of reporting under the Exchange Act and is based primarily on the recognition of the

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6/ Cohen, "Truth in Securities Revisited," 79 Harv.L.Rev. 1340 (1966). See also Chapter XIX at 605, 614-17.

7/ Securities Act Release No. 4886 (November 29, 1967).

8/ Securities Act Release No. 4849 (November 16, 1966).

availability of this information to the investing public.

Also in November 1967 the Commission announced the formation of an internal study group whose purpose was to examine the operation of the disclosure provisions of the 1933 and 1934 Acts and to determine what steps the Commission might take administratively to further integrate the Acts. 9/ The study's report (the Wheat Report) examined the use of Form S-7 and recommended that its availability be expanded to a broader class of issuers. 10/ Since that time the Commission has amended the Form on several occasions, continually expanding the class of issuers entitled to use the Form and the types of transactions for which it is available. 11/

Pursuant to the recommendation of the Wheat Report, the Commission also adopted short form registration statement Form S-16. 12/ Form S-16 is available to issuers entitled to use Form S-7 for the registration of shares to be offered (1) in secondary distributions; (2) upon the conversion of outstanding convertible securities; or (3) upon the exercise of outstanding transferable warrants. Form S-16 is also premised in part on the availability of a significant body of disclosure which has been provided under the Exchange Act and which need not

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9/ Securities Act Release No. 4885 (November 29, 1967).

10/ SEC, Disclosure To Investors (Wheat Report) (1969) [hereinafter referred to as the Wheat Report].

11/ See Securities Act Release No. 5791 (December 20, 1976).

12/ 17 CFR §239.27 (1976).

be repeated in a 1933 Act registration statement. However, unlike Form S-7, Form S-16 requires that the issuer's most recent periodic reports be incorporated by reference into the registration statement.

A continuous, coordinated, and integrated disclosure system for industrial issuers required to file information under the 1933 and 1934 Acts will curtail registration costs and administrative obstacles incurred by industrial issuers in raising capital, facilitate timely access to the capital markets, and simplify the exchange offer and business combination processes. Further integration is warranted at this time. This chapter reports recommendations intended to further this goal.[13/]

B. Upgrading 1934 Act Reports

One caveat accompanies the recommendations for further integration which are discussed in Parts C and D of this Chapter. Furthering integration by short form registration procedures which take into account information available in the market place and permit incorporation by reference of 1934 Act reports must be conditioned on the improved quality and dissemination of disclosures in periodic reports. Since the enactment of Section 12(g) in 1964, the Commission has

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13/ The instant recommendations are not applicable to disclosure under the Investment Company Act. While the Committee was favorably disposed to the streamlining of disclosure under the Investment Company Act, it was agreed that it did not have adequate resources to develop recommendations in this area.

taken steps to improve significantly the quality of Exchange Act reporting. Specifically, the Commission has adopted numerous amendments to 1934 Act forms to bring their disclosure requirements into congruence with those provisions in 1933 Act forms concerning similar information.

Nevertheless, it remains apparent that 1934 Act documents are of lower quality and less detail than Securities Act prospectuses, with the exception generally of proxy and information statements. This distinction may arise for several reasons, including the differences in civil liability between 1933 and 1934 Act documents and the "adversary" relationship of underwriters and issuers that attends the preparation of 1933 Act registration statements. 14/ In addition, it appears that 1934 Act filings have been little used by investors. (See, e.g., Chapter VI. at 291.)

In connection with the discussion following regarding the use of a short form registration statement which would incorporate by reference 1934 Act reports, the Committee considered the requirement that a majority of the issuer's board of directors must sign each such report as a condition to the subsequent use of the short form. The Committee rejected this concept believing that the increased liability to be incurred by the directors signing such reports might deter use of the short form. Although it has made no specific recommendation concerning Exchange Act report signature requirements, the Committee encourages the Commission to consider this concept as a possible means of upgrading the

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14/ These provisions are fully discussed in Chapter XXI.

quality of reporting by improved attention by directors and top officers to their filings and the consequent enhanced possibility of liability.

The Committee believes that a further improvement in the quality of 1934 Act reports may also be realized by the exercise of certain administrative procedures by the Commission. The Committee recommends that the Commission reexamine its utilization of those procedures suggested by the Wheat Report, including trading suspensions and injunctive actions.[15/] In addition, the Committee believes that a new emphasis should be placed on the review of 1934 Act reports. One of the most significant accomplishments of the Commission with respect to the quality of 1933 Act documents has been the review and processing of registration statements. The Committee believes that the contributions of the Commission staff and the preparers of the registration statement during the review period are essential to the end product of a high quality disclosure document. As the Commission moves towards the further integration of the Securities Acts, through the incorporation of the 1934 Act reports, the traditional level of substantive review of 1933 Act documents should be carried over to Exchange Act reports. To the extent feasible, the Commission should expedite the review of 1934 Act reports and instruct staff members to execute a substantive review consistent with the quality of information sought in regis-

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15/ Wheat Report, Chapter XII.

tration statements under the Securities Act.

C. Form CD - Integrated Disclosure Form

In order to maximize the integration of the registration requirements of the Securities Act and the periodic reporting requirements of the Exchange Act, the Committee recommends that a single integrated disclosure form be promulgated. The Commission should rescind all registration forms (S-1 through S-16 and Forms 10 and 20), all periodic reporting forms (10-K, 10-Q and 8-K) and Schedule 14-A. The single disclosure form, designated Form CD ("Coordinated Disclosure") would replace these forms, and would set forth all Commission established general disclosure requirements.

In order to facilitate an understanding of the operation of the integrated form, the Committee has prepared a draft Form CD which appears as Section F of this chapter.[16/] The form contains instructions with respect to the form, content, and timing of registration statements and reports required to be filed under the Securities Act and the Exchange Act. For purposes of compliance with the disclosure requirements of the 1933 Act, the Committee proposes that Form CD classify companies into Levels 1, 2, and 3. These levels are defined as follows:

1. Level 1 - Any person

(a) that (1) has a class of securities registered

16/ The provisions of Forms 10 and 20 and of Schedule 14-A have not been included in the draft form.

pursuant to Section 12(b) of the Exchange Act or (2) is organized under the laws of the United States or any State or Territory or the District of Columbia, has its principal operations in the United States or its Territories and has a class of equity securities registered pursuant to Section 12(g) of the above Act or is required to file reports pursuant to Section 15(d) of the above Act;

(b) that (1) has been subject to the requirements of Section 12 or 15(d) of the Exchange Act and has filed all the material required to be filed pursuant to Sections 13, 14, 15(d), as applicable, for a period of at least thirty-six calendar months immediately preceding the filing of the registration statement; (2) has filed in a timely manner all reports required to be filed during the twelve calendar months preceding the filing of the registration statement; and (3) if subject only to the requirements of Section 15(d) of the Exchange Act, has sent to all security holders of each class of securities (including debt) to which the registration statements declared effective pursuant to the Securities Act of 1933 relate, a report containing the information called for by Rule 14a-3(b) and Part II of Form 10-K under the Exchange Act within the twelve calendar months preceding the filing of the registration statement;

(c) that, including its subsidiaries, has not during the past thirty-six calendar months defaulted in the payment of any dividend or sinking fund installment on preferred stock, or installment on any indebtedness for borrowed

money, or in the payment of rentals under long term leases; and

(d) that has had a net income, after taxes but before extraordinary items and cumulative effect of a change in accounting principles net of tax effect of at least $250,000 for three of the last four years, including the most recent fiscal year. 17/

2. Level 2 -- Any person which has been subject to and complied with the periodic reporting requirements of the Exchange Act for a period of at least 36 months prior to the date of filing of the registration statement.

3. Level 3 - All other persons.

In order to determine the applicable disclosure requirements of the 1933 Act or 1934 Act, issuers would simply locate the instruction applicable to the particular transaction or report involved. For example, a registrant seeking to make a public distribution of its securities for cash would determine its status as a Level 1, 2, or 3 company and then locate the applicable instructions for such transaction under the heading "Registration Statements and Amendments Under the Securities Act of 1933" which would specify the disclosure items which would be required to be included in the registration statement. Similarly, the instructions with respect to 1934 Act reporting under the caption "Registration Statements and Reports Under The Securities Exchange Act of

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17/ These provisions represent the current requirements for use of Form S-7.

1934" would specify the particular items of disclosure to be complied with in registration statements and annual, quarterly, or current reports. In each case the General Instructions with respect to signature requirements, number of copies to be filed, filing dates, and so forth, currently at the beginning of each form, would be set forth once under the General Instructions for each Act.

The Committee believes that the adoption of a single integrated disclosure form, while compelling from the standpoint of further coordination of the Securities Acts, will provide several other advantages over the present system. First, it assures that the disclosure requirements applicable under the 1933 and 1934 Acts will be identical. This should result in substantially similar, if not identical, disclosure with respect to a given item of information whether included in a periodic report or statutory prospectus. Secondly, it reduces the number and complexity of disclosure forms thereby facilitating an understanding of the mechanics of compliance. A single integrated form would also provide a significant administrative advantage to the Commission by facilitating the amendment of its disclosure items since only Form CD would have to be amended.

The Committee notes that the Commission has recently proposed a new integrated disclosure form, Form S-K. 18/

18/ Securities Act Release No. 5826 (May 10, 1977).

As proposed, Form S-K would, over time, contain a selected number of disclosure items which are common to a number of the Commission's forms, with appropriate cross references to these forms. To the extent disclosure items may be included in Form S-K, it may result in consistent disclosure under the 1933 and 1934 Acts with respect to those items. The Committee does not believe, however, that Form S-K as proposed goes far enough. In addition, it would appear that the creation of Form S-K, while retaining the Commission's current forms with cross references, may be counter productive in terms of simplifying the compliance process.

D. Short Form Registration Procedures

When a company is engaged in a public offering of its securities, the Committee believes that the necessity of providing information to offerees should vary with the type of company and the type of security involved, and the amount of information already available. Accordingly, it is the Committee's view that a further integration of the 1933 and 1934 Acts, by means of substitution of 1934 Act filed information for that traditionally required in a statutory prospectus, could be effectuated by varying the particular combination of (1) the information comprising the registration statement; (2) the information delivered to offerees; and (3) the information available on request. The following recommendations are premised on this rationale.

Registration of Securities To Be Sold For Cash. It is clear from the results of the survey conducted by the staff

of the Committee that the primary criticisms by issuers and underwriters of the registration process are: (1) the amount of time expended in a registered public offering; that is the total amount of time between the date the decision is made to make a public offering and the date it is declared effective, largely caused by registration preparation and SEC staff review; and (2) the costs resulting from the unnecessary duplication in a 1933 Act document of information previously filed with the Commission pursuant to the 1934 Act reporting provisions The Committee believes, however, that these concerns of issuers and underwriters may be met while at the same time providing the information necessary for the protection of investors in making an informed investment decision through the further integration of the Securities Acts as recommended herein.

Form S-16. The Committee recommends that the Commission make available to Level 1 companies, those companies currently entitled to register on Form S-7, a short form registration procedure for the registration of securities to be offered directly to the public.

In proposing the availability of a Form S-16 type short form registration statement for primary offerings of debt and equity, the Committee is recognizing that for a small top tier of companies a statutory prospectus containing disclosure other than that relating to the terms of the transaction is not necessary. These are companies which usually provide high quality corporate communication documents, including 1934 Act reports, and whose corporate

information is widely disseminated. In addition, members of this class of registrants are widely followed by debt and equity analysts. Therefore, there appears to be a greater reliance on dissemination and analysis by securities industry intermediaries than on individual investor self-analysis of a particular offering document.

In framing this recommendation, the Committee has identified this top tier as those companies who currently satisfy the criteria contained in the Rule As To Use Of Form S-7. It should be emphasized that these criteria do not necessarily reflect that class of registrants described above but were selected by the Committee since they represent a system currently utilized by the Commission for use of its shortest registration forms and, therefore, the class is readily recognized and comprehended. The Committee notes that the Commission has published an advance notice of rule-making relating to the availability of Form S-16 for primary offerings and recommends that it use the notice and comment procedure to determine the appropriate criteria for the class of issuers entitled to use the form for those transactions recommended by the Committee.

The Committee envisions that the short form document would include those applicable disclosures currently required by Form S-16 plus such additional information as the Commission may deem necessary with respect to the terms of the offering, such as the market price of the securities or the manner in which the offering price was determined. In addition, companies would be required to incorporate by

reference their most recent proxy or information statement, annual report to the Commission on Form 10-K, and any subsequent quarterly or current reports. 19/

Under this procedure, registrants would furnish to offerees a Form S-16 type prospectus. Pursuant to the Committee's recommendation regarding the dissemination of corporate periodic reports, registrants would also be required to make available to any person their most recent proxy or information statement, annual report to the Commission, and any subsequent quarterly or current reports. 20/ Although presented with minimal information in the prospectus, offerees would have access to those documents incorporated by reference. Specifically, a legend would be required in any preliminary or final prospectus stating that these specific reports have been incorporated by reference and that these documents are available on a continuing basis from the registrant. It is the Committee's opinion that this procedure will provide and/or make available to offerees the necessary firm oriented information for making an informed investment decision and eliminate additional

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19/ Companies subject to the provisions of Section 15(d) of the 1934 Act would not be required to incorporate their proxy statement since they are not required to comply with the provisions of Section 14 and Schedule 14A. That information which Section 12 registrants might include in their proxy statements pursuant to General Instruction A of Form 10-K would of course be provided by Section 15(d) companies in Part II of their current report on Form 10-K.

20/ See Chapter XVIII.

burdens on registrants incurred in the preparation of a new document covering information previously disclosed.

During the Committee's consideration of these proposals, it was suggested that the documents incorporated by reference should be made available during the waiting period and for a period of time after the effective date pursuant to an undertaking in the registration statement. Such a requirement, however, does not recognize the economic realities of the market place during a public offering. Underwritten offerings by Level 1 companies normally are completed within hours after the registration statement is declared effective. The time spent in registration is also usually a short period. The net effect is that offerees, if furnished a preliminary prospectus, 21/ would not have an adequate amount of time to request and receive available information. In order to remedy this problem, the Commission would have to require that preliminary prospectuses be furnished to all offerees a specific number of days in advance in order to allow sufficient time for the request and transmittal of documents. The Committee does not believe this to be appropriate in the context of a primary offering for cash by a registrant meeting the requirements for use of the recommended short form. Any requirement by means of an undertaking to furnish these documents during the waiting period or after effectiveness would, therefore,

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21/ It is the Committee's understanding that preliminary prospectuses are rarely distributed to prospective purchasers.

seem useless from a practical standpoint. Rather, the Committee recommends that the documents incorporated by reference be made available on a continuous basis without reference to a current registration statement.

In reaching this conclusion the Committee does not intend to upset the Commission's current distribution requirements with respect to registration statements filed by registrants not subject to the reporting provisions of the Exchange Act. As announced in Securities Act Release No. 4968 [22/], the Commission, in the exercise of its responsibilities in accelerating the effective date of a registration statement under Section 8(a) of the Securities Act, particularly the requirement that adequate information concerning the registrant be available to the public, will consider that reasonably adequate steps have been taken to assure that preliminary prospectuses have been furnished to prospective purchasers if the managing underwriter, in a written statement, indicates that copies of the preliminary prospectus have been distributed to all persons it is then expected to mail confirmations of sale, not less than 48 hours prior to the time it is expected to mail confirmations.[23/] The Committee is of the opinion that these procedures are appropriate and necessary with respect to those issuers who do not have a history of filing reports under the

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22/ Securities Act Release No. 4968 (April 24, 1969).

23/ This time period may not be reasonable in view of normal postal processing schedules.

Exchange Act. In such case, prospective investors have no reasonable means other than the preliminary prospectus of acquiring valid information regarding the issuer prior to purchase.

The Advisory Committee also considered and rejected a proposal to create an additional level of companies between the proposed Level 1 and 2 companies. As proposed, this level of registrants would have been required, in a public offering for cash, to have prepared an S-16 type short form registration statement and to also furnish with the prospectus a copy of the registrant's most recent annual report to stockholders. Proponents of this registration procedure believe that the annual report to stockholders is the most readable and most communicative of all corporate documents and should play a larger role in the further integration of the 1933 and 1934 Acts. The Committee determined not to require an annual report to accompany a prospectus in the distribution process since it was of the opinion that the annual report's free writing style would be threatened, thus undercutting its current usefulness.

Form S-7. In order to further extend the benefits of the integration of the securities acts, the Committee recommends that a Form S-7 type registration statement be made available to Level 2 registrants: Any person which has (1) been subject to the requirements of Section 12 or 15(d) of the Exchange Act and has filed all the material required

to be filed pursuant to Sections 13, 14 or 15(d), as applicable, for a period of thirty-six months immediately preceding the filing of the registration statement; (2) has filed all such reports in a timely manner for the twelve months preceding the filing of the registration statement; and (3) if such person is subject only to the requirements of Section 15(d), has sent to all security holders of each class of securities to which the registration statement declared effective pursuant to the 1933 Act relates a report containing the information called for by Rule 14a-3(b) of Schedule 14A and Part II of the current Form 10-K. 24/

The Commission's theory in adopting Form S-7 was that elimination of certain disclosures in the statutory prospectus could be justified if these disclosures had been made in other reports filed under the Exchange Act for a substantial period of time. 25/ The Commission also intended the adoption of Form S-7 as an experiment in integration which was to be monitored closely. The initial criteria for use of the Form, therefore, restricted its use to a small number of issuers. These criteria have been substantially amended to broaden widely the category of companies eligible to use the Form.

The Committee believes that the increased availability of Form S-7 has proved successful. It, therefore, recommends

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24/ This requirement conforms with present paragraphs A(a) and (b) of the Rule As To Use of Form S-7.

25/ Wheat Report at 75.

that, in connection with its recommendations regarding the improved quality and availability of 1934 reporting, the criteria for use of a Form S-7 type registration statement other than a thirty-six month reporting history be deleted. It is the opinion of the Committee that with respect to firm-oriented information the disclosures currently required by Form S-7 are sufficient for making an informed investment decision with respect to any company which has a substantial history of reporting to the Commission.

Exchange Offers and Business Combinations. Registration statements relating to the public offering of securities in an exchange offer or a transaction subject to paragraph (a) of Securities Act Rule 145[26/] historically have involved some of the longest and most complex disclosure documents presented to investors. A study conducted by the Division of Corporation Finance[27/] indicates that some of the business combination transactions registered on Form S-14[28/] exceed 200 pages in length. The average length is approximately 110 pages. More than 50 percent of these documents normally constitute historical and pro forma financial statements.

26/ 17 CFR 230.145(a) (1977).

27/ The staff reviewed 40 registration statements on Form S-14 constituting all Form S-14 registration statements filed in three of the Division's 15 branches between June 1, 1975 and May 30, 1976. The Division believes these registration statements are a representative sample.

28/ 17 CFR §239.23 (1977).

In order to shorten and simplify these documents the Commission has recently adopted and proposed amendments to certain of its forms. First, in Securities Act Release No. 5791[29/] the Commission adopted amendments to Form S-7 which would make the form available for the registration of securities to be offered in exchange for other securities of the registrant or securities of any other person. In addition, the Commission made the form available for an offer to exchange the securities of the registrant for the assets of another person. Registrants meeting the requirements for use of Form S-7 may now utilize the short form registration procedure for exchange offers provided additional information concerning the management and principal security holders is presented. Information regarding the other person involved may also comply with that called for by Form S-7 if the other person also meets the requirements as to use of the Form.

The Commission also recently proposed a new Form S-14A to be utilized for the registration of shares to be offered in reclassifications or business combinations subject to Rule 145(a).[30/] As proposed, S-14A would have provided for a single document to be filed with the

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29/ Securities Act Release No. 5791 (December 20, 1976).

30/ Securities Act Release No. 5744 (September 27, 1976).

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Commission containing substantially the same information included in a registration statement prepared pursuant to existing Form S-14. This document would have consisted of three parts. Part I, which would constitute the statutory prospectus and be delivered to all security holders, would contain summary information concerning the terms of the transaction and the parties to the transaction. Part II, which would be incorporated by reference into Part I and be available on request to any security holder at the registrant's expense, would contain detailed narrative and financial disclosure concerning the nature of the transaction and the parties thereto. Part III would contain that information currently required as Part II of a registration statement.

In proposing S-14A the Commission had two primary goals in mind. First, it was thought that a substantially shorter, simpler prospectus summarizing the information normally included in Form S-14 registration statements would be more useful to the ordinary investor. Second, it was intended that the furnishing of a shorter prospectus with additional information (Part II) available on request would result in cost savings to registrants engaged in transactions subject to Rule 145(a). After an analysis of the comments received, the Commission determined not to adopt the Form.[31/] Although there was sub-

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31/ Securities Act Release No. 5806 (February 16, 1977).

stantial support for the Commission's goals, commentators indicated that (1) the proposal would increase preparation and printing costs, since two separate documents would have to be developed and numerous copies of Part II printed in advance of request, and (2) that potential liabilities resulting from the use of a statutory prospectus not containing all material information would be substantial and thereby discourage registrants from using the form.

The Committee concurs with the Commission's objectives of making disclosure of exchange offers and Rule 145(a) transactions more understandable to investors while at the same time reducing the burdens on registrants and believes that further steps can and should be taken. There is no need for a detailed registration statement repeating information already available about the participating companies and of which the professional investor/analyst is already aware. It also is important that in this situation where the disclosure document reaches the individual investor and requests an investment decision without the presence of an intermediary adviser the document not overwhelm and confuse. Significant in the formulation of the Committee's recommendations in this area are two concepts expressly approved by the Commission in its amendments to Form S-7 and the proposal of Form S-14A. First, an investor need not be furnished all material information about an issuer before making an investment decision provided that sub-

stantial information concerning the issuer is otherwise available to the investor and the trading markets.[32/] Second, under certain circumstances, the economic realities of the market plainly do not necessitate that an investor be provided a full prospectus.[33/]

Accordingly, assuming the improved quality of 1934 Act disclosure, especially through the Committee's recommendations concerning Form 10-K, the Committee believes that the Commission's objectives may be reached through the further integration of the securities acts by means of the incorporation by reference of 1934 Act reports into the statutory prospectus under the Securities Act of 1933.

The Committee, therefore, recommends that the following registration procedures be utilized for public offerings involving exchange offers or Rule 145 transactions.

Information Regarding the Terms of the Transaction. Information concerning the terms of the transaction is normally not available to security holders by any means other than the offering document. Accordingly the prospectus would contain the same information regarding the terms of the transaction as currently required for exchange offers by Form S-1 and for Rule 145(a) transactions by Form S-14: (1) the securities being registered; (2) the material features of the plan, the reasons therefor and the effect

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32/ Securities Act Release No. 5744.

33/ Id.

thereof; (3) comparative market prices of securities affected; (4) dissenters' rights; (5) material interest of management in the proposed transaction; and (6) a list of parents of the registrant indicating control currently and as affected by the plan or transaction. Since a prospectus relating to a Rule 145(a) transaction could be in the form of a proxy or information statement, the prospectus would also include information currently called for by Schedule 14A concerning revocability of proxy, persons making the solicitation, voting securities and principal holders thereof, vote required for approval, and similar items required to be included in a proxy or information statement regardless of the matters to be acted upon.

Information Regarding the Parties to the Transaction.

The Committee recommends that disclosure regarding the parties to the transaction be provided as set forth below. It should be noted that disclosure is provided with respect to each party appropriate to that party's level. Thus, if a Level 1 company acquired a Level 3 company, the Level 1 company provides the disclosure set forth in paragraph (1) below and the disclosure set forth in paragraph (3) below is made for a Level 3 company If two Level 2 companies combine, both provide the disclosure prescribed in paragraph (2).

1. Level 1 Company - If any person involved in the transaction is a Level 1 company, the prospectus would not contain any disclosure regarding such person but would incorporate by reference such person's most recent proxy or information statement and annual report on Form 10-K and any subsequent quarterly or current reports. In addition the registrant would undertake to make available at his expense a copy of such documents and a copy of the Level 1 company's most recent annual report to stockholders. The prospectus would also include a prominent statement that these documents are available on request at no expense.

The Committee recognizes that transactions of this nature impose an investment decision on security holders. The Committee agrees with the Commission that under these circumstances investors should not have the burden of searching for the registrant's periodic reports in order to see detailed information regarding the registrant. 34/

At the same time, the Committee believes that a substantial number of investors may not need or desire information regarding a Level 1 company. Therefore, the Committee recommends that a Level 1 company's most recent annual report to stockholders or information statement and annual report, and any subsequent quarterly or current reports, be made available on request. In order to

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34/ See Securities Act Release No. 5791 (December 20, 1976).

assure that these documents, if requested, are received prior to the expiration of the exchange offer or the date of the shareholders meeting, a condition as to the use of this short form procedure would require that the prospectus be furnished a minimum number of days prior to the expiration of the exchange offer or the date of stockholders meeting on which the vote is to be taken.

2. Level 2 Company - If any person involved in the exchange offer or Rule 145(a) transaction is a Level 2 company, the prospectus would not contain any disclosure regarding such person but would incorporate by reference its most recent proxy or information statement and annual report and any subsequent quarterly or current reports. In addition, the registrant would undertake to furnish together with the prospectus the documents incorporated by reference and the Level 2 company's most recent annual report to stockholders.

3. Level 3 Company - If any person involved in the exchange offer or Rule 145(a) transaction is a Level 3 company, the prospectus would include the disclosure regarding such person as is currently required in an exchange offer by Form S-1 or in a Rule 145(a) transaction by Form S-14.

Other Information. In recommending the incorporation by reference of the 1934 Act reports of Level 1 and 2 companies in lieu of information otherwise required to be included in the prospectus, the Committee understands that

in certain cases registrants may feel it necessary to include additional information with respect to their operations. The Committee encourages the inclusion of additional information which might make these documents more understandable or meaningful provided such information is briefly and fairly presented. Similar to its recommendation above with respect to primary offerings by Level 1 companies, the Committee recommends that the short form procedures available to Level 1 and Level 2 companies provide for the inclusion in the prospectus of certain additional information.

As envisioned by the above proposals, the prospectus furnished to investors would in all events include information concerning the terms of the exchange offer or Rule 145(a) transaction. Disclosure with respect to the parties involved would vary according to their classification as Level 1, 2 or 3 companies. For example, in a public offering subject to Rule 145(a) involving a Level 1 and Level 2 company the prospectus would describe the terms of the transaction but contain no disclosure concerning the parties. However, the prospectus would indicate that the most recent proxy or information statement and annual report, and any subsequent quarterly or currents reports of each party are incorporated by reference. These reports and the Level 2 company's most recent annual report to stockholders would be furnished together with the prospectus and the prospectus would

indicate that the same documents concerning the Level 1 company are available on request. Similarly, in a Rule 145(a) transaction involving a Level 2 and Level 3 company, the prospectus would describe the terms of the transaction and include disclosure concerning the Level 3 company as currently required by Form S-14. The Level 2 company's most recent annual report to stockholders, proxy or information statement, and annual report and any subsequent quarterly or current reports would be furnished together with the prospectus.

As indicated above, the primary concerns expressed with respect to proposed S-14A were 1) the absence of any cost savings to registrants and 2) the increased exposure to liability resulting from the failure to include all material information in the prospectus. The Committee believes that its recommended procedures will result in significant cost savings to registrants. Although periodic reports and other documents with respect to Level 1 companies must be furnished on request, registrants will incur cost savings since no new preparation and printing costs are involved.[35/]

35/ If the Level 1 company involved is also the issuer of the securities to be offered it will most likely have on hand a substantial number of copies of these documents which would be required to be made available pursuant to the Committee's recommendations regarding their public dissemination.

Savings in mailing costs may be realized through the reduced bulk of the initial mailing if a significant number of requests for the available documents are not received. Similar savings in preparation and printing costs would also result where the exchange offer or Rule 145(a) transaction involved a Level 2 company. In addition, the recommended procedures will not give rise to the potential liabilities seen by the commentators with respect to Form S-14A. The incorporation by reference of a Level 1 or Level 2 company's most recent proxy or information statement and annual report and any subsequent quarterly or current reports will include all material information in the prospectus.

It should be reiterated at this time that the Committee's definitions of Level 1, 2 and 3 companies in Form CD for purposes of 1933 Act compliance do not necessarily reflect the classes of issuers which should be entitled to use the short form registration procedures recommended in this Chapter.[36/] The Committee recommends that in proposing Form CD for comment and the new short form registration procedures contained therein, the Commission also solicit comment regarding the appropriate classifications of registrants.

36/ See discussion at 434 supra.

E. Liability for Documents Incorporated by Reference.

As explained above, the Committee recommends that the Securities Acts be integrated to the extent practicable by means of the incorporation by reference of a registrant's 1934 Act reports into the statutory prospectus. The Committee believes, however, that this expanded utilization of incorporation by reference of 1934 Act filings necessitates a corresponding limiting interpretation of the liability provisions of the Securities Act and the Exchange Act. The basic effect of incorporation by reference will be to subject 1934 Act filings to the standards of the 1933 Act. Under the 1933 Act, speaking generally, the various participants in the registration process, including officers, all of the directors, experts and underwriters are not responsible for omissions or misstatements in a registration statement if, after reasonable investigation, they had reasonable grounds to believe and did believe that the registration statement was not misleading--the so-called "due diligence" standard.[37/] The company itself has no defenses under the 1933 Act. Under Section 18 of the 1934 Act, which governs filed reports such as the

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37/ See Securities Act § 11.

Form 10-K, liability is imposed on persons responsible for the filing who make or cause to be made a misstatement and who act in bad faith or have knowledge of the misrepresentation.[38/] Rule 10b-5 probably establishes similar standards of responsibility.[39/] In summary, the 1933 Act establishes an obligation of inquiry upon all participants in the registration process (except the issuer as to which liability is absolute) whereas the 1934 Act emphasizes a knowledge standard.[40/]

The evolving emphasis on "integration" of the 1933 and 1934 Acts has led to proposals to refine liability concepts for "integrated" documents. Thus, the Wheat Report suggested a rule to the effect that, under certain circumstances, (including a limitation on the amount of sales commissions to be received by the selling broker), a broker acting as an underwriter in a secondary offering on an exchange would be deemed to have made a reasonable investigation and to have reasonable grounds to believe the statements made in a registration statement and the documents incorporated by reference if he has

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38/ Exchange Act § 18.

39/ 17 CFR §240.10b-5 (1977).

40/ For a more detailed discussion of the liability provisions of the 1933 and 1934 Acts see Chapter XXI.

read the registration statement and the documents and is not aware of any false or misleading statements.[41/] Furthermore, the proposed ALI Federal Securities Code, in the counterpart provision to Section 11, provides that, in determining the reasonableness of conduct, the fact of incorporation by reference may be taken into account. The commentary to this provision states that the problem is to reconcile two conflicting goals:

> (i) furthering the S-16 concept, which makes it impossible to ignore the underwriter's practical problems with respect to material incorporated in an offering statement and subsequent reports, and (ii) nondilution of the underwriter's standard of care, which is essential to the credibility of the offering statement.[42/]

Representatives of investment banking firms have also expressed to members of the Committee and its staff their concern over liability (as well as the quality of disclosure) if offering documents rely primarily on 1934 Act materials incorporated by reference. It was felt that this procedure would result in making underwriters near-guarantors of the quality of 1934 Act reports. In their view this is unsatisfactory because underwriters do not presently and cannot practically assist in the

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41/ Wheat Report at 98-102

42/ Federal Securities Code, The American Law Institute, p. 104 (Tentative Draft No. 2) (March 1973). The substantive provision remains the same in the Reporter's Revision of Text of Tentative Drafts No. 1-3 (October 1974).

preparation of these documents. It is also their opinion that it would be difficult to have these documents amended to comply with their desires should they be so incorporated.[43/]

In order to encourage the use of the short form registration statements, and taking into account the practical problems confronting underwriters and others, while balancing the need for appropriate liability standards, the Committee recommends that the Commission propose a rule to the effect that the facts of incorporation by reference and the nature of "underwriting arrangements"[44/] may be taken into account in determining liability for the incorporated documents.

The Committee recommends that the text of a proposed rule relating to incorporation by reference be as follows:

> In determining what constitutes reasonable investigation or care and reasonable ground for belief under the Securities Act of 1933, of information incorporated by reference into a registration statement or prospectus, the standard of reasonableness is that required by a prudent man under

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43/ The Committee has recommended that an additional item captioned "Other Information" be included in a registration statement by Level 1 companies in part to allow additional information which underwriters may deem necessary after review of the documents incorporated by reference.

44/ Thus, a court might conclude that a lesser duty of inquiry should be imposed on a broker selling shares on the market from time to time under a "shelf" registration statement as compared with an investment banker involved in a firm commitment underwriting.

> the circumstances, including but not limited to (1) the type of registrant, (2) the type of particular person, (3) the office held when the person is an officer, (4) the presence or absence of another relationship to the registrant when the person is a director or proposed director, (5) reasonable reliance on officers, employees, and others whose duties should have given them knowledge of the particular facts (in the light of the functions and responsibilities of the particular person with respect to the registrant and the filing), (6) the type of underwriting arrangement, the role of the particular person as an underwriter, and the accessibility to information with respect to the registrant when the person is an underwriter, (7) the type of security, and (8) whether or not, with respect to information or a document incorporated by reference, the particular person had any responsibility for the information or document at the time of the filing from which it was incorporated.

This proposal is based primarily on the ALI Code draft of the counterpart provision to Section 11. Unlike the proposal of the Wheat Report, the rule would not deem that a person has made a reasonable investigation and has reasonable grounds to believe the statements made in the registration statement or the documents incorporated by reference are true if he has simply read the documents. Rather, it embodies many of the factors which a court should consider in determining the adequacy of a person's conduct.

F. Form CD (Coordinated Disclosure)

I. This form contains instructions with respect to the form and content of filings to be made with the Commission under the Securities Act of 1933 ("Securities Act") and the Securities Exchange Act of 1934 ("Exchange Act"). Issuers shall comply with the following instructions applicable to the particular registration or report involved.

II. REGISTRATION STATEMENTS AND AMENDMENTS UNDER THE SECURITIES ACT OF 1933

A. General Instructions

1. Application of General Rules and Regulations.

2. Documents Comprising the Registration Statement.

3. Form and Content of Prospectus.
Note: See Guides No. 1-8; 10; 12; 13; 19; 20; 26; 38; 42; 45; 48; 50; 52; 54; and 59.

4. Preparation of Part II.

5. Omission of Information With Respect to Foreign Subsidiaries.

6. Filing of Financial Statements in Certain Cases.

7. Signatures.

8. Notice of Intention to File.

9. Exclusion of Issuers Which Are Investment Companies Registered or Required To Be Registered Under The Investment Company Act of 1940.

B. Classification of Registrants

For purposes of this Section the following classification of registrants shall apply:

1. Level 1- Any person

(a) that (1) has a class of securities registered pursuant to Section 12(b) of the Exchange Act or (2) is organized under the laws of the United States or any State or Territory or the District of

Columbia, has its principal operations in the United States or its Territories and has a class of equity securities registered pursuant to Section 12(g) of the above Act or is required to file reports pursuant to Section 15(d) of the above Act;

(b) that (1) has been subject to the requirements of Section 12 or 15(d) of the Exchange Act and has filed all the material required to be filed pursuant to Sections 13, 14, 15(d), as applicable, for a period of at least thirty-six calendar months immediately preceding the filing of the registration statement; (2) has filed in a timely manner all reports required to be filed during the twelve calendar months preceding the filing of the registration statement; and (3) if subject only to the requirements of Section 15(d) of the Exchange Act, has sent to all security holders of each class of securities (debt or equity) to which the registration statements declared effective pursuant to the Securities Act of 1933 relate a report containing the information called for by Rule 14a-3(b) and Part II of Form 10-K under the Exchange Act within the twelve calendar months preceding the filing of the registration statement;

(c) that, including its subsidiaries, has not during the past thirty-six calendar months defaulted in the payment of any dividend or sinking fund installment on preferred stock, or installment on any indebtedness for borrowed money, or in the payment of rentals under long term leases; and

(d) that has had a net income, after taxes but before extraordinary items and cumulative effect of a change in accounting principles net of tax effect of at least $250,000 for three of the last four years, including the most recent fiscal year.

2. Level 2 - Any person which has been subject to and complied with the periodic reporting requirements of the Exchange Act for a period of at least 36 months prior to the date of filing of a registration statement.

3. Level 3 - All other persons.

C. Registration of Securities to Be Sold For Cash in a Public Distribution

Note: It should be noted that the short form registration procedures contained in paragraphs 1(a) and (b) below are permissive. Registrants need not utilize the shortest registration procedure for which they qualify.

1. General

(a) Level 1 Registrants - A registration statement for the sale of securities to the public for cash by a Level 1 registrant may be prepared as follows:

(i) Part I - the information called for by disclosure Items 12; 20-21; 70-75; and

(ii) Part II - the information called for by disclosure Items 66; 67; and 69; and

(b) Level 2 - A registration statement for the sale of securities to the public for cash by a Level 2 registrant may be prepared as follows:

(i) Part I - the information called for by disclosure of Items 1; 3; 12; 20-22; 25-27; 49-50; 65;

(ii) Part II - the information called for by disclosure Items 28; 44-45; 48; 65-67; and 69.

(c) Level 3 - A registration statement for the sale of securities to the public for cash by a Level 3 registrant shall include:

(i) Part I - the information called for by disclosure Items 1 -11; 20-29; 65; and

(ii) Part II - the information called for by disclosure of Items 12; 43-48; and 64-69.

2. Specific Types of Securities

(a) If the securities to be registered are (1) securities issued by real estate investment trusts as defined by Section 856 of the Internal Revenue Code, or (2) securities issued by other issuers whose business is primarily that of acquiring and holding for investment real estate or interests in real estate or interests in other issuers whose business is primarily that of acquiring and holding real estate or interests in real estate for investment, information called for by disclosure Items 13-19 shall be provided in addition to that information otherwise required pursuant to paragraphs C(1)(a) - (c) above.

(b) If the securities to be registered represent interests in real estate limited partnerships, the information called for by disclosure Item No. 76 shall be provided in addition to that information otherwise required pursuant to paragraphs C(1)(a) - (c) above.

(c) If the securities to be registered represent interests in oil and gas drilling programs, the information called for by disclosure Item No. 77 shall be provided in addition to that information otherwise required pursuant to paragraphs C(1)(a) - (c) above.

D. Exchange Offers and Business Combinations

If any of the securities to be registered are (1) to be offered in exchange for securities of any other issuer or (2) to be issued in a transaction specified in paragraph (a) of Rule 145, the following procedure for registration under the Securities Act may be utilized:

1. Part 1

A. Terms of the Transaction

Depending on the nature of the transaction, the prospectus shall contain disclosure of: (1) the securities being registered; (2) the material features of the plan or transactions and the reasons therefor and general effect thereof

on existing security holders; (3) comparative market prices of the securities affected by the plan or transaction; (4) dissenters' rights; (5) material interests of management in the proposed transaction; and (6) a list of parents of the registrant indicating control currently and as affected by the plan or transaction.

B. Information Regarding the Parties

(1) Level 1 Company - If any person involved in the transaction is a Level 1 company, the prospectus shall: (a) incorporate by reference the Level 1 company's most recent proxy or information statement and annual report and any subsequent quarterly or current reports; and (b) prominently state that such documents and a copy of the Level 1 company's most recent annual report to stockholders are available from the registrant at no charge.

(2) Level 2 Company - If any person involved in the transaction is a Level 2 company: (a) the prospectus shall incorporate by reference the Level 2 company's most recent proxy or information statement and annual report and any subsequent quarterly or current reports; and (b) such documents and the Level 2 company's most recent annual report to stockholders shall be furnished together with the prospectus.

(3) Level 3 Company - If any person involved in the transaction is a Level 3 company the prospectus shall contain such information concerning the Level 3 company as is required pursuant to paragraph C(1)(c)(i) above.

2. Part II

Part II of the registration statement shall contain:

(a) the information called for by disclosure Items 28, 66, and 69; and

(b) if the transaction involves a Level 1 company, the undertaking required by disclosure Item 67 to provide at no charge to each offeree the Level 1 company's most recent proxy or information statement, annual report to stockholders, and annual report and any subsequent quarterly or current reports.

E. Securities Offered Pursuant to Employee Benefit Plans or Interests in Such Plans.

If the securities to be registered are (1) securities of the issuer to be offered to its employees, or employees of its subsidiaries or parents pursuant to any employee benefit plan or (2) interests in such plans, the registration statement shall include the information called for by disclosure Items 1; 3; 5; 9; 25; 27; 30-42; 65; 66; and 69 provided that (1) at the time of filing the issuer has been subject to the requirement to file reports pursuant to Section 13 or 15(d) for the prior 90 days and has filed all reports and other materials required to be filed during the preceding six months and (2) in the case of a company subject to Section 15(d), the company has furnished or prior to the effective date of the registration statement will furnish an annual report to security holders for its last fiscal year.

Note: See Guides No. 44 and 49.

F. Reoffers Or Resales Of Securities Acquired Pursuant To A Registration In Compliance With Paragraph E.

Securities acquired by affiliates pursuant to a registration statement prepared in compliance with paragraph E above may be reoffered or resold pursuant to a registration statement filed with the registration statement under paragraph E, prepared as follows:

1. Such prospectus may be prepared in accordance with paragraph C(1) above if:

   (a) the issuer, at the time of filing a prospectus under this paragraph is a Level 1 or 2 company; or
   (b) the amount of securities proposed to be reoffered or resold pursuant to the prospectus, by each person affiliated with the issuer, and any other person with whom he is acting in concert for the purpose of selling securities of the issuer, does not exceed, during any six month period, the amount specified in Rule 144(e) calculated as of the date of filing such prospectus.

2. Such prospectus shall be prepared in accordance with paragraph C(1)(c) above, if subparagraph (1) above is inapplicable.

III. REGISTRATION STATEMENTS AND REPORTS UNDER THE SECURITIES EXCHANGE ACT OF 1934

A. General Instructions

1. Application of General Rules and Regulations

2. Preparation of Registration Statement or Report

3. Signature and Filing of Registration Statement or Report

4. Omission of Information Regarding Foreign Subsidairies

5. Incorporation By Reference

B. Registration Pursuant to Section 12(b) or 12(g) of the Exchange Act

A registration statement pursuant to Section 12(b) or (g) of the Exchange Act shall include the information called for by disclosure Items 1-11; 25-28; 63-66; 68, and 69.

C. Annual Reports

1. Unless otherwise authorized or prescribed, annual reports to the Commission pursuant to Section 13 or 15(d) shall include the following information:

   (a) Part I - Part I shall include the information called for by disclosure Items 1-4; 9; 28; 52-55; 59; 62; 65; 66; 69; and

   (b) Part II - Part II shall include the information called for by disclosure Items 5-7 and 10.

2. Annual reports shall be filed within 90 days after the end of the fiscal year covered by the report. However, all schedules required by Regulation S-X may, at the option of the registrant, be filed as an amendment to the report not later than 120 days after the end of the fiscal year covered by the report.

3. (a) Except as provided in paragraph (b) below, the information called for by Part I of this form is to be furnished by all registrants required to file an annual report with the Commission. Part II may be omitted from the report by any registrant which, since the close of the fiscal year, has filed with the Commission a definitive proxy statement pursuant to Regulation 14A, or a definitive information statement pursuant to Regulation 14C, which involved the election of directors, or which files such a proxy or information statement not later than 120 days after the close of the fiscal year.

   (b) If the information called for by disclosure Items 4, 9, or 64 would be unchanged from that given in a previous report which includes the required information, a reference to the previous report which contains the information will be sufficient. Copies of such previous report need not be filed with the report currently being filed.

4. Attention is directed to Rule 15d-21 which provides that separate annual and other reports need not be filed pursuant to Seciton 15(d) of the Act with respect to any employee stock purchase, savings or similar plan if the issuer of the stock or other securities offered to employees pursuant to the plan furnishes to the Commission the information and documents specified in the rule. If the registrant elects to follow the procedure permitted by Rule 15d-21, the information, financial statements and exhibits specified in paragraph (a)(2) of the rule shall be furnished as an exhibit to the registrant's annual report. Such exhibit need not be signed, but the accountant's certificate accompanying the financial statements included therein shall be manually signed.

D. Quarterly Reports

1. Quarterly reports to the Commission under Section 13 or 15(d), filed pursuant to Rule 13e-13 or 15d-13, shall be prepared as follows:

   (a) Part I - Part I shall include the information called for by disclosure Item 66; and

(b) Part II - Part II shall include the information called for by disclosure Items 4; 52-56; 59; and 61.

2. A quarterly report shall be filed within 45 days after the end of each of the first three fiscal quarters of each fiscal year. No report need be filed for the fourth quarter of any fiscal year.

3. If the registrant makes available to its stockholders or otherwise publishes, within the period prescribed for filing the report, a financial statement containing the information required by subparagraph 1(a), the information called for may be incorporated by reference to such published statement provided copies thereof are filed as an exhibit to Part I of the report.

E. Current Reports

1. Current reports to the Commission under Section 13 or 15(d) filed pursuant to Rule 13a-11 or 15d-11, shall include, to the extent applicable, the information called for by disclosure Items 49; 51; 60-62 65; 66; and 69.

2. A current report is required to be filed upon the occurrence of any one or more of the events specified in the items specified above. Reports are to be filed within 15 days after the occurrence of the earliest event required to be reported. However, reports which disclose events pursuant to Item 62 may be filed within 10 days after the close of the month during which the event occurred. If the letter from the independent accountants to be furnished pursuant to Item 60(d) is unavailable at the time of filing, it shall be filed within thirty days thereafter. Moreover, if substantially the same information as that required by this form has been previously reported by the registrant, an additional report of the information pursuant to this paragraph need not be made. The term "previously reported" is defined in Rule 12b-2.

IV. DISCLOSURE ITEMS

Item 1. Description of Business (Item 9 of Form S-1)
Note: See Guides No. 27-31; 58; and 61.

Item 2. Description of Property (Item 10 of Form S-1).

Item 3. Summary of Operations (Item 6 of Form S-1).
Note: See Guide No. 22.

Item 4. Pending Legal Proceedings (Item 12 of Form S-1).

Item 5. Directors and Executive Officers (Item 16 of Form S-1).
Note: See Guides No. 34 and 35.

Item 6. Remuneration of Directors and Officers (Item 17 of Form S-1).

Item 7. Principal Holders of Securities (Item 19 of Form S-1).

Item 8. Organization of Registrant (Item 7 of Form S-1).

Item 9. Parents and Subsidiaries (Item 4 of Form 10-K).

Item 10. Interest of Management and Others in Certain Transactions (Item 20 of Form S-1).

Item 11. Options to Purchase Securities (Item 18 of Form S-1).
Note: See Guide No. 36.

Item 12. Selling Security Holders (Item 4 of Form S-7).
Note: See Guides No. 43 and 53.

Item 13. Policy with Respect to Certain Activities (Item 8 of Form S-11).

Item 14. Investment Policies of Registrant (Item 9 of Form S-11).

Item 15. Description of Real Estate (Item 10 of Form S-11).

Item 16. Operating Data (Item 11 of Form S-11).
Note: See Guide No. 25.

Item 17. Tax Treatment of Registrants and Its Security Holders (Item 12 of Form S-11).

Item 18. Policy with Respect to Certain Transactions (Item 23 of Form S-11).

Item 19. Limitations of Liability (Item 25 of Form S-11).

Item 20. Distribution Spread (Item 1 of Form S-1).
Note: See Guides No. 1; 14; 17; and 18.

Item 21. Plan of Distribution (Item 2 of Form S-1).
Note: See Guides No. 16 and 40.

Item 22. Use of Proceeds to Registrant (Item 3 of Form S-1).
Note: See Guide No. 21.

Item 23. Sales Otherwise than for Cash (Item 4 of Form S-1).

Item 24. Capital Structure (Item 5 of Form S-1).

Item 25. Capital Stock Being Registered (Item 13 of Form S-1).
Note: See Guides No. 13, 32; 33; and 51.

Item 26. Long-Term Debt Being Registered (Item 14 of Form S-1).
Note: See Guides No. 32; 33; and 51.

Item 27. Other Securities Being Registered (Item 15 of Form S-1).
Note: See Guides No. 32; 33; and 51.

Item 28. Indemnification of Directors and Officers (Item 9 Form S-1).
Note: See Guides No. 46 and 47.

Item 29. Organization Within Five Years (Item 11 of Form S-1).
Note: See Guide No. 9.

Item 30. General Information Regarding the Plan. (Item 3 of Form S-8).

Item 31. Securities to be Offered and Employees Who May Participate in the Plan (Item 2 of Form S-8).

Item 32. Purchase of Securities Pursuant to the Plan (Item 3 of Form S-8).

Item 33. Payment For Securities Offered (Item 4 of Form S-8).

Item 34. Contributions Under the Plan (Item 5 of Form S-8).

Item 35. Withdrawal From the Plan-Assignment of Interest (Item 6 of Form S-8).

Item 36. Defaults Under the Plan (Item 7 of Form S-8).

Item 37. Administration of the Plan (Item 8 of Form S-8).

Item 38. Investment of Funds (Item 9 of Form S-8).

Item 39. Charges and Deductions and Liens Therefor (Item 10 of Form S-8).

Item 40. Financial Statements of the Plan (Item 11 of Form S-8).

Item 41. Market Prices of Issuers Securities and Dividend Policy (Item 15 of Form S-8).

Item 42. Description of Certain Significant Developments In Last Three Years (Item 16 of Form S-8).

Item 43. Marketing Arrangements (Item 22 of Form S-1).

Item 44. Other Expenses of Issuance and Distribution (Item 23 of Form S-1).
Note: See Guide No. 15.

Item 45. Relationship with Registrant of Experts Named in Registration Statement (Item 24 of Form S-1).
Note: See Guide No. 56.

Item 46. Sales to Special Parties (Item 25 of Form S-1).

Item 47. Franchises and Concessions (Item 26 of Form S-1).

Item 48. Treatment of Proceeds of Stock Being Registered (Item 30 of Form S-1).

Item 49. Changes in Control of Registrant (Item 1 of Form 8-K).

Item 50. Statement of Available Information (Item 12 of Form S-7).

Item 51. Acquisition or Disposition of Assets (Item 2 of Form 8-K).

Item 52. Changes in Securities (Item 2 of Form 10-Q.)

Item 53. Changes in Security for Registered Securities (Item 3 of Form 10-Q).

Item 54. Defaults Upon Senior Securities (Item 4 of Form 10-Q).

Item 55. Increase in the Amount of Outstanding Securities or Indebtedness (Item 5 of Form 10-Q).

Item 56. Decrease in Amount of Securities Outstanding (Item 6 of Form 10-Q).

Item 57. Options to Purchase Securities (Item 9 of Form 8-K).

Item 58. Extraordinary Item Charges and Credits, Other Material Charges and Credits to Income of an Unusual Nature, Material Provisions for Loss and Restatements of Capital Share Accounts (Item 10 of Form 8-K).

Item 59. Submission of Matters to a Vote of Security Holders (Item 11 of Form 8-K).

Item 60. Changes in Registrant's Certifying Accountant (Item 4 of Form 8-K).

Item 61. Other Materially Important Events (Item 5 of Form 8-K).

Item 62. Bankruptcy or Receivership (Item 3 of Form 9-K).

Item 63. Approximate Number of Equity Security Holders (Item 9 of Form 10-K).

Item 64. Nature of Trading Market (Item 12 of Form 10).
Note: See Guide No. 45.

Item 65. Financial Statements (Financial Statements requirements and instructions to be collapsed into one Item to the extent possible).
Note: See Guides No. 23 and 37.

Item 66. Financial Statements and Exhibits (Item 31 of Form S-1).
Note: See Guides No. 39; and 41.

Item 67. Undertakings

Item 68. Recent Sales of Unregistered Securities (Item 26 of Form S-1).

Item 69. Instructions As To Exhibits (Various similar instructions to be collapsed into one Item).

Item 70. Identity of Issuer (Item 1 of Form S-16).

Item 71. Securities to Be Offered and Manner of Offering (Item 4 of Form S-16).

Item 72. Securities to Be Offered Upon Conversion of Other Securities (Item 6 of Form S-16).

Item 73. Securities to Be Offered Upon the Exercise of Warrants (Item 7 of Form S-16).

Item 74. Additional Information (Item 9 of Form S-16).

Item 75. Incorporation of Certain Documents by Reference (Item 8 of Form S-16).

Item 76. Interests In Real Estate Limited Partnerships (Present Guide 60).

Item 77. Oil and Gas Programs (Present Guide 55).

CHAPTER XV

REPORTING REQUIREMENTS UNDER THE 1934 ACT

RECOMMENDATIONS:

Regarding reporting requirements under the 1934 Act:

The Commission should encourage companies which file periodic reports on Forms 10-K and 10-Q to substitute, as official filing documents, their annual and quarterly reports to shareholders.

The Form 10-K should be reorganized and the disclosure requirements should be written in a way that will minimize duplication and boilerplate language. The reorganized 10-K should contain five sections: (1) a fact sheet consisting principally of capsule financial data and a brief description of the registrant's business; (2) background information about special risks or uncertainties and special or distinctive features of the registrant's operations or industry; (3) an analysis of the financial statements and forward-looking information; (4) information currently found in Part II of 10-K which may be omitted if a proxy statement has been filed (this includes details about management's security holdings, options, remuneration, and similar data); and (5) the audited financial statements.

A. Introduction

This chapter discusses two recommendations intended to reduce the reporting burden on publicly held companies, and at the same time improve the quality of disclosure in both annual reports to shareholders and registration statements and periodic reports filed with the Commission.

The first recommendation encourages the filing of annual and quarterly reports to shareholders to meet 10-K and 10-Q requirements. This recommendation will reduce the number of reports prepared by companies and is intended to improve the content quality of the report to shareholders.

The second recommendation urges the Commission to revise the reporting requirements on Form 10-K to eliminate unnecessary requirements and present the information which results from remaining requirements in a more effective format.[1/] This recommendation is based on the Committee staff's analysis of the results of the case study of issuers and users of information.

B. Filing Annual and Quarterly Reports to Shareholders in Satisfaction of 10-K and 10-Q Reporting Requirements

The Committee recommends that the Commission encourage

1/ Although the changes are presented in the context of Form 10-K as a matter of Committee convenience, these changes would also appropriately carry over to the items in Form CD which the Advisory Committee is recommending as a new form to further integrate 1933 Act and 1934 Act disclosures. See Chapter XIV.

companies to publish readable, understandable, annual and quarterly reports which include the information content of the 10-K and 10-Q without the rigidities of those forms, and to file these documents with the SEC in satisfaction of 10-K and 10-Q reporting obligations. For several years the Commission has permitted companies to file their annual and quarterly reports to shareholders to meet reporting obligations,[2/] but few companies have done so. The Advisory Committee believes that the Commission should call attention to the option and encourage registrants to elect it.

This recommendation is an attempt to shift the emphasis of SEC-mandated disclosures from a dialogue between reporting companies and the Commission to one between companies and the public. The proposal may also reduce the quality differential between filed documents and reports to shareholders by encouraging registrants to include the more detailed information required by Forms 10-K and 10-Q in their reports to shareholders.

This proposal would also reduce the reporting burden for those companies wishing to take advantage of this

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2/ E.g., the instruction to Form 10-Q includes the following language: "If the registrant makes available to its stockholders or otherwise publishes within the period prescribed for filing the report, a financial statement containing the information required by this form, the information called for may be incorporated by reference to such published statement provided copies thereof are filed as an exhibit to Part I of the report on this form."

option. Only one report instead of two would have to be prepared in each instance.

The Committee recommends four implementing guidelines: (1) The registrant should have the option to make this substitution for any single 10-K or 10-Q report without being required to do so for any series of reports or any specific period of time. (2) Management should have discretion to determine the format in which required information will appear. For example, a company might choose to incorporate the responses to 10-K requirements as a part of the text of the annual report. Or, a company might prefer to pursue a differential disclosure approach and have a separate section which includes those items which do not lend themselves easily to incorporation within the main text of the annual report. [3/] (3) The annual report or quarterly report should include a cross-reference sheet indicating where required information appears. [4/] (4) The Commission should clearly state that the intention of this program is to encourage registrants to use the annual and quarterly reports to shareholders

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3/ The Koppers Company, Inc. Annual Report for 1976, is not only a good example of the form and quality of the desired product here discussed, but also includes an attempt to provide forward-looking information (see pages 8-11) and an understandable explanation of the financial statements (see pages 39-43).

4/ The Koppers Report does this quite well along with presenting in an unusual way the standard cover sheet for the 10-K on the inside of the fold-out front cover.

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with their more communicative writing style to meet 10-K and 10-Q requirements rather than to encourage registrants to send 10-K's and 10-Q's or documents that read like 10-K's or 10-Q's to their shareholders.

The last guideline is intended to respond to the charge that this recommendation may cause the annual and quarterly reports to exhibit the technical language and the boilerplate characteristics of 10-K's and 10-Q's. 5/

This is exactly the opposite of what the Committee intends. As a part of the continuous reporting system the annual report has a unique and important position. It is widely circulated, it is useful throughout the spectrum of investor sophistication, it does provide information not available through other media, for instance, the contents of the president's letter. Thus, the Committee believes that present requirements relating to the annual report to shareholders are use-

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5/ This results in part because some attorneys believe that there is a higher degree of exposure to liability under the 1934 Act in connection with statements contained in or omissions from documents "filed" pursuant to the provisions of the 1934 Act as opposed to statements contained in or omissions from documents not filed. Research done for the Committee indicates this is probably not the case and that the standard is the same, and thus it would appear that there is no reason why a filed document should be more carefully prepared than an unfiled one. See Chapter XXI at notes 106-08.

ful, but that, within the limits of Rule 14a-3 and the general antifraud provisions, management should have wide discretion in deciding how it will present the presentations, and other matters. The Committee recommends that issuers be encouraged to combine the annual report to shareholders with the Form 10-K. It does this with the expectation that issuers which follow such a practice willl fashion the unitary document to resemble the annual report to shareholders; if the contrary were to result, the Committee would urge continuation of the present current practice of preparing two separate documents.

The following draft release attempts to communicate the Committee's position.

C. Proposed Release.[6/]

ACTION : Announcement of Commission policy encouraging companies which file periodic reports on Forms 10-K and 10-Q to substitute, as official filing documents, their annual and quarterly reports to shareholders.

6/ On June 17, 1977 the Commission issued Securities Exchange Act Release No. 13639 announcing Guide 4 of the Guides to the Preparation and Filing of Reports and Registration Statements under the 1934 Act. Guide 4 announces the availability of the integrated report option.

SUMMARY : The Commission announces its policy to encourage companies which file periodic reports on Forms 10-K and 10-Q to substitute as official filing documents, their annual and quarterly reports to shareholders. This action is taken as part of an effort to upgrade the substantive content of publicly disseminated corporate reports and to reduce the burden of Commission filing requirements since only one report would be prepared rather than two. There are four implementing guidelines: (1) The registrant should have the option to make this substitution for any single 10-K or 10-Q report without being required to do so for any series of reports or any specific period of time. (2) Management should have discretion to determine the format in which required information will appear. For example, a company might choose to incorporate the responses to 10-K requirements as a part of the text of the annual report. Or, a company might prefer to pursue a differential disclosure approach and have a separate section which includes those items which do not lend themselves easily to incorporation. (3) The annual report or quarterly report should

include a cross-reference sheet indicating where required information appears.

(4) The Commission should clearly state that the intention of this program is to encourage registrants to use the annual and quarterly reports to shareholders with their more communicative writing style to meet 10-K and 10-Q requirements rather than to encourage registrants to send 10-K's and 10-Q's to their shareholders.

EFFECTIVE DATE: Immediately.

FOR FURTHER INFORMATION CONTACT:

Office of Disclosure Policy and Proceedings, Division of Corporation Finance, Securities and Exchange Commission, Washington, D.C. 20549 (202) 755-1750.

SUPPLEMENTAL INFORMATION:

The Securities and Exchange Commission announced today that companies which file periodic reports on Forms 10-K and 10-Q with the Commission are encouraged to substitute, as official filing documents, their annual and quarterly reports to shareholders.

For several years, the Commission has permitted companies subject to the periodic reporting requirements of Section 13 or 15(d) of the Securities Exchange Act of 1934 (the "Act") to file with the Commission the

annual or quarterly report to shareholders to meet the annual or quarterly reporting obligations imposed by those sections of the Act. The Commission wishes to call attention to the availability of this option and to specifically encourage registrants to avail themselves of it.

The essence of this optional substitution program is to urge companies to publish readable, understandable, comprehensive annual and quarterly shareholder reports which serve both the functions of effective corporate communication and substantive corporate reporting. Companies selecting this option would still be responsible for including the substance of the requirements of Forms 10-K and 10-Q in the annual and quarterly shareholder reports, respectively. However, the manner of integrating the requirements of Forms 10-K and 10-Q with the annual and quarterly reports would be left to the discretion of the companies.

If this option is widely used by companies filing annual and interim reports with the Commission, it could result in an upgrading of the substantive content of publicly disseminated corporate reports. Furthermore, it would reduce the burden of compliance with the Commission filing requirements since only one report rather than two would be prepared.

In its Report to the Commission, the Advisory Committee on Corporate Disclosure has identified the ". . . function of the Commission in the corporate disclosure system

(as being) to assure the public availability in an efficient and reasonable manner on a timely basis of reliable, firm-oriented information material to informed investment and corporate suffrage decision-making." In the past the Commission has attempted to achieve this objective primarily through the system of forms required to be prepared and submitted to the Commission by companies whose securities are publicly traded. At the same time, these public companies have regularly prepared and disseminated directly to shareholders, professional security analysts, registered representatives, and other interested constituencies, annual, and in most cases, quarterly reports, wherein the content has been mandated to a far lesser degree than the content of reports filed with the Commission. This dual system, while assuring that the required information was prepared and disclosed to the Commission, may have fallen short of the objective of assuring that this information actually reaches the public.

This optional substitution program attempts to shift the flow of meaningful communication to a direct dialogue between the company and the public, instead of a dialogue between the company and the Commission with the Commission attempting to act as a conduit to the public. Furthermore, the program should enhance the communication process by encouraging the use in 10-K and 10-Q filings of the free writing style normally applied in shareholder reporting.

Those companies electing to avail themselves of this option have discretion with regard to the way the 10-K or 10-Q information is presented in the shareholder report, as long as all information required by those forms is included. Experimentation in the method of integrating the filing requirements and the shareholder report is specifically encouraged by the Commission. Companies should provide a cross-reference to those pages or sections of the annual or quarterly shareholder report which include the responses to 10-K or 10-Q items. This cross-reference may be a table of contents of 10-K or 10-Q items published in the annual or quarterly report, or it may be attached to the report which is submitted to the Commission. Only those sections of the shareholder reports which are in direct response to the 10-K or 10-Q requirements as indicated by the cross-reference sheet will be considered "filed" reports under the Act.

Any schedules which the company normally files with the Commission but which are not readily included in the shareholder report may be attached to the shareholder report when submitted to the Commission.

The Commission emphasizes that this substitution procedure is optional and is available for either the annual or quarterly report. Furthermore, the substitution may be discontinued or reinstated at any time.

This optional program is an experiment by the Commission in an attempt to allow companies more discretion in meeting reporting obligations and to lessen the burden of the reporting process, as well as to upgrade the quality, understandability, and substantive content of their written communications to the public. As an experiment, this program will be evaluated by the Commission at the end of a three-year period to assess its usefulness and effectiveness.

Staff members of the Division of Corporation Finance, Office of Disclosure Policy and Proceedings (202-755-1750), are available to respond to specific questions concerning this option.

D. Form 10-K Revision

The Advisory Committee's staff has drafted a revised Form 10-K[7/] in an effort to (1) delete unnecessary reporting requirements; (2) add some new requirements; (3) reorganize the document so that the information which remains is presented more effectively; and (4) frame the text of the form in a way that will minimize boilerplate and other information not material to the particular reporting company. The amendments proposed reflect the staff's analysis of the results of the case study as they reflect on information used and not used in investment

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7/ The text of the Form appears in this chapter as Section E.

decision-making and an item-by-item analysis by the staff of requirements of the present Form 10-K and the current compliance with those requirements.

The changes proposed ultimately should be reflected in Form CD and thus would also affect the content of 1933 Act registration statements. The changes were considered by the Committee and are presented to the Commission in the context of present Form 10-K so that proposed amendments may be easily compared to current requirements. The Committee does believe, however, that for many companies the format of and, if current, the information in the revised 10-K, would, together with the details of the offering, constitute an effective 1933 Act registration statement.

Format--Five Sections. The proposed 10-K would have five sections: (1) a fact sheet consisting principally of capsule financial data and a brief description of the registrant's business; (2) background information which is intended to report special risks or uncertainties and special or distinctive features of the registrant's operations, or industry; (3) an analysis of the financial statements and forward-looking information similar to the material which a chief executive officer might present to the board of directors of a company; (4) information currently found in Part II of 10-K which may be omitted if a proxy statement has been filed (This information includes details about management's security holdings, options, remuneration,

and similar data.); and (5) the audited financial statements.

The benefit of this approach is that it groups data so that the user can turn directly to the information which is of interest to him. For example, an analyst who follows a registrant closely might wish to focus on the fact sheet and the financial statements and only skim through the background and analytical material since he or she would be familiar with that information as a result of frequent contact with the company. On the other hand, an individual investor who is considering several alternative investment opportunities might take the opposite approach, looking first at the background and analytical information to get a feel for the industry, the company, and its management before turning to the financial details. Adoption of the fact sheet format should also shorten the 10-K.

As proposed, the fact sheet will have six items: (1) capsule financial data and operating statistics; (2) products and services by business segment including five year sales, income, and asset information; (3) number of equity security holders, average weekly trading volume, and number of five-percent beneficial owners; (4) productive properties and related capacities and utilization by business segment; (5) pending legal proceedings; and (6) new officers and directors.

The information in this section should be terse and

factual. The draft rules and instructions are worded to discourage unnecessary verbiage: "Present in columnar form . . ." and "Present a list of . . .." Only Item 5, "Pending Legal Proceedings," calls for descriptions, and even here registrants are encouraged to incorporate by reference the discussion of legal matters found in the footnotes to the financial statements.

There is no reason why hard factual information should be set out in narrative form. A concise fact sheet presentation will shorten the length of the presentation to its information content and eliminate unnecessary prose. Lengthy narratives should only be used when the information to be conveyed needs explanation. This should also minimize boilerplate.

Content. The content of the revised 10-K differs considerably from current requirements. The observations and comments which follow may assist the Commission in understanding the purposes of the changes. Not every item is commented on.

1. Capsule Financial Data and Operating Statistics. The second subsection of Item 1 of the fact sheet would require operating statistics as called for by industry guides. For example, the disclosures called for by the current Guide 61, "Statistical Disclosures by Bank Holding Companies," would go into this section. This information together with capsule financial data will provide a ready reference for those statistics which are used in decision-making.

2. Segment Information. One characteristic of the fact sheet which significantly expands the volume of data required is that most of the information is called for "by business segment." This was done with the expectation that the Commission will soon require narrative disclosure to be presented on a segmented basis in response to Statement of Accounting Standards No. 14 and the Committee's recommendation. (See Chapter XI, Segment Reporting.)

3. Properties. The description of properties item has been revised to make clear that what is required is information about the suitability, adequacy, productive capacity and utilization of facilities in the enterprise, rather than a list of properties and locations.

The instructions for this item call for an exhibit to be filed which would list the location and general character of each production, sales and distribution facility of the registrant. Also, a second exhibit would list all subsidiaries. This information may be important to analysts and investors, particularly those who follow a company closely, but it normally does not change significantly between periods. Therefore, it seems unnecessary to require the lists to be published in each 10-K.

4. Market for the Registrant's Securities. Disclosure of average weekly trading volume of the registrant's equity securities is called for in this item. The case study of analysts revealed that this information is important

because the number of shares traded affects the liquidity of the investment, and for many investors liquidity is a major consideration in an investment decision.

The current Form 10-K requires data showing increases and decreases in outstanding securities from period to period. This requirement is unnecessary and has been deleted because the same information is available in the financial statements. Furthermore, changes in outstanding securities are reported in Form 10-Q.[8/]

5. Indemnification of Directors and Officers. The current 10-K requires a statement explaining any insurance or indemnification of any officer or director by the registrant. This disclosure has been deleted from the draft revision of Form 10-K in response to comments from both management and analysts who agreed the information has no value in the investment decision-making process.

6. Background Information. The second part of the proposed 10-K contains background information about the registrant and its industry.

Item 7, "Information Concerning Special Risks or Uncertainties," calls for descriptions of factors, if any, which cause the company's securities to be high risk or

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8/ Fourth quarter changes in outstanding securities could be reported on the first 10-Q of the next fiscal year.

highly speculative in nature. This is a requirement currently in some 1933 Act registration forms and is material to investment decision-making. Item 8, "Information Concerning Special or Distinctive Features of the Registration's Operations or Industry," would require information about distinctive or special characteristics of the registrant's operations or industry which may have a material impact upon future financial performance. It is possible that some registrants would be able to respond that they have no disclosures pursuant to this item. However, it is expected that most registrants would have some distinctive industry or company characteristics to discuss.

Much of the content of these two items is currently required by the "Description of Business" item. The draft revision (in addition to segregating soft background information) is an attempt to reduce boilerplate. It is hoped that the words "special" and "distinctive" will convey the idea that it is neither necessary nor desirable to report that "competition is keen but we are competitive" or "there is an energy shortage but the company is attempting to minimize its effects." To a large extent the success of this revision depends on the cooperation of companies and their counsel.

7. Management's Analysis of the Financial Statements and Forward-Looking Information. The third part of the

proposed 10-K, following the fact sheet and background information, would be management's evaluation of the past and assessment of the future (Item 9). The text of Item 9 incorporates the language for the management analysis requirement proposed and discussed in Chapter X, "Soft Information."[9/] In addition, it includes two additional instructions. Instruction 3 indicates that if management desires to include voluntary projections of future economic performance or future financial condition in the Form 10-K, the information should be appear under the caption of Item 9. It urges but does not require that assumptions underlying the forecast be included. Instruction 4 encourages disclosure of planned capital expenditures and financings.[10/]

8. Audited Financial Statements. All financial statements and related footnotes would be included in this section of the report. In addition to the advantages of putting similar kinds of data into separate sections

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9/ See Chapter X at 365-75.

10/ Instruction 4 is discussed in Chapter X at 375-77.

of the 10-K, as discussed above, this proposal will reduce some problems caused by the organization of the current 10-K.

The current 10-K results in the financial statements being divided since many registrants place the Statement of Income in the front part of their 10-K instead of giving a Summary of Operations. This practice is confusing because users must flip back and forth between two parts of the 10-K in order to read the complete set of financial statements. This practice also causes problems with footnote disclosures because the preparer must decide which footnotes should follow the Statement of Income in the front part of the 10-K and which footnotes should remain with the other statements. Moreover, footnotes often must be rewritten from the way they appear in the annual report to shareholders in order that they can be split in the 10-K.

The practice of including the Statement of Income up front also could cause investors to be misled by creating the impression that the Statement of Income can be read standing alone. The balance sheet and the related footnotes contain important information which complements and, in a sense, modifies the information in the Statement

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of Income. It is for this reason that auditors do not give piecemeal opinions on separate parts of the financial statements, such as the Statement of Income, but state their opinions with respect to the financial statements taken as a whole.

In view of the above the Committee believes that the practice of separating the Statement of Income from other financial statements should be discontinued irrespective of whether or not the proposed 10-K format is adopted.

Other recommendations which would affect the financial statements are offered in Chapter XVI, "Financial Statement Requirements."

9. Schedules to Financial Statements. One of the intended effects of the Committee's recommendation that the Commission delete those disclosure requirements in Regulation S-X which unnecessarily supplement generally accepted accounting principles (GAAP). (See Chapter XVI.) is the elimination of some schedules to the financial statements required by Form 10-K. Both analysts and companies believe the schedules are of little utility. Moreover, they are expensive to prepare not only because they are separately stated, but also because they require additional auditor review.

The staff has reviewed each schedule and it appears that a number of them could be deleted.[11/] They either duplicate information presented elsewhere in the financial statements or do not provide sufficient incremental information to warrant their preparation and filing. It is suggested that in implementing the S-X--GAAP recommendation in Chapter XVI, particular attention be given to deletion of the schedules to 10-K.

11/ See Appendix XVI-A in which analysis of the need for the schedules required by Regulation S-X, in light of existing GAAP requirements, is set forth.

E. Revised Form 10-K*

PART I: FACT SHEET

ITEM 1. CAPSULE FINANCIAL DATA

(a) Present in comparative columnar form the following financial data for the registrant and its subsidiaries (if any) consolidated for each of the last five fiscal years of the registrant (or for the life of the registrant and its predecessors if less): Net sales; income from continuing operations; net income; working capital; cash flow; total assets; total indebtedness; and shareholders' equity.

(b) Present in tabular form for at least the two most recent fiscal years any operating statistics called for by appropriate Industry Guide(s).

ITEM 2. PRODUCTS AND SERVICES

Present a list of all business segments identifying principal classes of products and services within each segment. For each reportable industry and homogenous geographic segment state for the registrant's last five fiscal years the approximate amount or percentage of (i) total sales and revenues, (ii) income (or loss) before income taxes and extraordinary items and (iii) identifiable assets attributable to each business segment.

INSTRUCTIONS:

1. Definitions of "reportable business segments", "principal classes of products and services," "identifiable assets" etc. would be included. The definitions set forth in Appendix A "Definitions and Guidelines for Compliance with Industry and Homogenous Geographic Segment Reporting Requirements" to the Commission's Release on Segment Reporting (1933 Act Release No. 5826) would provide an appropriate reference.

ITEM 3. MARKET FOR THE REGISTRANT'S SECURITIES

(a) State the appropriate number of holders of record as of the end of the period for which the report is filed and the number of shares outstanding of each class of equity securities of the registrant and the average weekly trading volume during the previous fiscal year.

(b) Furnish the following information, as of the most recent practicable date, with respect to any person (including any "group" as that term is used in Section

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*Instructions only appear in this draft where necessary to explain modification proposed and are not inclusive of all instructions in the revised form. A number of existing instructions will be carried over into the new form.

13(d)(3) of the Securities Exchange Act of 1934) who is known to the registrant to be the benefical owner of more than five percent of any class of the registrant's voting securities: (i) the title of class of securities owned; (ii) name of owner, (iii) the total number of shares beneficially owned, and (iv) the percent of class so owned. Of the number of shares owned, indicate by footnote or otherwise, the amount known to be shares with respect to which such listed beneficial owner has the right to acquire beneficial ownership, as specified in Rule 13d-3(d)(1) under the Exchange Act.

ITEM 4. PROPERTIES

If applicable, identify by appropriate unit or class of units manufactured the registrant's productive capacity by segment and the extent of utilization thereof.

INSTRUCTION:

The location and general character of the principal plants, mines, and other materially important physical properties of the registrant or its subsidiaries shall be filed as an exhibit to this report. A list of all subsidiaries should also be filed.

ITEM 5. PENDING LEGAL PROCEEDINGS

Briefly describe any material pending legal proceedings, other than ordinary routine litigation incidental to the business, to which the registrant or any of its subsidiaries is a party or of which any of their property is the subject. Include the name of the court or agency in which the proceedings are pending, the date instituted, the principal parties thereto, a description of the factual basis alleged to underlie the proceeding and the relief sought. Include similar information as to any such proceedings known to be contemplated by governmental authorities.

INSTRUCTION:

Registrants are encouraged to incorporate by reference any discussion of legal proceedings appearing in the footnotes to the financial statements, however, that discussion should be supplemented by any information required by the item but not appearing in the information incorporated by reference.

ITEM 6. EXECUTIVE OFFICERS AND DIRECTORS OF THE REGISTRANT

(a) List the names and ages of all executive officers and directors of the registrant who did not hold their current office with the registrant prior to the beginning of the period reported.

(b) Give a brief account of the business experience during the past five years of each executive officer named in (a) including his principal occupations and employment during the most recent five year period and the name and principal business of any corporation or other organization in which such occupations and employment were carried on.

(c) List the names and positions held of all officers and directors who terminated their employment with the registrant during the previous year.

PART II

ITEM 7. INFORMATION CONCERNING SPECIAL RISKS OR UNCERTAINTIES

Describe by business segment those factors, if any, which cause investment in the company securities to be high risk or highly speculative in nature. Examples of appropriate factors which might be discussed include the absence of an operating history of the registrant, an absence of profitable operations in recent periods, the financial condition of the registrant (including recent adverse changes therein), lack of management experience and the speculative nature of the business in which the registrant is engaged or proposes to engage.

ITEM 8. INFORMATION CONCERNING SPECIAL OR DISTINCTIVE FEATURES OF THE REGISTRANT'S OPERATIONS OR INDUSTRY

(a) Describe by business segment those distinctive or special characteristics of the registrant's operations or industry which may have a material impact upon the registrant's future financial performance. Examples of factors which might be discussed include dependence on one or a few major customers or suppliers (including suppliers of raw materials or financing), existing or probable governmental regulation, expiration of material labor contracts or patents, trademarks, licenses, franchises, concessions or royalty agreements, unusual competitive conditions in the industry, cyclicality of the industry and anticipated raw material or energy shortages to the extent management may not be able to secure a continuing source of supply.

INSTRUCTION:

This paragraph is intended to provide the investor with background information about the industry and company environment in which he or she has invested to the extent that information is distinctive or unique to either the industry or the company.

PART III

ITEM 9. MANAGEMENT ANALYSIS OF THE FINANCIAL STATEMENTS AND FORWARD-LOOKING INFORMATION

Provide an analysis for each business segment of the reported financial statements which (1) will enable investors to understand and evaluate material periodic changes in the various items of the reported financial statements, and (2) will enable investors to relate the reported financial statements to assessments of the amounts, timing and uncertainties of future cash flows for the reporting entity.

INSTRUCTIONS:

1. The analysis of material periodic changes (a) should explain material increases or decreases in discretionary items such as research and development costs, advertising expenses, and maintenance and repair expenses, and (b) should break down variances into components, such as the amounts by which changes in prices and changes in volume resulted in a material change in sales.

2. The analysis should focus on facts and contingencies known to management which would cause reported financial statements to be not indicative of future operating results or of future financial condition. This would include description of and amounts of (a) matters which will have an impact on future operations or financial condition and have not had an impact in the past, and (b) matters which have had an impact on reported financial statements and are not expected to have an impact upon future operations or financial condition.

The form and content of disclosures pursuant to this item will necessarily vary among registrants and will change from period to period for the same registrant as circumstances change. In general, the disclosures should be similar to that which the chief executive officer might prepare for the board of directors of a company. Both quantitative analysis and narrative discussions are important.

3. Voluntary disclosures of projections of future economic performance and of future financial condition, and voluntary disclosure of management's plans and objectives may be included as part of this analysis. Since management's projections, and plans and objectives will inevitably reflect some amount of management's biases, it would be desirable to disclose the major assumptions which were made in developing such projections, and plans and objectives; however, disclosure of assumptions is not required in conjunction with voluntary disclosures of projections or of management's plans and objectives.

4. Registrants are encouraged, but not required, to furnish for each business segment a description of planned capital expenditures and financing for (1) the current fiscal year and (2) the succeeding four year period. If this information is furnished, it would be desirable to disclose the amounts related to environmental control facilities and the expected effects upon production capacity, and to furnish an analysis of differences for the most recent fiscal year between previously disclosed budgets and actual capital expenditures.

PART IV: Part II of Current Form 10-K*

PART V : Financial Statements*

* Parts IV and V will remain substantially the same as in the current Form 10-k; but see recommendations regarding proxy statement disclosure (Chapter XIII) and financial statements (Chapter XVI).

CHAPTER XVI

FINANCIAL STATEMENT REQUIREMENTS

RECOMMENDATIONS

Regarding uncertainty in financial statements:

In drafting industry guides for companies with extended operating cycles, the Commission should call for disclosures which will focus on the uncertainties related to certain financial statement amounts. Financial statement disclosures called for by the industry guides should highlight: (1) economic assumptions underlying asset valuations and liabilities subject to greatest uncertainties; (2) information that will enable investors to evaluate the potential impact upon income from operations resulting from changes in those economic assumptions, and the likelihood of such changes; and (3) amounts included in the current year's income statement which are adjustments of estimates included in prior years' income statements.

Regarding criteria to be used by the Commission and the FASB in evaluating accounting standards:

The Commission (and the FASB) in evaluating accounting standards, should consider among other things: (1) the adequacy of disclosures regarding the uncertainties inherent in the measurement process; (2) the adequacy of information concerning the amounts and timing of historical cash flows; and (3) the adequacy of information useful in assessing the liquidity of the reporting entity.

Regarding differences between Regulation S-X and GAAP:

A continuing goal of the Commission should be the elimination of rules of general applicability which cause

differences between financial statements prepared in accordance with Regulation S-X and those prepared in accordance with generally accepted accounting principles (GAAP). When the Commission requires an extension of disclosures beyond those required by GAAP because of an emerging problem, the reasons for the extension and the underlying accounting issues involved should be stated. The Commission should then ask the FASB to consider the issue.

A. Introduction

Financial statement disclosure is, of course, fundamental to the corporate disclosure system. The Committee, however, recognizes that it does not have the expertise or resources to duplicate the ongoing work of groups like the Financial Accounting Standards Board. Instead, it did address certain deficiencies which it perceived in present accounting disclosure. The chapter reports three recommendations intended to improve financial statement disclosure.

In addition to the topics that are covered by the above recommendations, the Advisory Committee discussed two areas related to financial statements: materiality and the role of the auditor. The thoughts that were expressed on the subject of materiality are included in a separate chapter in the report.

With respect to the role of the auditor, the Advisory Committee does not make any specific recommendations because the Commission on Auditor's Responsibilities ("CAR") is currently concluding an extensive study on this subject. The vice-chairman of that Commission attended a meeting of the Advisory Committee and explained the extent of the CAR's work

and the reasons for its tentative conclusions. Considering the efforts and resources of CAR being devoted to this subject, the Committee determined to focus on other matters. The Committee did agree at that time to urge the Commission to encourage staff responses to CAR's report of tentative conclusions and to take no formal position itself until the final report is published. That recommendation is not included in the final Committee recommendations because the comment period has passed and because the Commission has already committed itself to make a response to the final report in its testimony before the Senate Subcommittee on Reports, Accounting and Management.[1/]

The Committee believes that the auditor's role in the corporate disclosure system is significant, and encourages the Commission to monitor the response of the accounting profession to the CAR's recommendations.

B. Communication of Uncertainty in Financial Statements

The Advisory Committee recommends that the Commission, in drafting industry guides for companies with extended operating cycles, call for disclosures which will focus on the uncertainties related to certain of their financial statement amounts.

1/ Statement of the Honorable Harold M. Williams, Chairman, Securities and Exchange Commission, Before the Subcommittee on Reports, Accounting and Management of the Senate Committee on Governmental Affairs (June 13, 1977).

In such cases, the financial statement disclosures called for by the industry guides should highlight:

1. Economic assumptions underlying valuation of assets and liabilities subject to the greatest uncertainties;

2. Information that will enable investors to evaluate the potential impact upon income from operations resulting from changes in those economic assumptions, and the likelihood of such changes; and

3. Amounts included in the current year's income statement which are adjustments of estimates in prior years' income statements.

Financial statements prepared in accordance with generally accepted accounting principles reflect the economic results of transactions between the firm and other economic entities and the impact of economic, environmental, and political events upon the firm. Some of these involve commitments for future receipt or payment of cash; therefore, even though the transaction or event has occurred during the current period, the future cash receipt or disbursement may be in an amount different from the recorded amount. Financial statements by the very nature of accrual accounting will contain some information that is more certain and, in that sense, more reliable than other information.

In the normal operations of most industries, amounts to be received or paid can be estimated with reasonable

precision because the time periods between the transaction and the cash receipt or disbursement are short. However, for some industries (e.g., banks, real estate developers, insurance companies, long-term contractors) this time period is often longer and amounts recorded at or near the transaction dates are based largely upon management's estimates of such uncertainties as amounts, timing, and collectability.

The uncertainties related to future cash flows and asset (and liability) values depend upon the uncertainties associated with underlying assumptions. Estimates of future cash flows are never precisely accurate when compared to actual cash flows for various reasons, including (1) the direction of general business conditions; (2) conditions in the business environment which are unique to the business enterprise; (3) measurement errors inherent in the accounting system; and (4) management biases which cause estimates to be overly optimistic (or pessimistic).

The Committee is particularly concerned about those situations in which there is an extended period of time (greater than six months) between the accrual of income (or expense) and the receipt (or disbursement) of cash. In such circumstances financial statements which do not clearly disclose the nature of the uncertainties relating to the future receipt (or disbursement) of cash, the assumptions which have been made regarding the outcome of these uncertainties, and the impact if these assumptions are not

realized may mislead users regarding the degree of reliability which they can ascribe to the information. Information about assumptions should be reasonably comprehensive so that users can assess the potential impact from changes in assumptions and the likelihood of changes. Even though in some cases the potential impact and likelihood of assumption changes can be quantified only very roughly, such information is important. Users should be aware of management's historical record in matching the accrual of income or expense with the subsequent receipt or disbursement of cash and of the amounts in the current year's accruals which are adjustments of previous accruals. Accordingly, disclosures about management's assumptions regarding the future should be supplemented with information which will assist users in assessing assumptions made in the past.

C. Considerations for Evaluation of Accounting Standards

The Advisory Committee recommends that in evaluating accounting standards, consideration should be given, among other things, to (1) the adequacy of information concerning the amounts and timing of historical cash flows, (2) the adequacy of disclosures regarding the uncertainties inherent in the measurement process, and (3) the adequacy of information useful in assessing the liquidity of the reporting entity.

The Financial Accounting Standards Board is in the process of developing a conceptual framework for establishing, interpreting and applying accounting and reporting

standards. This framework will deal with the objectives of financial statements; the appropriate balance among qualitative characteristics (e.g., relevance, objectivity, comparability) of financial statement information; the definition and determination of the essential characteristics of the basic elements of accounting (e.g., asset, liability, earnings); the selection of that criterion of financial measurement (e.g., historical cost, replacement cost, etc.) which communicates most clearly the essence of the basic elements of accounting; and the need to adjust the unit of financial measurement (e.g., the dollar) for changes in purchasing power. The FASB is devoting considerable resources to this effort. The Committee's research and deliberations regarding financial statement disclosures are relevant to the conceptual framework project in many respects. Its recommendations are directed to the FASB and the SEC since both have responsibilities regarding accounting standards.

The Committee has been impressed with the importance attributed by financial statement users to understanding the history of a firm's cash flow in order to predict the amounts, timing and uncertainties of future cash flows. The Committee believes that one test of the value of the conceptual framework will be its effectiveness in assisting preparers, auditors and the SEC in selecting accounting methods that most accurately measure and disclose the cash consequences of economic transactions and events. The term

"cash consequences," is intended to mean the amounts and timing of cash flows, including the assumptions related to financial statement accruals.

It is also important for users to recognize that financial statement accruals are based upon assumptions about future cash flows and that, by virtue of the future-orientation of this information, precise measurements of these future cash flows may not be possible in many cases. Accordingly, one consideration for evaluating any accounting standard must be not only how well it measures future cash flow, but perhaps more importantly, how well it discloses the uncertainties inherent in the measurement process.

Finally, the Committee considered disclosures reflecting the liquidity measurement of the enterprise as expressed in the historical information in the financial statements. Both equity and bond analysts interviewed by the staff indicated their interest in the following questions:

1. How much cash was earned from operations before financing costs but after taxes and excluding windfall gains and non-recurring losses? 2/

2/ Some security analysts would recommend changing the Statement of Changes in Financial Position to reconcile to cash instead of to working capital.

2. To what extent was the enterprise able to finance debt principal and interest payments, dividends on common and preferred stock, and capital expenditures from internally generated cash flow? 3/

3. What portion of the internally generated cash is subject to restrictions which might limit its availability to pay obligations and commitments when due? 4/

Accordingly, the Committee concludes that accounting standards should provide data useful for assessing the entity's liquidity.

D. Modifications to Regulation S-X

The Advisory Committee recommends that a continuing goal of the Commission should be to eliminate rules of general applicability which cause financial statements filed with the Commission to contain different disclosures

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3/ Some analysts have noted that the adequacy of available lines of credit to cover trade payables is critical to a company's survival, particularly in retailing. They suggest that an aging of accounts payable and information about available lines of credit are essential to liquidity assessments.

4/ For example, where there are material blockages to free movements of cash within a consolidated entity (e.g., caused by loan indentures, foreign currency restrictions, other legal constraints which limit a parent's or a subsidiary's movement of cash to another entity within the consolidated group), separate funds statements might be required for the entity in which the blockage had occurred in order to disclose adequately the significance of this blockage to the ability of the consolidated entity as a whole to meet its dividend, debt service and other commitments from internally-generated cash.

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from those contained in financial statements prepared in accordance with generally accepted accounting principles (GAAP).

In this connection the Commission should undertake the following:

1. Eliminate all financial statement disclosures required by Regulation S-X which duplicate those required in financial statements prepared in accordance with codified GAAP.

2. Critically review all disclosures of general applicability which are supplementary to those required by GAAP with the objective of eliminating disclosures which may not be necessary to users in making investment decisions.

The Commission has the authority under the Securities Act to prescribe the form and content of financial statements in filed documents. Regulation S-X was promulgated in 1940 in part because there was at that time relatively little authoritative accounting literature codifying accounting principles and disclosures. Regulation S-X provided uniform financial statement disclosure requirements for all filings with the Commission. Prior to that time each of the Commission's forms had its own differing requirements for financial statement disclosures. It was thought that questions of accounting disclosure could be handled more effectively if all accounting requirements were set forth in a single form or regulation.

Many Regulation S-X requirements have been codified by the accounting profession and are now required not only for SEC filings but in all financial statements. Since the Commission requires that financial statements be accompanied by the opinion of a certified public accountant that they have been prepared in accordance with GAAP, there has been no need to amend Regulation S-X for each change in GAAP. Consequently, Regulation S-X currently contains requirements that unnecessarily duplicate GAAP requirements.

Regulation S-X also requires several disclosures which supplement those required by GAAP. One reason for this is that the Commission is uniquely situated to learn of emerging problems and can respond to such problems relatively quickly. Another justification frequently given for additional disclosures is that the primary users of Commission filings are security analysts who generally demand more detailed financial statement information than do less sophisticated users. Those espousing this view argue that GAAP comprises rules of general applicability which do not distinguish between public and non-public companies. Nor does GAAP consider differences in the degrees of detail needed by sophisticated and unsophisticated users. 5/

5/ The results of the survey of individual investors show that 85 percent of the respondents read and understand financial statements included in annual reports to shareholders and are interested in the same types of information as so-called sophisticated investors. If these results are indicative of a broader base of shareholders, it may not be so important to differentiate between sophisticated and unsophisticated users of financial statements.

The Advisory Committee believes that the Commission must continue to require certain supplementary disclosures and certain accounting methods in response to emerging problems and in circumstances which are unique to particular industries. The Committee believes, however, that the Commission should seek the opinions of users regarding the continuing usefulness of its disclosure requirements so as not to cause unnecessary differences between financial statements in its filings and shareholder reports. For example, the case study shows that certain Commission-required footnote disclosures and schedules have limited usefulness for security analysts. 6/ The Committee recommends that the Commission delete these requirements from Regulation S-X.

The Committee also recommends deleting requirements already required by GAAP, thereby isolating supplementary requirements. This should result in a more convenient reference of incremental disclosures required of SEC registrants.

In order to minimize the differences between GAAP and Regulation S-X, when the Commission requires an extension of GAAP because of an emerging problem, the reasons for the extension and the underlying accounting issues involved should be stated. The Commission should request the FASB to consider the issue to determine whether

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6/ See Chapter II, "The Role of Security Analysts," at 137-41.

an appropriate accounting standard should be adopted. This practice would both minimize unnecessary differences between GAAP and Regulation S-X while still permitting the Commission to address the accounting issues it deems necessary.

Included in Appendix XVI-A is an analysis of those sections of Regulation S-X which are duplicative of GAAP (Articles 3, 4, 5, and 11). While the concept of GAAP contemplates more than the opinions of the Accounting Principles Board ("APB") and the Statements of the FASB, the analysis identifies only those instructions in Regulation S-X which are contained in the pronouncements of these two bodies (as codified in the AICPA Professional Standards, Volume 3, Accounting dated July 1, 1977). Article 12 has also been analyzed to identify schedules requiring information that is already provided either in the financial statements or in other sections of the disclosure document. These also should be deleted. Some schedules apply only to a limited number of industries. It is recommended that such disclosures be included in industry guides.[7/]

7/ See also AICPA, Report to the SEC Advisory Committee on Corporate Disclosure 24-31 (1977) (Appendix XVI-B) in which the AICPA presents a selected list of Regulation S-X items which it believes unnecessarily duplicate or vary from GAAP.

Certain required disclosures which relate primarily to the liquidity of conglomerate companies need to be studied further to determine whether they should be retained in their present form. These disclosures include:

1. Parent company financial statements;

2. Separate financial statements of consolidated and unconsolidated subsidiaries;

3. Guarantees of subsidiary and parent company debt;

4. Statements of intercompany cash flow and intercompany debt (e.g., Schedules III, IV, and X); and

5. Bonds, mortgages and similar debt (Schedule IX).

These disclosures have particular significance for bond analysts, and should be evaluated in light of the needs of this group.

CHAPTER XVII

THE SMALL COMPANY PROBLEM

RECOMMENDATION

The Commission should hold public hearings to determine: (1) Whether and to what extent, the Commission should attempt to define a category of "small companies" for the purpose of requiring less burdensome reporting; (2) how such a classification, if desirable and possible, should be defined; and (3) if definition is possible, what reductions of reporting requirements are possible, consistent with the purposes of the Federal securities laws.

A. Introduction

It has been argued that the indiscriminate application of governmental regulatory, disclosure, tax and other policies, including SEC registration and periodic reporting requirements, imposes a relatively greater compliance burden on small companies than on large ones. Some have contended further that the net effect of these policies is to endanger the continued existence of smaller companies and to inhibit the formation of new enterprises.

Although the discussion in Chapter VII clearly indicates that the objective of disclosure to investors should not be subordinated to other social and economic objectives, such

as the encouragement of small business enterprises, the Committee did indicate that the cost of compliance had to be weighed in any evaluation of a disclosure policy. The "small company problem" possibly presents a situation where the compliance burden may be unduly expensive and where a reduction in 1934 Act disclosure obligations might be achieved without an adverse effect on disclosure to investors.[1/] Section B of this chapter discusses the reasons why such a reduction may be appropriate; Section C proposes that the Commission explore the matter in public hearings, and identifies the issues which should be addressed. Section D presents the text of a proposed release announcing the hearings.

B. The Small Company Problem

The Advisory Committee recommends that the Commission undertake a fact-finding hearing to assess whether, and if so, to what extent, the 1934 Act reporting requirements may be revised to lessen their impact upon small businesses. In determining to forward this recommendation to the Commission, the Advisory Committee considered the following factors which taken together indicate that such a reduction may be appropriate: (1) The cost of compliance appears

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1/ The Advisory Committee focused only on the 1934 Act because of its awareness of the continuing efforts of the Commission to develop less burdensome 1933 Act registration procedures. See discussion at 526, infra.

relatively greater for small companies than for large ones; (2) the investment community is much less interested in small companies than in large ones; and (3) a reduction in 1934 Act reporting would not appear to affect adversely the potential for small companies to attract institutional and analyst interest.

Cost Burden. As discussed in Chapter I, the cost data collected in the Advisory Committee's survey of publicly held companies indicates that the burden of reporting weighs more heavily on small than large companies. As Table 3 from Chapter I (reprinted below) indicates, analysis of the data submitted by the case study participants reveals that the average cost per $100,000 sales for preparing disclosure documents is significantly higher for small companies than for medium and large ones.

TABLE III

(reprinted from Chapter I)

Average Cost/$100,000 Sales for Preparing Disclosure Documents

Size	10-K	S-1	S-7	10-Q
Large (above $1 billion)	$ 2.41	-	$ 7.59	$ .27
Medium ($100 million - $1 billion)	$ 3.21	$ 27.30*	$28.52**	$ .64
Small (Below $100 million)	$121.41	$1849.91	-	$30.87

* Two observations.
** Three observations.

Limited Investor Interest in Smaller Companies. Data from the Committee's studies and consultations with information disseminators confirm the impression that institutional investors and their advisers evidence little or no interest in the securities of smaller companies.

As more fully discussed in Chapter II, at the request of the Advisory Committee, the Financial Analysts Federation ("FAF") conducted a survey of 758 research directors to determine whether all publicly held companies are the focus of significant fundamental security analysis.

The FAF's results indicate that smaller companies do not receive the continued or widespread scrutiny of security analysts.[2/] Its data disclosed that while regional brokerage firms appeared to have a more flexible policy, New York City-based brokerage firms and, especially, institutions, overwhelmingly limit their continuing interest to companies having at least $50 million in market capitalization.

In response to a question concerning research thresholds based on market capitalization (shares outstanding times market price), the FAF reported that

> Taking all 99 respondents as a group, 78% work with a threshold as low as $50 million and 54% with a threshold of about $100 million. Only brokerage firms (especially regional firms) show significant tolerance for less-capitalized companies. This is presumably because of individual investor interest

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2/ See Chapter II at 39-42.

> rather than institutional interest. By contrast, trust departments and life companies show an overwhelming preference for stocks whose capitalization is at least $50 million or more.
>
> . . . 54 trust departments replied that smaller stocks (market capitalization less than $50 million) occupied less than 5% (in most cases zero) of their list of closely followed stocks. In only one trust department was the fraction of smaller stocks between 5% and 10% of followed stocks, and in only one other trust department did the fraction reach 10% (or more) of all names on the "followed" list. Since there are in fact far more smaller companies than giant companies, this skewing can be interpreted as a powerful bias in favor of size rather than as a natural reflection of real-world characteristics.3/

It appears, then, that the FAF survey and other literature 4/ lend support to the general proposition that,

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3/ FAF, Report to the Advisory Committee on Corporate Disclosure 3-4 (1976).

4/ Cf. Fisher, "What Happens to Capitalism When Money Managers Stop Acting Like Capitalists?", Fin. Anal. J. 21-22 (Jan.-Feb. 1977): "It is now over two years since the end of the great bear market of 1974, and yet it is still impossible for most companies in America to raise new capital for expansion, except on terms so unfavorable as to place in jeopardy the interests of present shareholders . . .. The principal cause of this mess is the refusal of the nation's largest financial institutions -- bank trust departments, pension funds, insurance companies, and some mutual funds -- to invest in anything but a handful of the giants of industry."

It is also contended that "[w]ithin the institutional favorites, the fact that 78 of the top 100 stocks held by institutions remained constant between 1969 and 1973 supports a further premise of the two-tier market, that institutions generally appear to focus

of the more than 10,000 companies registered and filing with the Commission, probably less than five percent and certainly less than ten percent, are closely followed by professional security analysts or are of interest to institutional investors.[5/]

This absence of analyst interest may result from several factors. Many institutional investors operate under formal constraints that preclude their purchase of certain types of equity securities or which impose overall limits on the amount of a particular equity security they may purchase. This considerably narrows the analytical focus of institutional investors.

For example, insurance companies and bank trust departments are constrained by "approved lists," defined by the various states in which they do business. The primary purpose of these lists is to assure that the assets of beneficiaries are invested in a prudent manner. "Approved lists" traditionally have consisted of older, well-established, larger capitalized companies, and apparently are based upon the assumption that investment in these companies is subject to less risk.

4/ (con't.) on a very limited number of stocks." Christner and Stover, "Institutional Research and Regulation Are on the Wrong Track," J. of Port. Management 12 (Winter 1975).

5/ This finding was confirmed in a limited way by the results of the case study of issuers. It was found that a number of the small companies reported no analyst interest in their securities. See Chapter I at 14.

Open-end management diversified investment companies are precluded by the Investment Company Act of 1940 [6/] from having more than five percent of their assets in the securities of any one issuer and from having more than ten percent of the voting securities of any one issuer. Similarly, liquidity requirements arising from the redemption rights imposed by the Act [7/] and valuation requirements [8/] result in powerful pressures upon asset managers to restrict their purchases to companies of larger capitalization and market liquidity.

Most recently, the Employee Retirement Income Security Act of 1974 ("ERISA") was perceived, even before its effective date, as requiring a more conservative investment strategy on the part of pension fiduciaries -- reputed to be the largest, most rapidly growing and most sophisticated customers of institutional portfolio managers. [9/] In an article published prior to the issuance of regulations under ERISA, it was suggested that ERISA's funding policies, valuation requirements, termination provisions, reporting and disclosure rules, fiduciary standards and diversification

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6/ Investment Company Act of 1940, Section 5(b)(1).

7/ Investment Company Act of 1940, Section 2(a)(32).

8/ Investment Company Act of 1940, Section 2(a)(41) Rules 2a-1 and 2a-4 under the Investment Company Act.

9/ Ellis, "Negotiated Commissions and the the Structure of the Institutional Brokerage Industry," Fin. Anal. J. 25,26 (Sept.-Oct. 1976).

requirements "all combine to make the portfolio manager's life more complex and more hazardous." [10/] The net effect of these factors is to provide portfolio managers with disincentives for consideration of smaller companies.

In addition to these formal constraints against investment in small companies, the impact of negotiated Commission rates and the development of theories concerning security analysis and portfolio management, in the aggregate, may have resulted in a diminution of the money available to pay for securities research, a de-emphasis of the necessity for fundamental research [11/] and consequently, a reduction in the number of security analysts. [12/] All of these reduce the number of companies which can be followed and encourage concentration on a top tier.

10/ Siegel, "The Impact of Pension Reform on Portfolio Management," J. of Port. Management 21 (Winter, 1975).

11/ For example, the suggestion has been made that, at least with respect to those stocks followed for and held by institutional investors, prices may react primarily in response to market or general economic influences. Thus, the study conducted by Christner and Stover concluded that "financial institutions should reorient their research effort away from specific industry and companies analysis in favor of macro-economic forecasting and projection of stock market levels." See Christner and Stover, supra note 4, at 14.

12/ An authoritative trade journal, which conducts a semi-annual survey of brokerage firms' hiring of security analysts, reported in a recent issue "a dramatic slow-down in analyst hirings, with 50 brokers reporting a net addition of only seven analysts since last July 1." Its last survey, in July, 1976, "showed a net increase

Effect of Reduced Reporting on Analyst Interest. The third factor weighing in favor of Commission consideration of this issue is that it does not appear that a reduction will adversely affect the possibility that smaller companies will attract analyst interest. This is true not only because it would always be possible for companies to voluntarily meet a higher disclosure standard if that is perceived as necessary, but also because the limited nature of investor interest in smaller companies in large part appears unrelated to the amount or quality of disclosure and rather is caused by the factors discussed above.

C. The Committee's Recommendation

It would appear that balancing of the relatively heavy cost of 1934 Act compliance against limited investor interest in small companies weighs in favor of some consideration being given to reducing this burden. This conclusion would not appear to be undercut by the possibility that such a course of action would adversely affect the ability of small companies to attract investors, because the option to meet a higher disclosure standard would be available.

12/ (con't.) of 43 analysts for roughly the same number of firms--an increase that itself was down from the 65 additional analysts reported hired in last January's (1976) survey." "Special Report" Securities Week (January 17, 1977).

Although this evidence tends toward a conclusion that a reduction in the reporting burden is appropriate, the sketchy nature of the evidence, the highly judgmental nature of an evaluation of the data's implications, and particularly the difficulty of assessing the information needs of shareholders who do invest in these companies, cause the Committee to believe that further study is necessary before a definitive conclusion is reached. The issuance of a "concept" release and the holding of public hearings are steps which would materially assist the Commission in its resolution of these problems. Such a concept release, in addition to notifying the interested public of the proposed course of action and providing a general framework for initial comment, would serve to identify specific issues and facilitiate the participation of constituencies with the special expertise and data which the Commission must consider before this issue can be resolved.

The specific issues the Committee believes should be addressed are:

(1) Whether and, if so, to what extent, the Commission should attempt to define a category of "small companies" for

the purpose of requiring less burdensome periodic reporting requirements?

(2) Assuming that such a classification is desirable, how should it be defined?

(3) Assuming that classification is desirable and definition possible, what reduction of periodic reporting requirements can occur consistent with the purposes of the Federal securities laws?

(These issues are more fully explained in Part D of this chapter.)

The effect of this proposed course of action might be a classification of reporting companies on the basis of capitalization, revenues, trading volume, number of shareholders, or a combination of these or other similar factors. The content of the various periodic reports currently required to be filed with the Commission, the annual report to shareholders and the proxy statement, might be better tailored to the size of reporting company. Some of the current required filings might be eliminated entirely.

As an example, a reporting company with under $10 million in assets and having less than 500 shareholders, might be required to send to its stockholders and file with the Commission, within 90 days after its fiscal year-end, only certified financial statements for the previous two years, a brief description of its business and a more elaborate description of its directors and officers. Form 10-Qs might be eliminated, or made discretionary.

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Two cautionary notes are necessary. A reduction in periodic reporting requirements could be accomplished within the Commission's existing authority. The Commission is authorized to classify issuers, both for purposes of periodic reporting [13/] and proxy solicitation. [14/] It should be noted, however, that fundamental to consideration of any specific proposals based upon classification of issuers is the requirement of an adequate data base for classification. The Committee has been unable to locate any comprehensive data base that would permit such a classification. The Commission has not created such a base and commercially available data bases do not encompass the bulk of registrants, who are considered too small to be of concern to potential users. Accordingly, a

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13/ Section 13(c) of the 1934 Act provides that "If in the judgment of the Commission any [periodic or other report] is inapplicable to any specified class or classes of issuers, the Commission shall require in lieu thereof the submission of such reports of comparable character as it may deem applicable to such class or classes of issuers."

14/ Section 12(h) of the 1934 Act authorizes the Commission, upon its own motion or by application of an interested person, by order and after notice and opportunity for hearing, to exempt in whole or in part any issuer or class of issuers from the provisions of Section 12(g), 13, 14 or 15(d), if the Commission finds, by reason of the number of public investors, amount of trading interest in the securities, the nature and extent of the activities of the issuer, income or assets of the issuer, or otherwise, that the exemption is not inconsistent with the public interest or the protection of investors. The Commission is also authorized to classify issuers and prescribe requirements appropriate for each such class. See also V Loss, Securities Regulation 2737 (1969 Supp.).

highly desirable first step is creation of a data base from which it can be determined whether it is possible to define a category of "small companies" and if so how it should be defined. Also, the precise classification(s) to be established and the particular disclosure modifications to be accomplished, will require careful consideration, among other things, of the public interest and the protection of investors.

Despite the current preference for rigid cost/benefit analysis and the appeal of "deregulation," history indicates that the Commission's use of its power to classify and exempt or modify will be examined with great care, not only by concerned constituencies, but by the Congress as well. 15/ The Committee does not believe that the possibility, or even the actuality, of such an examination should preclude Commission consideration of the course of action recommended. To the contrary, it will contribute to the effectiveness of the process and the soundness of the Commission's ultimate decision.

A draft release announcing the hearings appears below.

15/ The House Committee report commenting on Section 3(b) of the 1933 Act, which authorized the Commission to exempt small issues, stated that this power "is expected to be used only in a sparing manner." H.R. Rep. No. 85, 73d Cong., 1st Sess. 6-7 (1933). Subsequent efforts by the Commission to use its exemptive power, whether to "facilitate public financing by small business," S. Rep. No. 1036, 83d Cong., 2d. Sess. 8 (1954) or to reflect the effect of inflation, S. Rep. No. 1036, 82d Cong., 2d Sess. 3 (1954), have been met with some concern and skepticism. See generally, I Loss, Securities Regulation 605-09 (1961).

D. Proposed Release

ACTION : Proposed solicitation of comments and holding of public hearings to consider amendments to rules and forms.

SUMMARY : The Commission proposes to solicit public comments and hold public hearings to assess whether, and, if so, to what extent, its reporting requirements may be revised to lessen their impact upon small businesses. This action is being taken in response to suggestions that the Commission's periodic and interim reporting requirements disproportionately burden small businesses. Comments are invited on the following questions: (1) Whether and, if so, to what extent, the Commission should attempt to define a category of "small companies" for the purpose of requiring less burdensome reporting; (2) Assuming that such a classification is desirable, how it should be defined; and (3) Assuming that classification is desirable and definition possible, what reduction of reporting requirements can be made consistent with the purposes of the Federal securities laws?

DATES : Comments must be received on or before:

ADDRESSES: Comments should be addressed in triplicate to George A. Fitzsimmons, Secretary, Securities and Exchange Commission, Washington, D.C. 20549. All such communications should refer to File No. and will be available for public inspection in Room 6101, 1100 L Street, N.W., Washington, D.C.

FOR FURTHER INFORMATION CONTACT:

Division of Corporation Finance, Securities and Exchange Commission, Washington, D.C. 20549; (202) 755- .

SUPPLEMENTARY INFORMATION:

The Securities and Exchange Commission today announced its intention to invite public comment and hold public hearings for the purpose of assessing whether, and to what extent, certain of its regulatory policies may be revised to lessen their adverse impact upon small businesses. Specifically, the Commission is seeking comments and suggestions the implementation of which would lessen the impact of its periodic reporting and proxy solicitation requirements on small issuers without reducing "full and fair disclosure" and protection of investors which the Commission, by statutory mandate, is required to promote.

This request for comments in being undertaken in response to suggestions that certain of the Commission's regulatory policies have unnecessarily impeded the raising of capital

by small businesses. It is being limited to the impact of the periodic reporting and proxy solicitation provisions of the Securities Exchange Act of 1934, however, in view of efforts already underway by the staff concerning the impact of 1933 Act registration requirements. 1/ It should also be noted that the Commission has recently entered into an interagency agreement with the National Bureau of Standards, Experimental Technology Incentives Program, to design, develop, test and institutionalize a system for monitoring the economic impact of SEC regulations which significantly affect the capital markets used by small, technology-based firms. 2/

As a final preliminary matter, it should be noted that the Commission is of the impression that capital raising problems faced by small businesses arise primarily from general economic factors and taxation and regulatory policies not subject to the Commission's control. 3/ Nevertheless, particularly within

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1/ See pages 530-32 infra.

2/ See "A Monitoring System for Effective Regulation of Venture Capital Markets," A Joint Project of the U.S. Securities and Exchange Commission, Directorate of Economic and Policy Research, and The National Bureau of Standards, Experimental Technology Incentives Program, Economic Assistance Policy Area (February 1977).

3/ See, e.g., Report of the SBA Task Force on Venture and Equity Capital for Small Business (U.S. Small Business Administration, January 1977); see also the following addresses by Roderick M. Hills, former Chairman: "Democracy and the Planned Economy -- Friends or Foes?" (Pitzer College National Issues Forum, February 17, 1976); untitled address (American Enterprise Institute, June 21, 1976); untitled address (North American Securities Administrators' Association Annual Convention, September 20, 1976); untitled address (Investment Association of New York, September 30, 1976); untitled address (Economic Club of New York, November 8, 1976); untitled address (SEC Major Issues Conference, January 14, 1977); and untitled address (The SEC Speaks, March 4, 1977).

the past two years, the Commission has undertaken steps with a view toward reducing the overall burden of its registration and reporting requirements for all issuers and is publishing this request for comments because of its belief that additional revisions of its policies should be considered and, possibly, undertaken.

I. BACKGROUND

From the Commission's perspective, its statutory responsibilities and regulatory policies have a particular impact on small businesses at the following times:

1. When a company seeks to sell securities to the public, through either an exempt offering of securities or a registered offering of securities under the Securities Act of 1933;

2. When initial purchasers of the company's securities, whether via a private placement or small offering, attempt to resell such securities; and

3. When, by virtue of a registered offering or the company's growth, it becomes subject to the periodic reporting, proxy, and short-swing trading provisions of the Securities Exchange Act of 1934.

In all of these cases, the Commission's statutory responsibilities and regulatory policies impact small businesses both directly and indirectly. The most direct impact appears to stem from the costs of registration that the company must bear, the greatest portion of which appear to be for professional

services required in order to prepare certified financial statements, attorneys' preparation and review of documents to be filed with the Commission and the attendant printing costs.[4/] Moreover, it has been suggested that even where a small business desires to utilize less costly procedures, such as an offering under Regulation A or Rule 240, the ceilings upon the aggregate amount of securities that can be offered, when compared to the costs of even these procedures, do not permit equity financings at an efficient level.

A second point of direct impact appears to occur when investors in small businesses wish to liquidate their investments. Where the original offering has been pursuant to a fully registered offering, resale of the securities may not be of serious concern. However, the more common situation occurs when the investors have acquired their interests by means of a private placement of unregistered securities, whether pursuant to Section 4(2) of the Securities Act of 1933 or Rule 146; by means of an offering pursuant to Rule 240; or through a Regulation A offering.

In these cases, resales of securities are frequently undertaken pursuant to the Rule 144, which places restrictions on the holding period and on the volume of sales. Sales pursuant to Rule 144 are also subject to the information requirements of the Rule and the requirement

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4/ See Report of the Advisory Committee on Corporate Disclosure 26-28 (1977).

that sales be made in "brokers' transactions," i.e., unsolicited and without compensation. Moreover, because many, if not most, small businesses have a relatively small capitalization, an equity investment of even moderate size can result in an individual investor's possessing a "controlling interest" and, thus, falling within the restrictions of the Rule.[5/]

There can be little doubt that the net effect of these provisions is inhibiting on small companies. But that is because the Commission's statutory mandate is, in some respects, inconsistent with the objective of minimizing registration requirements. The disclosure requirements of the Federal securities laws are based on a Congressional determination that public investors shall have access to all material information that is necessary for them to make informed investment decisions. While the Commission has some measure of discretion to define what information should be made available to investors by prescribing the contents of disclosure documents, the Commission does not "collect" information from persons or entities who must comply with the disclosure requirements of the Federal securities laws. Instead, it serves as a means for bringing about the disclosure of material information to investors. In contrast to most Federal agencies, which "collect" information needed to carry out their

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5/ Where this is not the case, resale may be made pursuant to the exemption provided by Section 4(1) of the Securities Act.

"program responsibilities," the filing of reports with the Commission is, for the most part, merely a means of making the information contained in such documents available, directly or indirectly, to investors.

Within these limitations, however, the Commission has directed its staff to undertake consideration of what revisions of its regulations pertaining to registrations, small offerings, private placements and resales of securities might be effected to reduce the barriers to capital raising by small businesses and to lessen the overall burden.

For example, since adoption of Rule 146, the Commission has become aware of criticism that the Rule is hindering the investment of venture capital, and that as an experiment, the Rule is a failure and should be rescinded. Also, the Rule has been criticized as facilitating the fraudulent offering of certain types of securities. For these reasons, among others, the Commission, late in 1976, requested public comment on the operation of the Rule, including the volume of transactions effected in reliance on the Rule and the practices issuers have utilized in complying with the Rule and inquired particularly whether it should be rescinded, revised, or retained in its present form. 6/ The staff is presently reviewing the comments submitted preliminary to formulating possible recommendations to the Commission.

6/ Securities Act Release No. 5779 (December 6, 1976).

In addition, the staff is also reviewing the desirability and feasibility of revising Rule 240 to increase the limitation on aggregate sales price of securities offered, of simplifying the procedure for Regulation A offerings, and of revising Rule 144 to reduce the holding period and increase the volume limitations. Since any proposals developed will be noticed for comment, this request for comments does not encompass the impact of registration and resale provisions.

A third area of Commission impact results from the requirements of the periodic reporting, proxy solicitation, and short-swing trading provisions of the Securities Exchange Act of 1934. As a general matter, issuers required to file periodic reports with the Commission, whether by reason of their registration under Section 12(g) or pursuant to Section 15(d) of the 1934 Act, presently are required to provide essentially the same type and quality of information regardless of their size. 7/ Similarly, the present proxy solicitation provisions and the short-swing trading provisions do not recognize differences in issuers by size.

The empirical case study of the Advisory Committee on Corporate Disclosure, previously noted, found that

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7/ The only general exception concerns the financial information and auditing requirements for development stage companies filing Form 10-K. See Form 10-K, Instructions to Financial Statements, Instruction 8.

periodic reports, proxy statements and insider trading reports filed by or with respect to small issuers were infrequently consulted by security analysts, who normally would have the greatest need for the detailed information contained therein. Although the Advisory Committee also found that security analysts would not favor a significant reduction or differentiation of these reporting requirements by size of issuers, 8/ the Committee was of the preliminary opinion that the relatively greater burden of such reports, when weighed against the benefits derived therefrom, raised questions as to the justification for their continuance in their present form with respect to smaller issuers. Thus, the Advisory Committee recommended that the Commission consider the possibility of revising its periodic reporting requirements so that the burden of compliance might be reduced for smaller issuers. For example, the Committee suggested that the Commission investigate the possibility of permitting small issuers to provide periodic information directly to shareholders on a less frequent basis and to file that same information with the Commission, in lieu of existing filing requirements.

The Commission is authorized by Section 12(h) of the 1934 Act to exempt, in whole or in part, by rule or by order after notice and opportunity for hearing, any issuer or class of

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8/ See Report of the Financial Analysts Federation to the Advisory Committee on Corporate Disclosure (1976).

issuers from the registration requirements of Section 12(g) of the Act as well as from the reporting, proxy solicitation and short-swing trading provisions of the Act. In so acting, the Commission may permit exemptions, upon such terms and conditions and for such period as it deems necessary, or appropriate, if it finds, by reason of the number of public investors, amount of trading interest in the securities, the nature and extent of the activities of the issuer, income or assets of the issuer, or otherwise, that such an exemption "is not inconsistent with the public interest or the protection of investors." 9/ Thus, Congress clearly foresaw that the Commission might deem an exemption for small companies appropriate.

Somewhat different authority is provided by Section 13(c) of the 1934 Act, which empowers the Commission to permit a class or classes of issuers to file, in lieu of Section 13(a) reports, "reports of comparable character." In point of fact, virtually all relief from the periodic reporting requirements to date has been granted pursuant to Section 13(c) because of the greater flexibility permitted, particularly the lack of a necessity for notice and opportunity for hearing.

The present inquiry is intended to identify whether, and if so, to what extent, the Commission should exercise its authority to classify issuers by appropriate criteria for the purpose of reducing the burden upon small issuers of its periodic reporting and proxy solicitation requirements.

9/ Section 12(h), Securities Exchange Act of 1934.

II. SCOPE OF INQUIRY

The present inquiry involves three broad areas of concern. First, whether and, if so, to what extent, the Commission should attempt to define a category of "small company" registrants in order to differentiate it for the purpose of the reporting requirements of the Securities Exchange Act; second, assuming that some such classification is desirable, what criteria the Commission should consider in creating it; third, assuming categorization and differentiation, what changes in the frequency and/or content of filings can be undertaken, consistent with the purposes of the Act, that will effectively reduce the burden upon issuers.

A. Whether and to what extent a "small companies" category should be established.

The concepts of classification and differentiation of issuers, for both registration and reporting purposes, are already recognized in the Federal securities laws. Section 3(b) of the Securities Act of 1933 reflects a Congressional determination that "small offerings" should not be subject to the full panoply of Federal regulatory requirements where "the small amount involved or the limited character of the offering" permits the Commission to conclude that registration is "not necessary in the public interest and for the protection of investors."[10/] And while Section 12(g) of the

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10/ The legislative history of Section 3(b) discloses, however, that Congress did not wish the Commission to exercise its exemptive authority in a broad or sweeping manner. The

Exchange Act embodies Congress' decision that issuers having assets of more than $1 million and 500 or more shareholders have sufficient public interest to warrant Federal regulatory concern, Section 12(h) authorizes the Commission to permit exemptions from Sections 13, 14, or 15(d) of the Act where not inconsistent with the public interest or the protection of investors.[11/]

Because the Commission has never undertaken the broad classification or differentiation of registrants on the basis of their size, there is little empirical evidence available upon which to estimate what impact such a step might have, or, indeed, what factors the Commission should utilize in assessing the impact upon the public interest and the protection of investors.[12/]

10/ (con't.) House Committee report commenting on the original provision stated that the Commission's exemptive power was "expected to be used only in a sparing manner." H. R. Rep. No. 85, 73d Cong., 1st Sess. 6-7 (1933). Subsequent efforts by the Commission to increase the amount which might be offered pursuant to the exemption, from the original $100,000 to $300,000 in 1945, and from $300,000 to $500,000 in 1970, whether to "facilitate public financing by small business," or to reflect the effects of inflation, although successful, have been met with some concern and skepticism. See generally I Loss Securities Regulation 605-09 (1961).

11/ Section 12(h) also authorizes the Commission to exempt from Section 16 of the Act, any officer, director or beneficial owner of securities of an issuer.

12/ In recent years, the development of the efficient market hypothesis has led some observers to suggest that, because the market readily absorbs investment information, or perhaps even anticipates such information, little if any impact would result if registrants were not required to

Accordingly, the initial question the Commission must consider is whether and, if so, to what extent, establishment of a category of "small business" registrants should be undertaken in view of the public interest and the protection of investors. In addition to the benefits, if any, that might flow to such registrants by virtue of their being relieved of specified reporting obligations, the Commission must consider the subsequent difficulties that might be encountered by investors in attempting to obtain current information concerning such registrants.[13/] The Commission necessarily must

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12/ (con't.) publicly file financial and other information with the Commission. Because of limitations in obtaining the required data, however, most empirical studies have been confined to securities listed and traded on exchanges, which comprise a very small portion of the companies registered with and reporting to the Commission. Thus, it seems likely that the efficient market hypothesis is valid only with respect to those largest companies attracting widespread interest of institutional investors. In order to attract institutional interest, these issuers apparently must have revenues of about $100 million or, at a minimum, $50 million. In the aggregate there are only about 800 to 1,000 companies in either of these categories. However, there appear to be well over 4,000 companies having revenues of under $25 million and another 1,000 companies between $25 and $50 million. See Nelson's Directory of Securities Research Information (1977).

13/ For example, broad classification of issuers for differentiation of reporting obligations, while reducing burdens upon the various classes, might lead to increasing segmentation or "tiering" of issuers. Despite the fact that all issuers would be free to file or otherwise disclose the full spectrum of information currently required, broad classification of issuers by the Commission is likely to result in a somewhat lesser amount of information being disclosed. In this event, it is entirely conceivable that institutional investors, and the security analysts who

also assess the impact of such revisions upon dealers making a market in a security [14/] and the suitability standards required of brokers recommending a security to customers. Moreover, there may be questions concerning the impact upon the private rights of investors. [15/]

Although the Commission has not exempted a broad category of registrants from existing reporting requirements by virtue of their size, [16/] in recent years it has differentiated registrants by size for the purpose of requiring additional items of disclosure. This has occurred with respect to disclosure of current replacement cost information [17/] and selected financial data on a quarterly basis. [18/] The Commission's selective application of additional disclosure requirements came only after its conclusion that the

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13/ (con't.) service them, will be even less interested in smaller companies because of the reduced information. Under these circumstances, small companies would probably view reduced reporting obligations as a mixed blessing, at best.

14/ Cf. Rule 15c2-11.

15/ Cf. Section 10(b) of the 1934 Act and Rule 10b-5 thereunder, and Section 18.

16/ A short form registration, Form S-7, however, is available to companies meeting specified reporting and income criteria.

17/ Securities Act Release No. 5696, Accounting Series Release No. 190 (March 23, 1976).

18/ Accounting Series Release No. 177 (September 10, 1975).

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"greatest investor need for these data exists in the case of such companies whose activities are most closely followed by analysts and investors" and its recognition that "the costs of such disclosure would be relatively a greater burden to smaller companies." 19/ Similarly, with respect to the replacement cost information, the Commission "concluded that in the case of companies of large size which generally have the largest public investor interest, the data are of such importance that the benefits of disclosure clearly outweigh the costs of data preparation." 20/

Accordingly, as an alternative to the broad classification and differentiation of registrants, the Commission should consider the desirability of exempting from future increased and/or more specialized disclosure requirements registrants not meeting specified size criteria. 21/

B. Assuming classification, what criteria should be used?

Should the Commission conclude that establishment of a

19/ Id.

20/ Accounting Series Release No. 190 (March 23, 1976).

21/ A pertinent example concerns segment reporting, the burdens of which are particularly disproportionate for small companies. This is so because the level of detail that will be disclosed typically will be much greater than for large companies. However, where a small company is engaged in more than one line of business, it is possible that changes within one line may be of greater consequence to the company precisely because it is small.

category of "small company" registrants for the purpose of differentiating among reporting requirements is justified and useful, it must then determine what criteria should be used in establishing the category. Although preliminary consideration should be given to existing classifications for registration and reporting purposes, it appears likely that the classes eligible to use Form S-7 [22/] and required to disclose selected financial data on a quarterly basis [23/] will not be useful since they consist of large and medium-sized companies.

Because of the uncertainties inherent in such a project, the Commission would necessarily prefer to confine its application, at least initially, to the smallest category of registrants. Thus, although the following factors are not exclusive, a reduction of periodic reporting requirements might be considered for those companies having between 500

22/ In order to qualify for use of Form S-7, a registrant must have had a net income of $250,000 for three of the last four fiscal ears (including the most recent year); filed all material required by Sections 13, 14 or 15(d), as applicable, for the previous three years; timely filed all required reports during the previous year; and, if subject only to Section 15(d), sent a proxy statement containing the information called for by Rule 14a-3(b) during the previous year.

23/ Selected financial data on a quarterly basis are required to be reported by companies registered under Section 12(g) whose securities are quoted on NASDAQ and meet the Regulation T requirements for inclusion on the OTC margin list, and who had after-tax income of $250,000 for each of the last three years or had total assets during the previous year of $200 million or more.

and 1,000 shareholders and assets and sales, respectively, of between $1-20 million.

It is also conceivable that the Commission may wish to consider defining sub-categories of "small company" registrants.[24/] Such an undertaking would appear to require development of a comprehensive data base of all registered and reporting companies that could be matrixed for purposes of classification.[25/] In creating such a data base, the criteria contained in Section 12(h) of the Exchange Act would serve as a useful starting point.[26/] It is also possible that other criteria, or a combination thereof, may be more appropriate.

Whichever system of classification the Commission may ultimately utilize, if any, would have to be justifiable as not inconsistent with the public interest or the protection of investors and, at the same time, be likely to result in a material reduction in the existing reporting burdens.

24/ Obviously, from the perspective of both administration and compliance, there is a point beyond which sub-categorization should not go without becoming burdensome in and of itself. Moreover, it has been suggested that this additional differentiation cannot practically be justified, i.e., that is not possible to demonstrate the viability of such "fine tuning." Nevertheless, at this preliminary stage, it is a concept which the Commission must consider.

25/ The Advisory Committee on Corporate Disclosure has recommended that the Commission undertake development of such a data base.

26/ See text accompanying note 9, supra.

C. If the Commission defines a classifiction of registrants as "small businesses," what reduction of reporting obligations should be made?

Assuming that the Commission is able to define a category of registrants as "small companies," [27/] the final question to be resolved concerns specifically what reductions of existing obligations can and should be made.

Existing reporting obligations of issuers result from the interrelationship of three basic factors: (1) the requirement of filings with the Commission; (2) the practice and/or requirement of providing information to shareholders; and (3) the content of the information filed and/or provided to shareholders. The Commission believes that a significant reduction in the burden placed upon small companies may be possible by means of altering any one or combination of these factors.

As an example, issuers currently are required to file with the Commission annually a Form 10-K setting forth specified information and to provide to shareholders asked to elect directors a proxy or information statement, together with an annual report containing a somewhat lesser amount of

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27/ For example, the Commission might define "small companies" by reference to the following five criteria: number of public shareholders, trading volume, market capitalization, assets, and revenues. It is conceivable, of course, that sub-categories within this classification might be appropriate.

information.[28/] In order to fulfill these obligations, most issuers prepare two separate documents, despite the fact, as the Commission has recently re-emphasized,[29/] that annual reports containing the information called for in the 10-K may be filed in lieu of the 10-K. In order to reduce the expenses incurred by small companies in the preparation of two separate documents, the Commission might consider permitting small companies to file a condensed annual report to shareholders in lieu of the existing Form 10-K. The condensed annual report might contain a description of the business, background of executive officers and directors and a description of any of their transactions with the company, and certified financial statements for the last two years.

Alternatively or in addition, the Commission might consider relieving small companies from the obligation of filing Form 10-Q's entirely or permitting these small companies to file 10-K's with financial statements that are certified but not otherwise in compliance with Regulation S-X.

Alternatively, the Commission might consider amending Rule 14a-3 to permit, where the only matter to be acted upon by shareholders is the election of directors, transmittal to shareholders only of background information concerning the

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28/ Differences between the financial statements contained in the two documents which have a material effect on the financial position or results of operation must be noted and reconciled or explained. Rule 14a-3(b)(2).

29/ Securities Exchange Act Release No. 13639 (June 17, 1977).

directors. In such a case, existing requirements for the 10-Q and 10-K could be maintained.

In considering any or all of these alternatives, or any additional ones that might be suggested, the Commission must carefully weigh the reduction of burdens upon small companies againt the Commission's statutory obligation to promote the public interest and the protection of investors.

III. SOLICITATION OF COMMENTS

In view of the foregoing discussion, the Commission invites public comments and suggestions on the following questions:

A. Should the Commission attempt to define a category of "small company" registrants in order to reduce the reporting obligations of the Securities Exchange Act of 1934? (Respondents are directed to the discussion contained in Part II, A. of this release.)

1. Would classification of "small company" registrants be inconsistent with the Commission's mandate to promote full and fair disclosure under the Federal securities laws?

2. What criteria should the Commission utilize in determining whether classification is consistent with the public interest and the protection of investors?

3. To what extent, if any, would investor interest in "small company" registrants be inhibited or reduced by virtue of a reduction in the amount of information required to be filed with the Commission?

4. To what extent would a broker's or dealer's obligations pursuant to Rule 15c2-11 be affected by virtue of a reduction in the amount of information required to be filed with the Commission by "small company" registrants?

5. To what extent would a broker's obligation to ascertain that a proposed investment be "suitable" for a customer be affected by virtue of a reduction in the amount of information required to be filed with the Commission by "small company" registrants?

6. To what extent would the private rights of investors pursuant to Section 10(b) of the Exchange Act and Rule 10b-5 thereunder, and Section 18 of the Act, be affected by virtue of a reduction in the amount of information required to be filed with the Commission by "small company" registrants; conversely, would the disclosure obligations inherent in those antifraud provisions vitiate efforts to simplify reports and/or reporting requirements?

7. Would it be preferable for the Commission, as an alternative to reducing the amount of information presently required to be filed by "small company" registrants, to consider the desirability of exempting such registrants from future increased and/or more specialized reporting obligations?

B. Assuming that some relief from the reporting obligations of the Securities Exchange Act is desirable and justified, what criteria should the Commission use in

defining "small company" registrants? (Respondents are directed to the discussion contained in Part II, B. of this release.)

1. To what extent, if any, are existing criteria for classification useful in defining "small company" registrants?

2. To what extent must the Commission utilize any or all of the criteria specified in Section 12(h) of the Securities Exchange Act?

3. Should the Commission utilize criteria in addition to those specified in Section 12(h) and, if so, what criteria?

C. Assuming that the Commission can reasonably define a class or classes of "small business" registrants, and that differentiation of the reporting obligations can be justified, what reduction of reporting obligations should be considered? (Respondents are directed to the discussion contained in Part II, C. of this release.)

1. How and to what extent can the contents of the following reports be modified in order to reduce their burden upon "small company" registrants:

a) Form 10-K under the 1934 Act

b) Form 10-Q under the 1934 Act

c) Form 8-K under the 1934 Act

d) Annual report to shareholders pursuant to Rule 14a-3

e) Regulation 14A under the 1934 Act?

2. Should the Commission consider relieving "small company" registrants from the obligation to:

a) File financial statements prepared in compliance with Regulation S-X in any or all of the reports required to be filed under the 1934 Act?

b) Disclose segment data pursuant to FASB No. 14?

CHAPTER XVIII

DISSEMINATION OF INFORMATION

RECOMMENDATIONS:

Regarding Dissemination of Filings with the Commission:

The Commission should convert its filing system from a statutory reporting basis to a company basis and should maintain a "current file" for each Exchange Act reporting company containing the company's latest Form 10-K annual report and all subsequent filings, excluding exhibits, under the Securities Act and the Exchange Act.

The Commission should require public companies to make their filings with the Commission under the Exchange Act available to the public upon request.

Regarding Disclosure to Holders of Debt Securities:

The Commission should be sensitive to the information needs of holders of debt securities and, if information deficiencies are identified, corrective action should be undertaken.

The Commission should assure that all company reports available to equity holders are available to debt and warrant holders if requested.

A. Introduction

Although the interviews with analysts and the results of the individual investor survey indicate that filings with the Commission are not the primary source of information about a company for most users, filings are used by many to confirm information already obtained elsewhere and to acquire more detailed information than is available elsewhere.

The Committee believes that although dissemination of information by the Commission is not the Commission's primary function, it is appropriate for the Commission (1) to create and maintain a comprehensive and readily accessible reservoir of information for those shareholders and others who wish to use it; and (2) wherever reasonably possible, to enhance the ability of all interested persons to obtain this information, either from the preparer or from the Commission. The Committee believes that improvements are possible in both of these areas.

B. Converting the Commission File System to a Company Basis

At the present time, Commission maintained company filings are segregated according to the act pursuant to which the filing has been made. Thus, the Securities Act registration statement filings are in one file, and the Exchange Act periodic reports are in another.

This filing-by-act is inconvenient and unnecessary. Even sophisticated users are far more likely to seek filings [illegible] company rather than by act. Accordingly, the Committee [illegible] that the Commission convert its present filing [illegible] company basis." This would result in the [illegible] "ABC" containing in the order of filing, [illegible] 10-K, quarterly reports on Form [illegible] Form 8-K, proxy statements, Schedule 13d [illegible] under the 1933 Act. Not only will a "company basis" file permit more expeditious access to Commission files by the public and by the Commission's staff but perhaps, because of the elimination of multiple file numbers, it might be easier to maintain.

Consideration should also be given to maintaining a current file on each registrant. This would entail maintenance of a separate docket or folder which would include filings made by a company during the last year (i.e., the most recent Form 10-K and all filings under the 1934 and the 1933 Act made since that time). This current file will be much more convenient for members of the public because it will no longer be necessary to look through several different files to get current information about a company. The Committee was not able to assess the feasibility of this procedure, and accordingly its method of implementation has been left to the discretion of the Commission.

C. Increased Dissemination of Company Filings

Rule 14a-3 under the 1934 Act now requires companies to furnish to shareholders, upon request, a copy of the most recent Form 10-K. It is the Advisory Committee's position that shareholders, potential investors and analysts should be able to obtain from the company upon request a copy of any other filing made with the Commission. This position reflects the belief that although interested users may obtain copies of filings from the Commission, it is often easier and more logical to go directly to the company.

Unfortunately, companies often refuse to provide copies directly to requesting users, whether shareholders or not. This refusal is probably based more on a desire to avoid the costs and burdens of processing such requests, however minimal, than on a desire to withhold information.

This is an area in which the Commission should act to make it easier for persons to obtain information that is theoretically "public". Shareholders should be able to obtain copies of documents filed by their company, which are matters of public record, directly from their company and without charge.

While the policy justification for non-shareholders being able to obtain such documents may be less clear, the Committee believes that such a policy is sound and should be established. In the course of the case studies of security analysts, portfolio managers and financial

information disseminators, a frequently voiced complaint related to the unwillingness of companies to provide publicly filed documents on a regular basis. In view of the important role in the corporate disclosure system that all of these parties play, the Committee concluded that the establishment of a right of access is easily justifiable.

Because a non-shareholder category encompasses so many more potential requestors than does a shareholder category, the burden imposed on public companies may be more substantial. Moreover, professional users are willing to incur a reasonable cost for the convenience of obtaining such documents from the company on a regular basis. For these reasons, a majority of the Committee believes a reasonable charge for requested documents can serve to minimize frivolous requests. Some members believe, however, that all documents should be available to everyone free of charge.

D. Disclosures to Debtholders

The Committee's principal focus has been on disclosure as it relates to equity securities. From staff discussions with several disseminators of financial information, it is apparent that a considerable growth in the bond market occurred during this decade. Because of time constraints and limited staff and resources, it was impossible for the Committee to revise its focus to fully examine the information needs of debtholders. The Committee on Corporate Disclosure of the Fixed Income Analysts Society

was, however, invited to submit their opinions to the Advisory Committee.[1/]

The Society reports that since 1970 there has been a substantial increase in the amount of corporate debt outstanding. During the past six years, total straight public debt outstanding increased 164%. Total domestic corporate bonds outstanding at year-end 1976 are estimated at $334.3 billion. This total does not include preferred stock issues having fixed income characteristics or foreign bonds sold in the United States during that period.

During the same period, it appears that direct individual ownership of bonds has also increased substantially and now accounts for about 15 percent of the bonds outstanding. Indirect ownership by individuals, via private non-insured pension funds and state and local retirement funds, has also increased. This fact is of particular significance because of the greater stress laid on fiduciaries, i.e., pension investment managers, under ERISA.

This growth has been accompanied by increased demand for corporate bond research. Since 1970, a substantial number of brokerage houses and independent investment advisers servicing corporate bond investors with credit and market research have enlarged their capabilities. The growth of "in-house" institutional bond research

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1/ This report appears in the appendices as Appendix II-C.

and utilization of the private bond ratings has also been significant.[2/]

The Commission has not been unaware of this growth or of its broader implications. Former Chairman Hills, on a number of occasions, made public statements reflecting the Commission's concern with the increase of corporations' debt to equity ratio.[3/] Nevertheless, the Commission has focused little attention on the unique informational needs of bondholders or, indeed, their right to obtain information ordinarily provided to common stockholders. This latter omission is particularly curious because debt securities represent a contractual obligation of corporations such that the interest of the holders of such securities ranks senior to the interest of common stockholders in the event of liquidation.

At a minimum, therefore, the Committee believes that the Commission should take steps to assure that all company reports made available to equity holders are made available to debt holders if they request them.

2/ The increased disclosure expected of bond issuers, and the degree to which bond analysts and underwriters are attempting to refine the rather broad ratings traditionally provided by the rating agencies, is discussed by Klapper and Pappas, "Tell and Sell: "Wall Street Is Forcing Cities to Disclose More When Floating Bonds," The Wall Street Journal, June 30, 1977, at 1, col. 6.

3/ See, e.g., Address by Chairman Hills, American Institute of Certified Public Accountants, Washington, D.C., January 7, 1977.

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In addition, in view of the growth and dispersion of the bond market, the increases in the debt to equity ratio of many issuers and the trend toward more active management of bond portfolios, the Commission should also review the contents of existing periodic reports to determine whether they might be improved to better serve the needs of bondholders. Because the Committee had little opportunity to examine the area in detail, no specific recommendations for change are being made; however, the Commission might wish to review the report submitted by the Committee of the Fixed Income Analysts Society.

E. Related Matters Discussed by the Committee. The Committee discussed the desirability of the Commission publishing a pamphlet that would include simplified descriptions of the documents filed with it by publicly held companies and the procedures followed by the Commission in making these documents available to interested members of the public and concluded that such a pamphlet would be useful. Many Committee members believe that stockholders do not know what information companies are required to report to the Commission or how they can obtain copies of such material. There is also some feeling that such a pamphlet might be useful to a company newly subject to the Commission's reporting requirements.

Also, the Committee is aware of the materials developed by the Commission within the last few years not only in the

area of written information,[4/] but in other media, such as film and slides[5/] which explain the objectives of the Commission's work and how it goes about fulfilling those objectives. These preliminary efforts should be continued and expanded.

Finally, the Committee also considered recommendations for substantially expanding the Commission's educational functions, but rejected them. The decision reflects the belief that the private sector presently provides a range of educational materials far in excess of what the Commission might provide within the confines of its limited resources.

4/ Cf. The Work of the SEC; Investigate Before You Invest; and How to Avoid Pyramid and Ponzi Schemes; Because of the Commission's regulatory responsiblities, there are understandable difficulties in the preparation of such materials, not the least of which is the problem of preparing material that is truly informative without being overly complicated. The Committee believes that these problems can be overcome and that, equally important, investors promised Commission assistance in such publications in fact find such assistance.

5/ In 1975, in cooperation with the Practicing Law Institute, the Commission prepared an edited film of an actual Commission meeting. The following year, it created a synchronized slide and tape program explaining the basic functions of the Commission. Neither of these efforts have received the marketing and distribution efforts they require to bring them to public attention, despite the favorable reception by users who have viewed them.

PART IV

THE DISCLOSURE ENVIRONMENT

CHAPTER XIX

CORPORATE DISCLOSURE UNDER THE SECURITIES ACT OF 1933 AND THE SECURITIES EXCHANGE ACT OF 1934: A HISTORICAL PERSPECTIVE*

A. Introduction

After the 1929 crash, and in the midst of the ensuing depression, President Roosevelt requested Congress to enact legislation regulating transactions in securities. In his message of March 29, 1933, the President outlined his legislative proposal as follows:

> I recommend to the Congress legislation for Federal supervision of traffic in investment securities in interstate commerce. In spite of many State statutes the public in the past has sustained severe losses through practices neither ethical nor honest on the part of many persons and corporations selling securities.
>
> Of course, the Federal Government cannot and should not take any action which might be construed as approving or guaranteeing that newly issued securities are sound in the sense that their value will be maintained or that the properties which they represent will earn profit.

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> There is, however, an obligation upon us to insist that every issue of new securities to be sold in interstate commerce shall be accompanied by full publicity and information and that no essentially important element attending the issue shall be concealed from the buying public. This proposal adds to the ancient rule of caveat emptor, the further doctrine "let the seller also beware." It puts the burden of telling the whole truth on the seller. It should give impetus to honest dealing in securities and thereby bring back public confidence.
>
> The purpose of the legislation I suggest is to protect the public with the least possible interference to honest business. This is but one step in our broad purpose of protecting investors and depositors. It should be followed by legislation relating to the better supervision of the purchase and sale of all property dealt with on exchanges, and by legislation to correct unethical and unsafe practices on the part of officers and directors of banks and other corporations.
>
> What we seek is a return to a clearer understanding of the ancient truth that those who manage banks, corporations, and other agencies handling or using other people's money are trustees acting for others. 1/

The President anticipated comprehensive reform of the securities industry and his message, which reflected the influence of Louis D. Brandeis' philosophy for controlling those who manage other people's money, 2/ expressed four principles that subsequently became themes of federal securities regulation. First, the public should be protected

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1/ S. Rep. No. 47, 73d Cong., 1st Sess. 6-7 (1933); H. R. Rep. No. 85, 73d Cong., 1st Sess. 1-2 (1933).

2/ L. Brandeis, Other People's Money and How the Bankers Use It (1914).

against fraud and manipulation, but with the least possible interference to honest business enterprise. Second, the government's role should be limited so as not to be construed as an approval or guarantee of any security. Third, no essentially important element attending the issuance of securities should be concealed from the investing public. Finally, persons sponsoring the investment of other people's money should be held to the high standards of a trustee. Because only a dishonest man could object to legislation founded on those broad principles, the President's proposal was considered acceptable to both the public and the financial community. 3/

This philosophy of full disclosure was molded into a comprehensive regulatory framework that has continuously been refined and expanded under the aegis of federal securities legislation. When examining the role of disclosure, the interrelationship with other elements in the scheme of securities regulation must also be kept in perspective. The history of the existing system of corporate disclosure requirements, particularly the provisions in

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3/ H.R. Rep. No. 85, 73d Cong., 1st Sess. 3 (1933). Although the disclosure requirements of the Securities Act of 1933 did not generate significant opposition, the disclosure provisions of the Securities Exchange Act of 1934 were strenuously opposed. S. Rep. No. 792, 73d Cong., 2d Sess. 10 (1934); H.R. Rep. No. 1383, 73d Cong., 2d Sess., pt. 2 (1934).

the Securities Exchange Act of 1934, also reflects the uncertainties associated with regulating dynamic market mechanisms that are "as sensitive as a hair trigger".[4/] Despite the debacle of the late 1920's, the structure of the Nation's capital markets was generally regarded as the best in the world and an essential element of the national economic system. But in view of the increasingly important role of securities markets to the economy and the apparent inability of corporate management and professionals in the securities business to adjust their methods of doing business to changing conditions in society, regulatory reform was considered a belated attempt to eradicate destructive speculation, eliminate fraud and manipulation, elevate standards of business conduct and to thus restore investor confidence in those markets.[5/] In the absence of either a master plan for restructuring an ideal securities market or the knowledge and experience necessary to devise one, ideals were cautiously superimposed on segments of the existing market structure. The resulting disparities influenced the continuing development of those markets, which in turn influenced the structure of the regulatory framework. The erratic history of the time-consuming process through which the present system of

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4/ H.R. Rep. No. 1383, 73d Cong., 2d Sess. 3-4 (1934).

5/ See Id. at 2-5; S. Rep. No. 792, 73 Cong., 2d Sess. 2-5

corporate disclosure was created therefore sheds light that is useful to an evaluation of that system.

This chapter describes the evolution of the existing system of corporate disclosure. Section B outlines the original statutory framework set forth in the Securities Act of 1933 and the Securities Exchange Act of 1934. Section C focuses on the attempts to develop a more effective system of continuing disclosure obligations under the Exchange Act. Section D presents the areas in which the original system has been expanded to increase required disclosure and discusses the trend towards integrating the disclosure requirements of the Securities Act with those imposed under the Exchange Act.

B. The Original Statutory Framework

The system of corporate disclosure that emerged under the Securities Act and the Exchange Act can best be understood as one aspect of an essentially two-pronged regulatory approach that was designed to promote more efficient securities markets. The 1929 crash not only destroyed the fortunes of numerous investors, it also represented a catastrophic misallocation of the Nation's capital resources. In addition, the manner in which capital accumulations were decimated threatened public confidence in the securities markets as a reliable source of viable investment alternatives.

Extensive congressional hearings during the early 1930's revealed the complex and manifold ramifications of the securities business, as well as the unsavory details of numerous unscrupulous, fraudulent and unethical methods that were employed to exploit the public's avarice and gullibility.[6/] In devising a legislative remedy, Congress sought to prevent a reoccurrence of the tragic economic repercussions resulting from uncontrolled speculation and, at the same time, preserve a free enterprise economy. Assuming investors were satisfied that the remedial measures promulgated by Congress would provide adequate protection against abuses previously endured in the securities markets, the potential rates of return on investments in securities would once again attract much needed capital to a severely depressed economy. The Securities Act and the Exchange Act were therefore structured to improve the operation of securities markets by altering both the conditions under which investment decisions are made and the environment in which those decisions transpire.

6/ See, e.g., Hearings on Stock Exchange Practices Before the Senate Comm. on Banking and Currency, 72d & 73d Congs. (1932 - 1934) [hereinafter cited as Senate Hearings]. The Senate Hearings were summarized in Stock Exchange Practices Report of the Comm. on Banking and Currency, S. Rep. No. 1455, 73d Cong., 2d Sess. (1934) [hereinafter cited as Senate Report on Stock Exchange Practices].

The Securities Act was founded on the theory that informed investors seeking to maximize their own investment needs and objectives resulted in the most efficient allocation of capital among innumerable alternative investment opportunities. The fact that practically worthless securities were distributed to the public for billions of dollars was attributed to irresponsible investment bankers who, without "regard for the efficient functioning of industry", overstimulated the appetites of investors with "[a]lluring promises of easy wealth" and with "incomplete, careless, or false representations",[7/] rather than to the inability of investors to form more rational investment decisions. Congress was therefore satisfied that provisions requiring full disclosure of all information necessary "to bring into the full glare of publicity those elements of real and unreal values which lie behind a security"[8/] could be structured to provide an appropriate regulatory solution to the problems inherent in the sale of new securities issues to the public. Equally as important, Congress avoided the political, economic and administrative dilemmas associated

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7/ H.R. Rep. No. 85, 73d Cong., 1st Sess. 2 (1933); S. Rep. No. 47, 73d Cong., 1st Sess. 2 (1933).

8/ H.R. Rep. No. 85, 73d Cong., 1st Sess. 4 (1933).

with empowering a governmental agency with authority to decide the merits of each securities offering and, thus, to direct the allocation of capital among competing corporations and other organizations.

The Exchange Act was founded on the closely interrelated theory that competing judgments of informed buyers and sellers as to the value of a security in a free and open securities market reflected fair values for that security. The House Report accompanying the Exchange Act noted, however, that:

> Just as artificial manipulation tends to upset the true function of an open market, so the hiding and secreting of important information obstructs the operation of the markets as indices of real value. There cannot be honest markets without honest publicity. Manipulation and dishonest practices of the market place thrive upon mystery and secrecy. The disclosure of information materially important to investors may not instantaneously be reflected in market value, but despite the intricacies of security values truth does find relatively quick acceptance on the market. That is why in many cases it is so carefully guarded. . . . 9/

Since the Securities Act only dealt with the distribution of new securities issues, additional current disclosure on a continuous basis was also necessary with respect to outstanding securities that were traded among investors in the securities markets.

9/ Id. at 11.

The emphasis on disclosure in both statutes was consistent with the economic theories underlying the operation of securities markets in a free enterprise society. Disclosure would provide an intelligent basis on which all investors could make informed investment decisions.[10/] Presumably, Congress was aware that investors have different needs and objectives, and that some would use available information more than others.[11/] However, Congress clearly did not intend to superimpose its value judgments, or the value judgments of a governmental agency, over those of individual investors.[12/] As long as everyone had reasonably equal access to the same information, the securities markets

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10/ E.g., H.R. Rep. No. 85, 73d Cong., 1st Sess. 3-4 (1933); H.R. Rep. No. 1383, 73d Cong., 2d Sess. 11-13 (1934); Senate Report on Stock Exchange Practices, supra note 6, at 68-74, 150-53.

11/ Congress realized that an effective disclosure policy would require disclosure of technical information that would have little meaning for average investors. Those investors were expected to benefit, however, from the anayses of those for whom the information would be meaningful. See, e.g., H.R. Rep. No. 85, 73d Cong., 1st Sess. 4 (1933): "The type of information required to be disclosed is of a character comparable to that demanded by competent bankers from their borrowers and has been worked out in light of these and other developments." See also SEC, Disclosure to Investors: A Reappraisal of Administrative Policies Under the '33 and '34 Acts 52-53 (1969) [hereinafter cited as Wheat Report].

12/ The Commission was not authorized to approve or disapprove of particular securities. See, e.g., H.R. Rep. No. 85, 73d Cong., 1st Sess. 4 (1933); S. Rep. No. 792, 73d Cong., 2d Sess. 13 (1934).

were expected to be fair markets and in addition, disclosure requirements, when coupled with liabilities for false and misleading statements, would enable investors to obtain a remedy for misrepresentations in connection with securities transactions.[13/]

Disclosure was also thought to be a particularly versatile regulatory concept that, with a minimum of governmental interference to honest business, could be used to improve the fiduciary relationship between those in control of publicly held business enterprises and the investing public by indirectly deterring fraud and other more subtle forms of unethical behavior. Although Congress did not elaborate on the indirect aspects of disclosure, except in connection with the proxy requirements and insider trading provisions of the Exchange Act,[14/] the deterrent effect has consistently been recognized as an important element in the disclosure theory of investor protection.[15/] More-

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13/ See, e.g., H.R. Rep. No. 85, 73d Cong., 1st Sess. 9-10 (1933); S. Rep. No. 792, 73d Cong., 2d Sess. 12-13 (1934).

14/ See text accompanying notes 34 through 37 infra.

15/ Brandeis had argued pursuasively in favor of disclosure, recommending adequate publicity ". . . as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman." L. Brandeis, supra note 2, at 93. See, e.g., Wheat Report, supra note 11, at 10; S. Rep. No. 379, 88th Cong., 1st Sess. 6 (1963).

over, the liability provisions were expected to have a substantial impact on the securities business.[16/]

Disclosure was clearly intended to assume different roles and accomplish different purposes in the scheme of securities regulation. But disclosure alone would not necessarily protect the public against numerous practices and methods employed to manipulate investors and security values, or fluctuations in security prices resulting from excessive use of credit in speculative transactions. Disclosure was thus only a partial solution. Consequently, the system of corporate disclosure was accompanied with other more substantive provisions regulating both the process through which securities transactions were effected and the availability of credit in the marketplace. Viewed as one integrated approach, the legislation could reasonably be expected to improve all of the circumstances surrounding the manner in which investors formed competing investment judgments and would, therefore, promote more effective securities markets.

Securities Act Disclosure

When corporations and other organizations distribute securities for value, they must compete with all existing forms of alternative investment opportunities for a limited

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16/ *See* text accompanying notes 28 and 29 *infra*.

supply of investment capital. Rational investors theoretically compare the terms of an issuer's offering with alternative investment opportunities and select the alternative, or alternatives, that either maximizes their expected return on a given amount of risk or minimizes their risk for some expected return. Issuers offering securities to the public therefore have a direct pecuniary interest in the outcome of the selection process, and often provide financial intermediaries with various incentives to distribute their securities. Since the basis on which investors form investment decisions concerning an issue is composed primarily of representations from the issuer, and its agents in the distribution process, there is a financial incentive to distort investor expectations by overstating potential returns and understating risk. In view of the significance of the capital raising function of securities markets, the Securities Act was designed specifically to alter the manner in which investment capital was solicited from the investing public.[17/] Although a few securities and certain offerings were exempted,[18/]

17/ For an analysis of the capital raising function of securities markets see SEC, Report of Special Study of Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 1, at 481-595 (1963) [hereinafter cited as Special Study].

18/ For a discussion of the Securities Act exemptions see H.R. Rep. No. 85, 73d Cong., 1st Sess. 6-7 (1933); S. Rep. No. 47, 73d Cong., 1st Sess. 3-4 (1933).

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Congress anticipated utilizing disclosure in connection with most new issue distributions to the public and constructed a statutory framework consisting of four interrelated elements that would maximize the beneficial impact of "the full glare of publicity."

First, issuers were required to file a registration statement with the Commission setting forth all of the prescribed disclosures.[19/] When the registration statement was filed, it was intended to serve as "a source of information to prospective buyers and as a foundation for civil liability if the information" was false or misleading.[20/] The Commission, without approving or disapproving the issue, was authorized to review the form and content of the registration statement to assure compliance with applicable requirements.[21/]

Second, after the registration statement was filed a waiting period of twenty days was intended to prevent sales,

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19/ The registration statement was required to contain the information, and be accompanied by the documents, specified in Schedule A or B, as appropriate, but the Commission was vested with discretionary authority to vary those requirements by rule or regulation. See Securities Act § 7, Schedule A & B, ch. 38, 48 Stat. 78, 88 (1933), as amended 15 U.S.C. §§ 77g, 77aa (1970) See H.R. Rep. No. 85, 73d Cong., 1st Sess. 7, 17-19 (1933).

20/ H.R. Rep. No. 85, 73d Cong., 1st Sess. 7 (1933).

21/ See sources cited in note 12 supra.

and to discourage selling efforts, while the investing public, state securities commissions and independent securities services and advisers had an opportunity to scrutinize and digest the information contained in the registration statement.[22/] The waiting period contemplated a significant change in existing distribution tactics that would facilitate dissemination of the required disclosures prior to the date on which the securities were actually sold.[23/] At the expiration of the waiting period, the registration statement automatically became effective, unless an amendment was filed or a stop order issued, and the securities could thereafter by sold to the public.[24/]

Third, prospectus delivery requirements were intended to assure that the required disclosures were not "lost in the actual selling process."[25/] Since the prospectus contained information substantially equivalent to that in

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22/ H.R. Rep. No. 85, 73d Cong., 1st Sess. 3, 5-6 (1933).

23/ Id. at 7-8.

24/ The House Report stated that the Commission was authorized to issue a stop order if sales were being made without giving the buyer a prospectus, or if the Commission discovered that the registration statement was or had become false, inadequate, or misleading. The stop order, which was subject to court review, could temporarily or permanently stop the sale of securities covered by the registration statements. Id. at 6.

25/ Id. at 8.

the registration statement,[26/] and all written offers were required to meet the requirements of a statutory prospectus, the prospectus delivery requirements eliminated abbreviated sales literature. In addition, the prospectus was expected to "secure for potential buyers the means of understanding the intricacies of the transaction" and, at least, make investors aware that securities were "intricate merchandise."[27/] The impact may have been diminished by the fact that oral offers could be made, and sales consummated, without delivering the required prospectus until the security was delivered.[28/] But in any event, the prospectus was publicly available to those investors who were interested in obtaining one, and the elimination of potentially misleading sales literature during the prescribed waiting period provided a reasonable opportunity for the market as a whole to evaluate the merits of that security.

26/ Securities Act § 10, ch. 38, 48 Stat. 81 (1933), as amended 15 U.S.C. § 77j (1970). See H.R. Rep. No. 85, 73d Cong., 1st Sess. 8,21 (1933).

27/ H.R. Rep. No. 85, 73d Cong., 1st. Sess. 8 (1933).

28/ Although written offers were subject to the statutory prospectus requirements, oral offers were not. See Securities Act § 5, ch. 38, 48 Stat. 77 (1933), as amended 15 U.S.C. § 77e (1970). For obvious reasons, Congress did not intend to prevent salesmen from speaking to their customers concerning the issue. But see text accompanying note 30 infra.

Finally, civil liability for false or misleading information provided to investors in the course of the selling effort was imposed, jointly and severally, on the issuer, its officers and directors, the accountants and other experts authorizing and furnishing such information, the underwriters of the issue,[29/] and persons controlling any of the foregoing persons. The statute specified that persons other than the issuer could defend themselves by proving that they did not know, and by the exercise of due care, could not have known, a statement was false or misleading. The liability provisions were not only expected to produce full and accurate disclosures but also higher standards of ethical conduct in the distribution of securities issues. In discussing the civil liability provisions, the House Report stated:

> Their essential characteristic consists of a requirement that all those responsibile for statements upon the face of which the public is solicited to invest its money shall be held to standards like those imposed by law upon a fiduciary. Honesty, care, and competence are the demands of trusteeship . . . If it be said that the imposition of such responsibilities upon these persons will be to alter corporate organization and corporate practice in this country, such a result is only what your committee expects. The picture of persons, assumed to be responsible for

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29/ Securities Act §§ 11, 12, 15, ch. 38, 48 Stat. 82, 84, 77 (1933), as amended 15 U.S.C. §§ 77k, s, e, (1970).

> the direction of industrial enterprises, occupying 50 or more directorships of corporations is the best proof that some change is demanded. Directors should assume the responsibility of directing and if their manifold activities make real directing impossible, they should be held responsible to the unsuspecting public for their neglect. But to require them to guarantee the absolute accuracy of every statement that they are called upon to make, would be to gain nothing in the way of an effective remedy and to fall afoul of the President's injunction that the protection of the public should be achieved with the least possible interference to honest business. Whereas to insist upon the assumption of duties of trusteeship is to return the ancient truths of fair dealing. . .. Instead of impeding honest business, the imposition of liabilities of this character carries over into the general field of security selling, ethical standards of honesty and fair dealing common to every fiduciary undertaking. 30/

The disclosure obligations of the Securities Act were potentially applicable to all issuers of non-exempt securities, but only when new securities were offered to the public. In addition, the obligation to update the information provided in connection with an offering terminated upon completion of the distribution. Thus, Securities Act disclosure was designed specifically to confront the peculiar circumstances inherent in the distribution of securities to the public and, in view of the occasional nature of such distributions, did not assure a reliable source of information for investors continually buying and selling outstanding securities.

30/ H.R. Rep. No. 85, 73d Cong., 1st Sess. 5 (1933).

Exchange Act Disclosure

Securities trading markets are an extension of the capital raising function of the securities industry. Once securities are issued, they become the property of investors who, depending on their needs and objectives, may subsequently decide to transfer them to others. Securities trading markets therefore consist of investors continually buying and selling securities previously issued to the public. 31/ Aside from the legal distinctions imposed under securities laws, there is very little difference from an investor's point of view between a security purchased directly from an issuer and the same security acquired from another investor, except possibly the liquidity of the investment if there is no established secondary market for the security. Since trading markets provide a perpetual source of alternative investment opportunities with which issuers must compete when offering securities to the public, trading markets perform a central role in the capital allocation process. The Exchange Act, which had as its dominant purpose the regulation of securities trading markets, expanded the role of disclosure in the scheme of securities regulation in several important respects.

First, information essentially similar to that provided under the Securities Act was required to be filed with the

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31/ For an analysis of securities trading markets see Special Study, supra note 17, pt. 2.

Commission on a continuous basis. The framework for continuous disclosure was patterned after the listing requirements of the leading securities exchanges, and was intended to eliminate impediments which prevented the exchanges from "securing proper information for the investor." 32/ The Senate Report explained that:

> Although the exchanges have endeavored to bring about an improvement in the type of financial reports filed by corporations, they have been hampered by the terms of the listing contracts made with issuers, which they have not considered themselves entitled to modify without the consent of such issuers. Progress in this direction has been further retarded by the unwillingness of issuers to furnish adequate information, supported by the threat of withdrawal of their listings, and by the potential competition of exchanges having more lenient standards. Such impediments could not exist so far as a Federal regulatory body is concerned. The present bill would effectuate a reform which the exchanges themselves have been advocating for many years 33/

Absent artificial manipulation, the operation of securities trading markets as reliable indices of fair values was considered to be primarily dependent upon the availability of accurate information in the marketplace. Thus, in order to assure the general availability of such information, certain issuers were required to register outstanding securities by filing a registration statement containing required disclosures and to maintain the information current by filing periodic reports. Facsimile copies were not required to be

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32/ H.R. Rep. No. 1383, 73d Cong., 2d Sess. 13 (1934).

33/ S. Rep. No. 792, 73d Cong., 2d Sess. 5 (1934).

delivered to prospective investors but, on the other hand, investors purchasing securities in trading transactions were not ordinarily confronted with the organized selling effort that accompanied distributions of new securities issues. Assuming that all investors had reasonably equal access to current information concerning the business affairs of each issuer, the markets' evaluation of those issuers' outstanding securities was expected to reflect fair values. Thus, the Exchange Act requirements encouraged prompt disclosure of significant business developments and relied on the markets' interpretation of those developments to establish fair prices for outstanding securities.

Second, persons in control of publicly held corporations were considered fiduciaries who occupied positions of public trust. Consequently, provisions were enacted specifically: (i) to discourage insiders from profiting on inside information, and (ii) to prevent management from perpetuating itself through misuse of voting proxies. Because of the difficulties associated with determining what constituted "truly inside" information, the statute required officers, directors and beneficial owners of more than 10% of certain classes of equity securities to file reports with the Commission disclosing any changes in their ownership of such securities. The required disclosures, together with a provision authorizing suits to recover any profits realized by such persons from any purchase and sale or sale and purchase during a period of six months,

were expected to provide a remedy.[34/] The House Report indicated that the Committee was aware that the requirements were not "air-tight and that the unscrupulous insider" could still profit on inside information. It was hoped, however, that the publicity features of the Act would tend to "bring such practices into disrepute and encourage the voluntary maintenance of proper fiduciary standards by those in control of large corporate enterprises."[35/]

The proxy requirements were intended to prevent management from soliciting proxies unless shareholders were provided with an adequate explanation of the major questions of policy to be decided at shareholder meetings. The House Report stated that:

> Fair corporate suffrage is an important right that should attach to every equity security bought on a public exchange. Managements of properties owned by the investing public should not be permitted to perpetuate themselves by the misuse of corporate proxies. Insiders having little or no substantial interest in the properties they manage have often retained their control without an adequate explanation of the management policies they intend to pursue. Insiders have at times solicited proxies without fairly informing the stockholders of the purposes for which the proxies are to be used and have used such proxies to take from the stockholders for their own selfish advantage valuable property rights 36/

34/ Such persons were also prohibited from selling "short" and from failing to make delivery within 20 days following a sale. Exchange Act § 16(c), ch. 404, 48 Stat. 897 (1934), as amended 15 U.S.C. § 78p (1970).

35/ H.R. Rep. No. 1383, 73d Cong., 2d Sess. 13 (1934).

36/ Id. at 13-14.

In order to control the use of proxies, the Commission established rules and regulations restricting the manner in which proxies were solicited and providing minimum disclosure guidelines. 37/

Although the Exchange Act's disclosure framework provided important safeguards and protections for investors, and facilitated improvements in the operation of securities trading markets, policy considerations necessarily required balancing the burdens and costs of compliance with the public interest to be served. Thus, while Exchange Act disclosure was considered appropriate for large publicly held companies whose securities were actively traded in the

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37/ Section 14 proscribed the solicitation of proxies, consents or authorizations with respect to securities (other than exempt securities) registered on any national exchange "in contravention of such rules and regulations as necessary or appropriate in the public interest or for the protection of investors." Exchange Act § 14(a), ch. 404, 48 Stat. 895 (1934), as amended, 15 U.S.C. § 78n(a) (1970). The Commission first adopted rules in 1935 requiring information as to the action proposed to be taken at the meeting, the source of the solicitation and the interest of the solicitor. Exchange Act Release Release No. 378 (Sept. 24, 1935). In 1938, the rules were revised to require a "proxy statement" to be sent to each person whose proxy was being solicited. Exchange Act Release No. 2376 (Jan. 12, 1938). In 1940, the informal practice of submitting proposed material for inspection prior to the dissemination of definitive copies to shareholders was incorporated into a rule requiring proxy materials to be filed with the Commission for review 10 days prior to the date on which proxies were actually solicited. Exchange Act Release No. 2376 (Jan. 12, 1940). Two years later, annual reports to shareholders containing financial information for the last fiscal year were required to precede or accompany managements' solicitation of proxies relating to an election of directors. Exchange Act Release No. 3347 (Dec. 15, 1942).

securities markets, no one favored unnecessarily interfering with small local companies whose securities were infrequently traded among investors. In addition, it was not clear whether the Constitution would permit Congress to simply compel issuers of outstanding securities to disclose information, and the concurrence of management in the creation of a public market seemed to provide an essential nexus for imposing disclosure obligations.[38/] Implementing the system therefore involved differentiating a point at which trading interest in particular securities justified burdensome regulation and developing a practical method to include all of those securities within a regulatory framework.

When the Exchange Act was enacted, securities trading transactions were conducted on exchanges and in the over-the-

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38/ Congress was confident that the provisions finally enacted did not exceed constitutional limitations. But just in case the issue was presented to the Supreme Court, section 2 was drafted specifically to indicate the authority with which the law was enacted. Exchange Act § 2, ch. 404, 48 Stat. 881 (1934), as amended 15 U.S.C. § 78b (1970). See, e.g., 78 Cong. Rec. 7920 (1934) (Remarks of Congressman Frear: "There is a question of constitutionality, but we will not pass upon that. . . . [I]t is proper to submit that question to the Supreme Court."); Id. at 7715 (remarks of Congressman Wadsworth: ". . . section 2 is a speech, and I would advise you all to read it. I have never seen anything quite like it proposed in legislation . . .").

Several briefs on the constitutional issues were submitted to the House Committee on Interstate and Foreign Commerce. See Hearings on Stock Exchange Regulation Before the House Comm. on Interstate and Foreign Commerce, 73d Cong., 2d Sess. 917 et seq. (1934) [hereinafter cited as Hearings on Stock Exchange Regulation].

counter market. The exchanges were organized, self-regulated institutions that provided readily identifiable auction markets in which securities selected by each exchange were continually traded. Although the exchanges established different procedures for selecting securities, the nature of the auction process through which transactions were effected on an exchange necessarily limited exchange markets to trading in securities widely distributed among investors. By contrast, the over-the-counter market, which was defined to include all transactions in securities other than those occurring on an exchange, consisted primarily of numerous unregulated broker-dealer firms scattered throughout the country. The heterogeneity and disorganization of the over-the-counter market, together with the absence of information concerning its size, function and methods of operation, created a perplexing, and possibly less urgent, regulatory dilemma. Consequently, in devising the regulatory structure of the Exchange Act, Congress focused primarily on exchange markets and, rather than attempt to resolve questions associated with regulating the over-the-counter market, the entire problem was deferred to the Commission for resolution. Moreover, the detailed framework for corporate disclosure was superimposed on exchange listing requirements. Since exchanges selected a security for trading based on their ability to maintain a market in the security, whether or not the issuer agreed to comply with their listing requirements, not all securities that were traded on exchanges

were listed securities.[39/] Thus, Exchange Act disclosure encompassed only a segment, albeit an important one, of the securities actively traded in the securities markets.

Congress was aware that the emphasis on listed securities created an artificial classification that did not necessarily coincide with trading interest in outstanding securities, and believed that large publicly held corporations should not be permitted to circumvent Exchange Act disclosure obligations. Unlisted trading privileges were considered an anomaly and the statute was drafted to condition trading in any particular security on an exchange to compliance with exchange listing requirements. But in view of the potential impact of the measure on all but the New York Stock Exchange, Congress directed the Commission to study the issue and report to Congress by January 3, 1936 with its recommendations. Meanwhile, the Commission was given the power to permit a continuation of unlisted trading privileges in securities which had been admitted to trading prior to March 1, 1934.[40/]

39/ The New York Stock Exchange was the only exception. All of the other exchanges granted unlisted trading privileges. See Senate Report on Stock Exchange Practices, supra note 6, at 69-70; SEC, Report on Trading in Unlisted Securities Upon Exchanges 4-6 (1936) [hereinafter cited as Report on Unlisted Trading].

40/ Section 12(a) prohibited trading in a security on a national exchange unless "a registration is effective as to such security for such exchange in accordance with the provisions of this title and the rules and regulations thereunder." But section 12(f), in addition to directing the Commission to make a study of unlisted trading privileges, authorized the Commission in its discretion to adopt rules (1) permitting

(footnote continued on next page)

Trading in the over-the-counter market seemed to present a much more difficult problem for which there was no apparent solution. The Commission was therefore authorized to prescribe rules and regulations:

> . . . as necessary or appropriate in the public interest and to insure to investors protection comparable to that provided . . . in the case of national securities exchanges . . . Such rules and regulations may provide for the regulation of all transactions by brokers and dealers on any such market, for the registration with the Commission of dealers and/or brokers making or creating such a market, and for the registration of the securities for which they make or create a market and may make special provision with respect to securities or specified classes thereof listed, or entitled to unlisted trading privileges, upon any exchange on the date of the enactment of this title, . . . 41/

The Senate Committee explained that:

> It has been deemed advisable to authorize the Commission to subject such [manipulative] activities to regulation similar to that prescribed for transactions on organized exchanges. This power is vitally necessary to forestall widespread evasion of stock exchange regulation by the withdrawal of securities from listing on exchanges, and by transferring trading therein to "over-the-counter" markets where manipulative evils could continue to flourish, unchecked by any regulatory authority. Since the necessity for regulation of "over-the-counter" markets will depend largely on the extent to which

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40/ (footnote continued)
continuation of unlisted trading which had been carried on before March 1, 1934, and (2) extending until July 1, 1935 unlisted trading privileges in any security that was listed on March 1, 1934 and registered on any other national exchange. Exchange Act § 12, ch. 404, 48 Stat. 893-94 (1934).

41/ Exchange Act § 15, ch. 404, 48 Stat. 895 (1934).

> activities prohibited on exchanges are transferred to such markets, provision for their regulation has been made as flexible as possible. 42/

Since the securities of most large widely-held companies were traded on exchanges and the securities of small local companies were traded over-the-counter, the immediate problem was to prevent companies whose securities were traded on an exchange from moving into the over-the-counter market. No one knew the extent to which the Exchange Act's regulatory structure would affect exchange listings. On the one hand, the disclosure requirements imposed burdens and liabilities, both civil and criminal, that managements, even prudent managements, might prefer to avoid. 43/ On the other, the requirements only specified the manner in which information maintained in the files of well organized business should be prepared, and filing the information with the Commission would not be unduly burdensome in view of the advantages of an exchange market in the company's securities. 44/ The

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42/ S. Rep. No. 792, 73d Cong., 2d Sess. 6 (1933). See also Senate Hearings, supra note 6, at 6547 (Remarks of Thomas G. Corcoran, one of the principal drafters of the legislation: "It is almost impossible at the present time to draw any section more specific on the regulation of the over-the-counter securities.").

43/ E.g., 78 Cong. Rec. 8273, 8298-99 (1934) (Remarks of Senator Steiwer); Hearings on Stock Exchange Regulation, supra note 38, at 265 (Remarks of Eugene E. Thompson, President of the Associated Stock Exchanges).

44/ S. Rep. No. 792, 73d Cong., 2d Sess. 10 (1934).

delegation of authority to the Commission to require comparable disclosures as a condition to permitting broker-dealers to create to maintain a public market was considered broad enough to prevent corporations from immediately delisting their securities and, hopefully, sufficiently flexible to allow the Commission to establish an effective regulatory framework for securities traded in the over-the-counter market. Thus, the Exchange Act, as originally enacted, implemented an incomplete disclosure system that was dependent upon the development of comparable requirements for unlisted securities actively traded in the securities markets.

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C. Two Different Statutes--Two Separate Systems

The Commission recognized that the disclosure principles promulgated under the Exchange Act were applicable to both listed and unlisted securities and that one of its primary tasks was to devise a practical and effective plan for extending the Exchange Act's disclosure requirements to issuers of unlisted securities.[45/] The significance of such a plan was particularly evident in view of the fact that very few issuers of securities which had been admitted to unlisted trading were willing to voluntarily list their securities.[46/] Numerous issuers preferred to delist their securities rather than voluntarily comply with the Exchange Act's disclosure obligations,[47/]

45/ Report on Unlisted Trading, supra note 39, at 18. Before the Senate Committee on Banking and Currency, Chairman Landis testified that:

> My point is this: Congress has taken the position in the Securities Exchange Act that the public interest is served by getting out information about a corporation that has its securities on an exchange. It seems to me if securities are outstanding, whether or not they are on an exchange, the same principle is applicable, namely, that the public interest is to be protected by adequate information being obtained concerning the corporation.

Hearings on Trading in Unlisted Securities Upon Exchanges Before the Senate Comm. on Banking and Currency, 74th Cong., 2d Sess., pt. 2, at 31 (1936)[hereinafter cited as Senate Hearings on Unlisted Securities].

46/ Senate Hearings on Unlisted Securities, supra note 45, pt.1 at 4-9 (Remarks of Chairman Landis.).

47/ See Report on Unlisted Trading, supra note 39, at 8, Appendix IV.

and many large publicly-held companies, particularly banks and insurance companies, were not interested in an exchange market for their securities. 48/ Moreover, the Commission concluded that: (a) an abrupt termination of unlisted trading privileges on exchanges could result in an accelerated movement of securities among exchange markets and from exchanges to the over-the-counter market, thus causing an extraordinary disruption in the financial community 49/ and (b) the authority delegated to the Commission to regulate the over-the-counter market did not provide a practical basis for imposing comparable disclosure obligations on issuers whose securities were traded in the over-the-counter market. 50/ The Commission pointed out the close interrelation between the problem of obtaining information concerning securities admitted to unlisted trading on exchanges and the problem of obtaining information concerning securities traded in the over-the-counter market, and suggested that "[a] plan successful for

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48/ Senate Hearings on Unlisted Securities, supra note 45, pt. 1, at 9 (Remarks of Chairman Landis).

49/ See Report on Unlisted Trading, supra note 39, at 8, 14-16; Senate Hearings on Unlisted Securities, supra note 45, pt. 2, at 20 (Remarks of Chairman Landis).

50/ The major problem with attempting to induce disclosure by imposing requirements on broker-dealers was that such a system would impose burdens on those who might have little or no control over an obdurate issuer. See Report on Unlisted Trading, supra note 39, at 18-20; H.R. Rep. No. 2601, 74th Cong., 2d Sess. 4 (1936).

one would be successful for the other." [51/] In the absence of an immediate solution, the Commission presented a plan to Congress that was expected to gradually extend most of the Exchange Act's disclosure obligations to issuers of unlisted securities.

The scheme devised by the Commission basically involved three structural changes in the Exchange Act, but only two of the necessary changes were incorporated in the Commission's 1936 legislative effort.[52/] Moreover, the plan was based on the conviction that it was preferable to maintain an exchange market for securities which could be traded on an exchange, rather than have trading in those securities conducted in the over-the-counter market. Investors were perceived as benefitting from the accessibility of an exchange market. Further, the exchange mechanism facilitated the Commission's efforts to check manipulative and deceptive practices.[53/] Because the program would

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51/ Report on Unlisted Trading, supra note 39, at 17.

52/ The Commission's plan was presented in the Report on Unlisted Trading, supra note 39. The Commission's legislative proposals were examined in the congressional hearings on trading in unlisted securities. See Senate Hearings on Unlisted Securities, supra note 45, pts. 1, 2 & 3; Hearing on Unlisted Securities Before the House Comm. on Interstate and Foreign Commerce, 74th Cong., 2d Sess. (1936) [hereinafter cited as House Hearing on Unlisted Securities].

53/ Report on Unlisted Trading, supra note 39, at 16.

require a period of years to implement,[54/] it was dependent upon the continuation of the existing market equilibrium. Thus, the first element in the plan involved preventing the termination of unlisted trading privileges on exchanges without undermining the Exchange Act's disclosure framework.

The Commission recommended that, upon application by an exchange and approval by the Commission, unlisted trading privileges should be continued in securities that came within three carefully circumscribed categories.[55/] The first category grandfathered, for the time being, securities admitted to unlisted trading prior to March 1, 1934. The provision was clearly inconsistent with the policy considerations underlying Exchange Act disclosure, since issuers in this category would have the advantages of an exchange market without complying with the disclosure obligations imposed on fully listed securities. However, the Commission reported, and the Congress concurred, that an abrupt termination of such trading would probably cause "more harm than good."[56/]

54/ See House Hearing on Unlisted Securities, supra note 52, at 11 (Remarks of Chairman Landis: "It will be a program that will perhaps take 10 or 15 years of fulfillment before we get to a degree of investment information about the over-the-counter securities comparable to that about securities listed on exchanges.").

55/ See Exchange Act § 12(f), ch. 462, §1, 49 Stat. 1375 (1936).

56/ H.R. Rep. No. 2601, 74th Cong., 2d Sess. 2 (1936); S. Rep. No. 1739, 74th Cong., 2d Sess. 2 (1936).

Moreover, the number of securities in this category was expected to "gradually diminish through retirement, redemption, liquidation, reorganization, or the transition of seasoned securities to a listed status." [57/] The second category was comprised of securities duly listed and registered on another national securities exchange and, thus, the issuer was already subject to the Exchange Act's disclosure requirements. This provision was designed specifically to facilitate the continued existence of the regional exchanges. [58/] The third category included securities with respect to which information was publicly available that was substantially equivalent to that required for securities listed on a national exchange. This provision anticipated the development of comparable disclosure requirements for issuers of unlisted securities, and was intended to permit the creation of an exchange market, even over the objection of the issuer's management, but only in those circumstances where the existence of such a market was in the public interest. [59/]

The second element in the plan was to require future registrants under the Securities Act to undertake to comply with the periodic reporting provisions of the Exchange Act's disclosure framework. This aspect of the plan was enacted

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57/ Id.

58/ See Report on Unlisted Trading, supra note 39, at 15.

59/ See text accompanying note 65 infra.

as section 15(d) of the Exchange Act [60/] and was intended to effectuate the policy previously enunciated in section 15 concerning securities publicly-held and traded in the over-the-counter market. [61/] The statute limited the required disclosures to issuers of substantial size by specifying that: (a) the undertaking would become operative only if the aggregate offering price of the issue, plus the aggregate value of all other securities of the same class outstanding, amounted to $2 million or more, (computed on the basis of the issue's offering price) and (b) the duty to file such reports pursuant to the undertaking would automatically be suspended if, but only so long as, the aggregate value of all outstanding securities of the class in question was reduced to less than $1 million (computed on the basis of the offering price of the last offering of such securities to the public). The undertaking was also suspended if the issuer made substantially equivalent reports under the Exchange Act because that class, or any other class, of securities was listed on a national exchange. Since the registration statement filed by issuers of listed securities under the Exchange Act contained essentially the same information as that required under the Securities Act, section 15(d) was expected to gradually

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60/ Exchange Act § 15(d), ch. 404, 58 Stat. 895 (1934); § 3, ch. 462, 49 Stat. 1377 (1936).

61/ H.R. Rep. No. 2601, 74th Cong., 2d Sess. 5 (1936); S. Rep. No. 1739, 74th Cong., 2d Sess. 4 (1936). See text accompanying note 41 supra.

extend the registration and periodic reporting requirements of the Exchange Act's disclosure framework to issuers of unlisted securities.

The third and final element of the plan concerned the proxy disclosure obligations in section 14, and the insider trading provisions in section 16 of the Exchange Act.[62/] With respect to proxy disclosure, the Commission thought that, by subjecting solicitations through the mails or by an an instrumentality of interstate commerce to the rules and regulations promulgated by the Commission, the proxy requirements could be expanded to include all issuers whose size and security distribution justified imposing such requirements.

Section 16 presented a different problem in the sense that the Commission believed that the duty of disclosure and accountability for trading profits imposed thereunder was dependent upon the voluntary action of management in seeking an exchange market. When management did not choose to assume those obligations, the Commission did not see a practical means to compel compliance. However, based on the theory that, under appropriate conditions, an exchange market was in the public's best interest,[63/] the Commission believed that it would not be desirable either to (1) prevent an exchange market in particular securities from coming into existence for the

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62/ See Report on Unlisted Trading, supra note 39, at 21-23

63/ See text accompanying note 53 supra.

sole reason that insiders would not be required to comply with requirements comparable to those provided in section 16, or (2) to permit management to control the existence of an exchange market by simply refusing to comply with the duties imposed by section 16. Thus, assuming that issuers of unlisted securities were required to comply with registration and periodic reporting requirements comparable to those imposed on issuers of listed securities, and further, that section 14 was extended to both listed and unlisted securities, most of the information required with respect to listed securities would also be publicly available with respect to certain unlisted securities. Thus, in view of the policy considerations in favor of an exchange market, the Commission suggested that it should be authorized to permit exchanges to create a market in unlisted securities, even though managements might refuse to accept the duties specified in section 16, at least until a method was developed to compel managements to comply with the duties contained in section 16.[64/] Congress

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64/ The Commission somewhat optimistically stated that:

> A weakening of the obligations under section 16 is . . . not an essential outcome of the application of the principles above enunciated. It may be that upon a full consideration of the suggestions above advanced, factors, still unknown, will make possible complete comparability of obligation with reference to certain types of presently unregistered and registered securities and thus make possible the existence of an exchange market in all cases where the public interest is best served by such a market.

Report on Unlisted Trading, supra note 39, at 22-23.

adopted the Commission's position and the discretionary authority both to approve the creation of an exchange market in certain unlisted securities, if disclosure "substantially equivalent" to that required with respect to listed securities was publicly available, and to exempt those issuers from the provisions of section 16, was provided in connection with the continuation of unlisted trading privileges.[65/]

Although Congress responded to the Commission's recommendations by making the structural changes that were requested,

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65/ Under clause (3) of section 12(f), the Commission was authorized to:

> . . . extend unlisted trading privileges to any security in respect of which there is available from a registration statement and periodic reports or other data filed pursuant to rules or regulations prescribed by the Commission under this title or the Securities Act of 1933, as amended, information substantially equivalent to that available pursuant to rules or regulations of the Commission in respect of a security duly listed and registered on a national securities exchange, but such unlisted trading privileges shall continue in effect only so long as such a registration statement remains effective and such periodic reports or other data continue to be so filed.
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> . . . No application to extend unlisted trading privileges to any security pursuant to clause (3) of this subsection shall be approved except upon such terms and conditions as will subject the issuer thereof, the officers and directors of such issuer, and every beneficial owner of more than 10 per centum of such security to duties substantially equivalent to the duties which would arise pursuant to this title if such security were duly listed and registered on a national securities exchange; except that such terms and conditions need not be imposed in any case or class of cases in which it shall appear to the Commission that the public interest and the protection of investors would nevertheless best be served by such extension of unlisted trading privileges. . ..

Exchange Act § 12(f), ch. 404, 48 Stat. 892 (1934); § 1, ch. 462, 49 Stat. 1375 (1936).

the Commission did not propose amending section 14 at that time.[66/] Thus, the subtle scheme prepared by the Commission was not fully implemented in 1936 and, for some unrecorded reason, subsequently abandoned. In 1941, the two New York stock exchanges recommended extending the requirements of sections 14 and 16 to issuers with more than $3 million in assets, no fewer than 300 shareholders, and which were engaged in interstate commerce or the securities of which were traded in an interstate market.[67/] The Commission did not urge Congress to adopt the proposal because it would "materially extend" the applicability of both sections beyond their present limits and the Commission did not desire any "expansion of the area of its jurisdiction."[68/]

Five years later, the Commission prepared a second plan for extending the Exchange Act's disclosure requirements to large publicly-held issuers of unlisted securities. The proposal incorporated the earlier recommendations of the

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66/ See Senate Hearings on Unlisted Securities, supra note 45, pt. 2, at 39. The Commission first exercised its power to adopt rules regulating the solicitation of proxies in late 1935 and, in view of the number of existing administrative details imposed under the securities laws, an extension of the Commission's jurisdiction may have seemed premature at that time. See note 37 supra.

67/ SEC, Report on Proposals for Amendments to the Securities Act of 1933 and the Securities Exchange Act of 1934, printed for House Comm. on Interstate and Foreign Commerce, 77th Cong., 1st Sess. 35-36 (Comm. Print 1941) [hereinafter cited as SEC Report on Proposals].

68/ Id.

New York stock exchanges into a more comprehensive statutory amendment that would require any company which had both $3 million in assets and 300 security holders to comply with all of the disclosure requirements of sections 12, 13, 14 and 16, whether or not a registration statement was filed under the Securities Act. The technique employed by the Commission, which reflected a reappraisal of the constitutional problems previously associated with simply compelling issuers of outstanding securities to provide required disclosures, avoided the subtle intricacies of the plan presented in 1936. In presenting its proposal to the Congress, the Commission outlined the compelling arguments in favor of such an amendment as follows:

> SIRS: There is submitted herewith a report of the Securities and Exchange Commission recommending an amendment to the Securities Exchange Act of 1934 which would extend to investors in certain unregistered securities the protections now enjoyed by investors in securities which are registered by their issuers with this Commission. The purpose of the amendment is to eliminate a double standard with respect to the protection of investors which--more as a result of accident than of design--has developed over the past 13 years. The effect of the securities acts adopted by Congress since 1933 has been to afford various essential protections to investors in certain companies while leaving unprotected the investors who buy and sell securities issued by other companies of comparable size, importance, and public interest.
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> As a result of existing legislation, it is possible for investors to obtain reliable information with respect to securities which are registered by their issuers on securities exchanges, and with respect to registered public utility holding companies and subsidiaries and registered investment trusts. Corporations issuing such securities file with the Commission current reports on their finan-

cial position. Since these reports are public information, the investor can buy or sell on the basis of something other than "tips" and "trends." The investor in these securities also enjoys a more effective voice in the management of his corporation. When his proxy is solicited he is not faced with the alternatives of giving a blank check to the soliciting persons or of foregoing the right to vote altogether. The Commission's proxy rules require that the security holder be given the information necessary to an intelligent exercise of his voting rights; he must be given an opportunity to indicate his wishes separately with respect to all matters which are expected to arise at the meeting; and he is also given a reasonable opportunity to present his own proposals and views to the other security holders. Another of the basic protections enjoyed by the investor in such registered securities is the safeguard against trading abuses by "corporate insiders"--that is, by officers, directors, and principal stockholders. Short-term trading profits by corporate insiders in the equity issues of the registrant may be recovered by the corporation. Such insiders are forbidden to sell short the equity securities of their own corporations. Moreover, any trading in these securities in which such insiders engage must be promptly reported and is made public at once.

These protective provisions are contained in sections 12, 13, 14, and 16 of the Securities Exchange Act and in parallel provisions of the Public Utility Holding Company Act and the Investment Company Act. As a result of the limited coverage of these provisions, a security which is not listed on a national securities exchange, unless it happens to be a registered public utility or investment company security, lacks these vital protective features. Commission surveys show that these unregistered securities are commonly bought and sold on the basis of information which is at best inadequate and sometimes misleading. Financial statements of the issuers of such securities are bare and uninformative; they lack much of the information needed for an informed appraisal of the issuer's securities. Proxies are usually powers of attorney conferring blanket authority upon the soliciting persons, and the information to guide the security holder in the execution of the proxy instrument is withheld. The stockholder is provided with so little information that at times, when solicited

for his proxy in connection with the election of directors, even the names of the nominees are not disclosed. Moreover, the stockholder has no way of knowing whether and to what extent corporate insiders are utilizing their inside information at his expense.

The only provisions of the securities acts applicable to unregistered securities are those which outlaw fraudulent and manipulative practices. Within the limits of its manpower, the Commission has sought to carry out the statutory mandate with respect to unregistered securities. It has discovered, however, that in this as in other matters, correction is not as effective as prevention; that security holders are much more adequately protected when issuers and corporate insiders are under an obligation to supply information.

The importance of requiring such information is considerably enhanced by current and prospective conditions in the business world. The manner in which some corporate insiders have taken advantage of their private knowledge during the war years illustrates what may be expected in years to come. Insiders having advance information have frequently been enabled to exploit their advantage to buy up publicly held unregistered securities at depressed prices. This and similar patterns of fraud recur again and again in the files of the Commission.

The Commission proposes at this time that the safeguards relating to registered securities be extended to cover the securities of large unregistered corporations which have one or more issues widely held. . .. The legislative history of the Securities Exchange Act discloses that the proposal which the Commission is making at this time is simply a means of attaining Congress' original objective as declared in 1934--the objective of providing equal protection to all investors, whether on the organized exchanges or over-the-counter. The principal factor which prevented Congress from carrying out this intention at that time was its uncertainty as to the nature and scope of the issuers of unregistered securities and the conditions under which such securities were traded. The feasibility of extending the protective disclosure provisions to securities which were not traded upon the exchanges was not then established.

. . .

> The proposed amendment, it should be noted, would put an end to any tendency on the part of corporate management to select that market for its security holders which is available with fewest restrictions upon management. Any tendency on the part of management to deny security holders the facilities of an organized securities exchange in order to avoid the attendant disclosure responsibilities would disappear. The exchanges and over-the-counter markets would then be on a truly competitive basis with the governing consideration being the service which each can supply the investor. That investors would benefit from such increased competition can scarcely be questioned. The New York exchanges have gone on record in the past in support of a program comparable to that proposed here.
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> . . .
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> In essence, what is proposed is a moderate and overdue extension of provisions which are at the heart of the Securities Exchange Act and which are basic to the Public Utility Holding Company Act and the Investment Company Act--provisions which are essentially informational, which have operated smoothly and successfully, and with which there can be no quarrel in principle. It is an extension which is badly needed and easily effected 69/

Despite the nature of the proposal, and the reasons in favor of its adoption, the necessary changes were not enacted. The plan subsequently formed the basis of repeated attempts to eliminate the disparity between listed and unlisted securities in the securities markets, none of which were successful. 70/ Finally, the Securities Acts Amendments of 1964 71/ expanded the scope of the Exchange Act's disclosure framework basically along the lines suggested in the Commission's 1946 proposal.

69/ SEC, Proposal to Safeguard Investors in Unregistered Securities, H.R. Doc. No. 672, 79th Cong., 2d Sess. v-viii (1946).

70/ For a detailed analysis of the legislative history of the Commission's proposals to expand the scope of the Exchange Act's disclosure framework see II L. Loss, Securities Regulation 1152-54 (1961); S. Rep. No. 379, 88th Cong., 1st Sess. 14-19 (1963).

71/ Pub. L. No. 88-467, 78 Stat. 565, 15 U.S.C. §§ 77d, 78c, l-o, o-3, p, t, w, ff, (1970).

During the interim, however, the structure of the Exchange Act framework had a significant impact on both the securities trading markets and the Commission's disclosure policy.

Since issuers of listed securities voluntarily agreed to comply with exchange listing requirements and, thus, subjected themselves to the Exchange Act's disclosure requirements, the inability to impose comparable disclosure obligations on issuers that preferred not to comply with those requirements created a curious regulatory phenomenon. The principal persons to be regulated could decide whether to submit themselves to regulation. Aside from any moral arguments in favor of making the required disclosures, issuers could only be expected to assume the obligations imposed on listed securities as long as the benefits from an exchange market exceeded the costs inherent in the assumption of those obligations. The over-the-counter market may not have been as organized as exchange markets when the Exchange Act was enacted, but for a large number of issuers, the advantages of an exchange market for their securities did not exceed the costs of subjecting themselves to the Exchange Act's disclosure requirements. 72/ Moreover, as the over-the-counter market became more efficient through technological developments and increased trading activity, fewer issuers perceived any additional benefit, after incurring the costs of Exchange Act regulation, from an exchange market for their securities. Although section 15(d) minimized the dis-

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72/ See note 47 supra.

parity between issuers of listed securities and certain issuers registering securities under the Securities Act, issuers of unlisted securities, as a group were required to comply with less stringent, and considerably less pervasive, disclosure obligations. Thus, the structure of the Exchange Act's disclosure framework encouraged the development of the over-the-counter market, with the resulting adverse impact on the effectiveness of the Exchange Act disclosure system.

Similarly, attempts to improve and refine Exchange Act disclosure could only exacerbate the disparity by providing additional burdens for issuers to consider in connection with any existing advantages of an exchange market, and would therefore have been self-defeating. Consequently, the Commission focused its primary attention on Securities Act disclosure. Despite its sporadic nature, Securities Act disclosure could be administered effectively without the concern that by doing so it might have an unwise or unacceptable impact on the securities markets. 73/ For some unknown reason, the Commission did very little to encourage compliance with the Exchange Act's disclosure requirements by minimizing the disclosure required in connection with the distribution of new securities issues, particularly since substantially similar information

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73/ The impact of the Exchange Act's disclosure framework on disclosure policy was considered by the Commission in the Wheat Report, supra note 11, at 57-62.

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was provided under the Exchange Act on a continuous basis.[74/] Thus, for all practical purposes, the Commission administered two separate disclosure systems under the Securities Act and the Exchange Act.

74/ See Report on Unlisted Trading, supra note 39, at 19-20 ("To induce registration the requirements of disclosure as to those who seek new financing might justifiably be made less onerous for issuers who have theretofore registered either under section 12 of the Exchange Act or under a similar scheme of registration for over-the-counter issues than for issuers who have not so registered . . .") For an analysis of the Commission's efforts to tailor the contents of the Securities Act prospectus to meet particular disclosure needs see Wheat Report, supra note 11, at 68-80.

D. The Trend Towards One Integrated System

The 1964 Amendments altered the Exchange Act system of corporate disclosure in several important respects. The registration, periodic reporting, proxy and insider trading provisions of section 12, 13, 14 and 16 were expanded to include, in addition to securities listed on a national exchange, unlisted securities for which the costs and burdens of those requirements were not considered disproportionate to the public interest to be served.[75/] Since the solicitation of proxies and insider trading were only rarely problems related to debt securities, and then usually in insolvency cases when other protections were available,[76/] the scope of the extension, which became section 12(g), was limited to classes of equity securities, other than

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75/ The 1964 Amendments were preceded by the Commission's Special Study, a primary purpose of which was to answer all unresolved questions concerning an extension of Exchange Act disclosure to unlisted securities. For an analysis of the factors considered in connection with the scope of the extension see Special Study, supra note 17, pt. 3, at 17-35; S. Rep. No. 379, 88th Cong., 1st Sess. 19-21 (1963).

76/ Special Study, supra note 17, pt. 3, at 34-35. The Special Study also noted that section 314(a)(1) of the Trust Indenture Act of 1939 already authorized the Commission to require issuers qualifying indentures under the 1939 Act to comply with the reporting requirements of section 13 of the Exchange Act
(footnote continued on next page.)

exempt securities, that were (i) issued by an issuer with total assets exceeding $1 million, and (ii) held of record by at least 500 persons.[77/] The obligations imposed under section 12(g) could not be terminated by the issuer unless each class of its equity securities was held of record by less than 300 shareholders.[78/] The provision therefore effectively eliminated the concern that issuers could circumvent astringent disclosure obligations by simply delisting their securities from an exchange. Section 15(d) was also revised to require issuers registering securities under the Securities Act to continue filing the periodic and other reports specified in section 13, unless, but only so long as, (i) any issue of securities of such an issuer was registered pursuant to section 12, or (ii) each class of securities to which the registration statement related was held of record by less

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(continuation of footnote 76)
in the event that such companies were not otherwise required to do so, and suggested that the power could by exercised to adequately protect investors. Id. The Commission has never exercised the power vested by section 314(a)(1) of the 1939 Act and the retention of section 15(d) of the Exchange Act obviated the necessity for doing so. See text accompanying note 79 infra.

77/ Securities Acts Amendments of 1964 § 3(c), Pub. L. No. 88-467, 78 Stat. 566 (1964), as amended 15 U.S.C. § 78l(g) (1970). The extension was implemented in two phases beginning with classes held of record by more than 750 persons and, two years later, requiring registration of classes held of record by more than 500 persons. Id.

78/ Exchange Act § 12(g)(4), 15 U.S.C. § 78l(g)(4) (1970).

than 300 persons.[79/] Thus, for securities registered under the Securities Act that did not meet the tests enumerated in section 12, section 15(d) established minimum continuing disclosure obligations.[80/]

In addition, section 14 was amended to require issuers to transmit to shareholders information substantially equivalent to that previously required only in connection with proxy solicitations.[81/] Under the Exchange Act system, the proxy rules provided the only disclosures that were required to be delivered directly to security holders. Consequently, as the proxy rules evolved, the proxy statement and the annual report to shareholders were considered particularly relevant disclosure documents. However, since the proxy rules were originally intended to prevent corporate managements from

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79/ Exchange Act § 15(d), 15 U.S.C. § 78o(d) (1970).

80/ The Special Study recommended extending the requirements of sections 12, 13, 14 and 16 to classes of equity securities that were held of record by 300 or more persons, without regard to the amount of the issuer's assets. Special Study, supra note 17, pt. 3, at 60-62. Adoption of that recommendation, together with the Commission's power in section 314(a)(1) of the 1939 Act, would have eliminated the necessity for section 15(d) of the Exchange Act. The Senate Committee's Report indicated, however, that companies registering equity securities under the Securities Act that did not meet the proposed test of section 12(g) were not large enough to justify imposing the proxy and insider trading provisions at that time "in the light of administrative burdens" that such a measure would create S. Rep. No. 379, 88th Cong., 1st Sess. 27 (1963).

81/ Exchange Act § 14(c), 15 U.S.C. § 78m(c) (1970).

misusing corporate proxies, proxy disclosure was only required in connection with proxy solicitations. But the decision of management not to solicit proxies, thereby avoiding the proxy disclosure requirements, came to be viewed as an abuse in and of itself.[82/] Section 14(c) was justified as a measure to prevent evasion of the proxy rules. However, since the information statement contemplated by section 14(c) involved situations where proxies were not solicited, the provision expanded the policy considerations underlying section 14 to include direct dissemination of information to security holders, even though such information was also included in reports filed with the Commission and generally available to the investing public.[83/] Thus, the disclosure required under section 14 has gradually assumed the role of periodically providing updated information to security holders concerning their investment.

The adjustments in the structure of the Exchange Act disclosure framework successfully eliminated the disparity in the obligations previously imposed on issuers of comparable signif-

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82/ See S. Rep. No. 379, 88th Cong., 1st Sess. 24-25 (1963); SEC Report on Proposals, supra, note 67, at 35.

Prior to the 1964 Amendments, the New York Stock Exchange required, and the American Stock Exchange was beginning to require, issuers of securities listed on their exchanges to solicit proxies each year, thus indirectly assuring compliance with the proxy disclosure requirements by those issuers.

83/ See also text accompanying note 114 infra.

icance and established a solid foundation on which to develop a more meaningful corporate disclosure system. The Report of the Special Study indicated areas in which improvements could be made administratively[84/] and, in addition, the prospect of continually updated information substantially equivalent to that provided in a current Securities Act registration statement stimulated considerable interest in integrating the disclosure systems of both Acts by strengthening the Exchange Act system in terms of quality, currency and accessibility of filed data, and then eliminating burdens under the Securities Act that became essentially superfluous.[85/] As the Commission proceeded to consider rules, regulations and internal policies that could result in either a less burdensome or more effective disclosure system, the courts began to impose substantial continuing disclosure obligations on public companies under Rule 10b-5 and Congress expanded the Exchange Act disclosure framework with amendments requiring disclosure in connection with tender offers and certain other matters affecting control of publicly held companies. Developments in all three areas have contributed to the structure of the present disclosure system.

E. Prompt Dissemination of Material Corporate Information

Following World War II, public companies began to demonstrate an increasing tendency to publicize corporate affairs and to

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84/ See Special Study, supra note 17, pt. 3, at 58-60.

85/ See Cohen "Truth in Securities Revisted," 79 Harv. L. Rev. 1340 (1966).

provide disclosures beyond those required under the federal securities laws. In 1957, the Commission commended companies that recognized the importance of informing both security holders and the public of important business and financial developments, suggesting that the trend should be encouraged. 86/ Shortly thereafter, the Commission became aware of signs indicating that public relations consultants and corporate public relations departments were being employed to influence investment decisions in a manner contrary to the policies underlying the federal securities laws. 87/ Consequently, the Special Study devoted a section of its Report to an analysis of corporate publicity and public relations activities. 88/ The Report documented potential abuses in the manner in which corporations were disseminating information to the public and expressed concern with the absence of appropriate regulatory controls. 89/ The Special Study concluded that

> [c]onsideration should be given to the enactment of a statute providing criminal sanctions and civil liability for intentional or reckless dissemination by issuers or their agents, of false and misleading statements 90/

86/ Securities Act Release No. 3844 (Oct. 8, 1957).

87/ E.g., In re Carl M. Loeb, Rhoades & Co. and Dominick & Dominick, 38 S.E.C. 843 (1959); In re G. J. Mitchell, Jr., Co., Exchange Act Release No. 6433 (Dec. 13, 1960).

88/ Special Study, supra note 17, pt. 3, at 65-102.

89/ Id. at 93-99.

90/ Id. at 99.

Since the Special Study, however, judicial interpretations of section 10(b) of the Exchange Act, and Rule 10b-5 thereunder, 91/ have mitigated the necessity for a new statute.

The courts began to focus on the problems created by materially misleading statements in corporate press releases in SEC v. Texas Gulf Sulphur. 92/ Two press releases were involved, one presenting a generally pessimistic view of the company's explorations and the other, four days later, detailing the extent of a valuable mineral strike. Disparities between the two releases, and their impact on the securities markets, provided a dramatic precedent for imposing a duty on corporate managements to disseminate complete and accurate information concerning material corporate developments. In its opinion, the Second Circuit explained that:

> The dominant congressional purposes underlying the Securities Exchange Act of 1934 were to promote free and open public securities markets and to protect the investing public from suffering inequities in trading, including, specifically, inequities that follow from trading that has been stimulated by the publication of false or misleading corporate information releases. 93/

Although Texas Gulf Sulphur involved insider trading, as have most of such cases under Rule 10b-5, the court clearly

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91/ 15 U.S.C. § 78j(b) (1970); 17 C.F.R. § 240.10b-5 (1976).

92/ 258 F. Supp. 262 (S.D.N.Y. 1966), rev'd 401 F.2d 833 (2d Cir. 1968), cert. denied sub. nom. Coates v. SEC, 394 U.S. 976 (1969). The Texas Gulf Sulphur litigation involved 4 different actions and 24 reported decisions.

93/ 401 F.2d at 858.

indicated that insider transactions were not necessary to create a cause of action for materially false or misleading press releases.[94/] The court stated, however, that where a valuable corporate purpose was served by delaying publication, the timing of disclosure was subject, "within the affirmative disclosure requirements promulgated by the exchanges and by the SEC", to the business judgment of those entrusted with the management of the corporation. But during the interim, those persons could not be permitted to deal personally in the corporation's securities or provide confidential information to others for their personal gain.[95/]

In 1970, the Commission published its policy concerning timely disclosure of material corporate developments. The Release cautioned issuers that:

> Notwithstanding the fact that a company complies with . . . reporting requirements [under section 13 of the Exchange Act], it still has an obligation to make full and prompt announcements of material facts regarding the company's financial condition . . ..
> . . .

94/ Id. at 860. Accord, Mitchell v. Texas Gulf Sulphur Co., 446 F.2d 90, 101 (10th Cir.), cert. denied, 404 U.S. 1004 (1971).

95/ SEC v. Texas Gulf Sulphur, 401 F.2d 833, 850 n. 12 (2d Cir. 1968). Accord, Financial Indus. Fund, Inc. v. McDonnell Douglas Corp., 474 F.2d 514 (10th Cir. 1973), cert. denied 414 U.S. 874 (1973) (absent insider trading, the exercise of good-faith judgment in the timing of disclosures provided a defense under Rule 10b-5 for delaying disclosure of a material development).

> Not only must material facts affecting the company's operations be reported; they must be reported promptly. Corporate releases which disclose . . . favorable developments but do not even suggest existing adverse corporate developments do not serve the public needs and may violate the antifraud provisions of the Securities Exchange Act of 1934. 96/

The courts have also implied that companies have an obligation to make full and prompt announcements, but the parameters of such an obligation, absent insider trading, have not been considered directly by the courts. 97/

F. Changes In Control Of Publicly Held Companies

The 1968 amendments to the Exchange Act 98/ were enacted in response to the increased use of cash tender offers and other techniques for acquiring control of publicly held companies, which did not require disclosure under the federal securities laws. 99/ While disclosure concerning a proposed

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96/ Exchange Act Release No. 8995 (Oct. 15, 1970).

97/ See Financial Indus. Fund, Inc. v. McDonnell Douglas Corp., 474 F.2d 514 (10th Cir. 1973), cert. denied, 414 U.S. 874 (1973); Chris-Craft Industries, Inc. v. Bangor Punta, 426 F.2d 569, 579 (2d Cir. 1970) (Lumbard, J., dissenting). For an analysis of the potential prophylactic effect of the substantial liabilities imposed under Rule 10b-5 for negligently prepared releases of information, see SEC v. Texas Gulf Sulfur, 401 F.2d 833, 866-68 (Friendly, J., concurring) ("If the only choices open to a corporation are either to remain silent . . . or to make a communication, not legally required, . . . most corporations would opt for the former.").

98/ Pub. L. No. 90-439, 82 Stat. 454, 15 U.S.C. §§ 78m(d)-(e), n(d)-(f) (1970).

99/ In 1960, there were only eight cash tender offers involving companies with securities listed on a national exchange as compared to over 100 in 1966. H.R. Rep. No. 1711, 90th Cong., 2d Sess. 2 (1968); S. Rep. No. 550, 90th Cong., 1st Sess. 2 (1967).

change in corporate control was required in connection with proxy contests and exchange offers, large blocks of stock could be acquired through cash tender offers, market transactions and other arrangements in almost complete secrecy.[100/] When a cash tender offer occurred, shareholders were simply presented with an offer to buy all or a specified portion of their holdings, usually at a price exceeding the current market value, which they could either accept or reject. In other situations, controlling interests were accumulated in market transactions, or through other arrangements, without any indication of a proposed change in management. Congress did not want to discourage corporate takeovers because they served a useful purpose in providing "a check on entrenched but inefficient management".[101/] On the other hand, the secrecy surrounding changes in corporate control of publicly held companies was considered inconsistent with the disclosure theory of investor protection, particularly in view of the disclosure required in comparable situations.

Sections 13(d) and 14(d) of the Exchange Act[102/] were designed to assure the public availability of relevant information con-

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100/ Proxy contests are subject to the disclosure requirements of Rule 14a-11 (special provisions applicable to election contests), in addition to the requirements otherwise imposed in connection with a solicitation of proxies. See 17 C.F.R. § 240. 14a-11 (1976). Exchange offers are subject to the registration and prospectus delivery requirements of the Securities Act.

101/ H.R. Rep. No. 1711, 90th Cong., 2d Sess. 3 (1968); S. Rep. No. 550, 90th Cong., 1st Sess. 2 (1967).

102/ 15 U.S.C. §§ 78m(d), n(d) (1970.

cerning acquisitions of substantial interests in publicly held companies.[103/] In the absence of information concerning a proposed change in corporate control, investors were forced to make investment decisions based on a market price that did not necessarily reflect a fair evaluation of the target company's securities because the persons seeking control of a company possessed information concerning themselves and their plans that might substantially change the assumptions underlying the market value of those securities.[104/] Section 13(d) focused primarily on the acquisition of large blocks of stock in market transactions and other arrangements. Certain persons acquiring a beneficial interest in more than 5 percent[105/] of a company's equity securities were required to file with the issuer, the Commission and each exchange on which the securities were traded, a statement containing information concerning the transaction.[106/] Section 14(d) was intended to deal specific-

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103/ Although originally limited to securities registered pursuant to section 12, and to equity securities issued by a closed-end investment company registered under the Investment Company Act of 1940, both sections were subsequently amended to include equity securities of an insurance company which would have been required to register under section 12 absent the exemption contained in section 12(g)(2)(G). Act of December 22, 1970 § 1, 15 U.S.C. §§ 78m(d), n(d) (1970).

104/ H.R. Rep. No. 1711, 90th Cong., 2d Sess. 2 (1968); S. Rep. No. 550, 90th Cong., 1st Sess. 2 (1967).

105/ The percentage figure in sections 13(d) and 14(d) was original 10 percent, but the figure in both sections was redu to 5 percent in 1970. Act of December 22, 1970 § 1, 15 U.S.C. §§ 78m(d), n(d) (1970).

106/ See Schedule 13D, 17 C.F.R. § 240.13d-101 (1977).

ally with cash tender offers for more than 5 percent of a company's equity securities. Since tender offers were usually opposed by management, the provision was carefully drafted to avoid "tipping the balance of regulation in favor of management or in favor of the person making the takeover bid" and to provide both "the offeror and management equal opportunity to fairly present their case."[107/] Thus, persons making a tender offer were not ordinarily required to disclose information concerning themselves or the offer until the date on which the offer was first announced to security holders.[108/] In addition, solicitations or recommendations to either accept or reject the offer were also subjected to disclosure requirements promulgated by the Commission.[109/]

A related problem involved the possibility that managements were utilizing corporate repurchases of the company's own stock to counteract tender offers or other attempted takeovers. 110/ Since substantial repurchases would have an impact on the market value of the security, disclosure in

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107/ H.R. Rep. No. 1711, 90th Cong., 2d Sess. 4 (1968); S. Rep. No. 550, 90th Cong., 1st Sess. 3 (1967).

108/ See Rule 14d-1 (filing of Schedule 13D and furnishing of information to security holders), 17 C.F.R. § 240.14d-1 (1977).

109/ See Rule 14d-4 (filing of Schedule 14D), 17 C.F.R. § 240.14d-4 (1977); Schedule 14D, 17 C.F.R. § 240.14d-101 (1977).

110/ H.R.Rep. No. 1711, 90th Cong., 2d Sess. 5 (1968); S. Rep. No. 550, 90th Cong., 1st. Sess. 5 (1967).

connection with certain corporate repurchases was considered appropriate. Section 13(e) of the Exchange Act[111/] prohibited companies from repurchasing their own securities in contravention of rules and regulations adopted by the Commission. Under section 13(e), the Commission promulgated Rule 13e-1,[112/] which prevented companies from repurchasing their own securities after receiving notice of a tender offer, unless appropriate disclosures were filed with the Commission and transmitted to the company's shareholders.

Finally, section 14(f) of the Exchange Act[113/] was intended to require a statement to be transmitted to shareholders if, in connection with a transaction subject to the requirements of either section 13(d) or section 14(d), a change was about to occur in a majority of the company's directors, otherwise than at a meeting of shareholders. Since state laws permitted directors to fill vacancies on the board without a meeting of shareholders, an entire board could resign seriatim and, at the direction of a controlling interest, directors appointed to fill their places. The reason for requiring the statement to include substantially equivalent information as that required in connection with an election of directors at a meeting of shareholders[114/] was explained as follows:

111/ 15 U.S.C. § 78m(e) (1970).

112/ 17 C.F.R. § 240.13e-1 (1977).

113/ 15 U.S.C. § 78n(f) (1970).

114/ See Rule 14f-1, 17 C.F.R. § 240.14f-1 (1976).

> The disclosures required by the proxy rules should be made before a new board of directors is installed pursuant to a private agreement for transfer of control. Even if the controlling interest consists of a majority of the outstanding shares so that there would be no need to solicit proxies from other shareholders to obtain a majority of the votes for the new directors, it is still important that the disclosures be made before the new directors take office. The approach taken in the bill recognizes that the proxy rules provide a valuable and important means of furnishing to investors material information about their company and is consistent with the approach taken in section 14(c), of the Securities Exchange Act added in 1964, which requires companies that do not solicit proxies from their shareholders to furnish the same type of information to shareholders prior to the annual meetings as those companies which do solicit proxies. 115/

G. Reappraising Administrative Policies

Although the federal securities laws were designed to maximize "the full glare of publicity," Congress clearly did not intend to impose disclosure obligations beyond the point of diminishing returns. Considerable administrative discretion was vested in the Commission to require only such information as "necessary or appropriate in the public interest or for the protection of investors." 116/ Until the mid-1960's, however, much required disclosure was neither necessary nor appropriate. Despite similarities between the information that was required to be disclosed, and continuously updated, under the Exchange Act and the information required to be included in a Securities Act registration

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115/ H.R.Rep. No. 1711, 90th Cong., 2d Sess. 5-6 (1968); S. Rep. No. 550, 90th Cong., 1st Sess. 6 (1967).

116/ The phrase defines the parameters of the Commission's authority to adopt rules and regulations that are consistent with specific statutory provisons, and appears throughout the sections compelling disclosure under the federal securities laws.

statement, the public availability of Exchange Act information was generally disregarded whenever new securities were publicly offered. 117/

Following enactment of the 1964 Act Amendments, nearly all large publicly held companies became subject to the Exchange Act's comprehensive system of corporate disclosure. Whatever the reasons for discounting Exchange Act disclosure in the preceding years, the compelling arguments in favor of a more balanced disclosure system through improved coordination of Securities Act and Exchange Act disclosure requirements justified a comprehensive re-examination of existing disclosure policy. 118/ Recognizing this, the Commission undertook a thorough evaluation of its rules, regulations, policies and procedures, one major intention of which was to administratively integrate the two systems to the extent possible.

In 1967, the Commission formed an internal study group, the Disclosure Policy Study, to consider areas in which administrative action should be taken to improve the system of corporate disclosure. Its Report (Wheat Report) recommended specific administrative reforms that would "enhance the degree of coordination between the disclosures required by the '33 and '34 Acts. . .." 119/

The Study recommended that the Commission acknowledge the improved content and dissemination of Exchange Act Reports and more closely coordinate the Exchange Act disclosures with Securities Act

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117/ The Commission adopted special forms limiting the disclosures required to be included in a Securities Act registration statement by issuers required to file reports pursuant to sections 13 or 15(d) of the Exchange Act during the early 1950's, but the forms could only be used in certain limited contexts. For an analysis of the historical development of the forms for registration statements, see Wheat Report.

118/ See Cohen, supra note 85.

119/ Wheat Report, supra note 11 at 8.

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disclosures. It also recommended increased availability of shortened registration forms for certain quality companies, suggesting development of one or two page prospectuses that incorporate by reference significant information in the company's Exchange Act file.

The Wheat Report also concluded that 1933-1934 Act coordination was dependent on substantial improvement in 1934 Act reporting. "[I]mprovement in '34 Act reporting would provide continuing sources of disclosure which could act, to a larger degree, as an acceptable substitute for the special and, at best, occasional disclosures produced under traditional '33 Act practice." The Report suggested (1) more comprehensive reporting forms, (2) better administration and enforcement of requirements relating to the preparation and filing of such forms, and (3) better dissemination of the information contained in such forms.

In response to the recommendations in the Wheat Report, the Commission took a number of steps to integrate the Acts. Form S-7 was made available to a much larger class of registrants. Form S-16 was adopted permitting incorporation by reference of Exchange Act Reports into Securities Act prospectuses for secondary offerings of securities of certain registrants. Both of these steps were acknowledgements by the Commission that Exchange Act disclosure should be taken into account in determining the necessary amount of Securities Act disclosure.

The Industrial Issuers Advisory Committee, appointed in 1969, also forwarded to the Commission recommendations intended to further the process of integration of information under the two Acts. The Committee recommended wider availability for use of

Form S-7 both as to nature of transaction and company eligibility.

Perhaps the most significant recommendation was that the Commission require through the proxy rules that management's annual report to shareholders be improved by requiring that it contain certain minimum information. This recommendation represents a recognition that the information filed with the Commission is not readily accessible by shareholders. The annual report is. It also permits management to editorialize, and is more readable. The intention was to increase the quality of the premier disclosure document and thus integrate a third component, the annual report to shareholders, into the disclosure system. In 1974 Rules 14a-3 and 14c-3 were amended to require that the annual report contain certain minimum information. 120/

Both these efforts have tended to reduce the anomoly of two distinct disclosure frameworks for a top tier of companies. However, for most registrants the systems remain separate. These administrative efforts introduced a period of ongoing introspection about the integration problem which it is hoped eventually will result in one disclosure framework for all securities whether or not they are part of new offerings.

120/ Securities Exchange Act Release No. 11079 (October 30, 1974).

CHAPTER XX

THE NATURE OF MANDATED DISCLOSURE */

When the Securities Act of 1933 was enacted, Congress felt that a mandated disclosure system was needed to protect the public against fraud in the sale of securities. The Securities Exchange Act of 1934 adopted a year later continued to reflect this philosophy. The purpose of this chapter is to discuss some of the economic issues involved in a mandated disclosure system.

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*/ This paper was prepared for the Advisory Committee by William H. Beaver, Professor of Accounting. Many of the issues raised in this chapter also appear in Boatsman (1977), a statement on disclosure regulation submitted to the Committee and found to be very helpful in the writing of this chapter.

I. The Investment Setting

The investment process involves the giving up of current consumption in exchange for securities, which are claims to future, uncertain cash flows. The investor must decide how to allocate wealth between current consumption and investment and how to allocate the funds set aside for investment among the various securities available. The investor naturally has a demand for information that will aid in assessing the future cash flows associated with the securities and the firms that offer those securities. However, the investor is not acting in isolation but within a larger investment environment. This environment consists of several attributes. (1) Investors, some perhaps with limited financial and accounting training, have the opportunity to avail themselves of the services of financial intermediaries, such as investment companies, to whom they can defer a portion of the investment process. (2) Investors, some perhaps with limited access to and ability to interpret financial information, have the opportunity to avail themselves of the services of information intermediaries, such as analysts, to whom they can defer a portion or all of the information gathering and processing function. (3) The information intermediaries compete with one another in the gathering and interpretation of investment information, including firm-specific information. Moreover, corporations, competing with one another for the

investors' funds, have incentives to provide information to the investment community. (4) Investors and the intermediaries have a set of information available that is more comprehensive and, perhaps in some cases, more timely than the SEC filings. (5) Recent security price research, primarily on listed securities, indicates that, as a reasonable approximation, security prices fully reflect publicly available information (sometimes referred to as market efficiency).

By recent estimates, there are over 14,000 analysts. 1/ Corporate management has incentives to provide information to the analysts, and the analysts have incentives to seek out and disseminate such information. This private-sector information system appears to be large and active. Results of research, commissioned by the Advisory Committee and discussed elsewhere in this Report, document the extent and nature of this system with respect to a selected sample of corporations and analysts. 2/ Moreover, private-sector information search may explain why security prices quickly reflect a broad set of information. For example, it has been argued that competition

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1/ The membership in the Financial Analysts Federation is reported in the May-June, 1977 issue of the Financial Analysts Journal.

2/ The results of this research are reported in Part I of the Committee Report.

among analysts results in security prices that reflect a broad set of information.[3/] At the time of the enactment of the Securities Acts, statements of legislative intent indicate that at least some reliance was placed upon competition within the professional investment community to interpret the SEC filings and to effect efficiently determined security prices.[4/]

The current mandated disclosure system consists of a series of highly technical documents which are filed with the SEC and reside in its archives. Many investors, the intended beneficiaries of the Securities Acts, usually do not read and, in the case of 10-K, 10-Q and 8-K filings under the 1934 Act, do not usually even receive copies of these filings. There is an implicit reliance on the functioning of the professional investment community in order to justify the current system as an effective mechanism for disclosure. Moreover, this community often relies on investment information that is more comprehensive and in some cases more timely than that contained in the mandated filings. Under these conditions, the question arises concerning the role of the SEC and its mandated disclosure system in the entire framework. Why is it desirable to have a portion of that disclosure system contain a mandated set of disclosures?

3/ A further development of this argument appears in Bernstein (1975).

4/ In this respect, see statements by Justice Douglas (1933) and discussions in The Wheat Report (1969). Legislative intent has been examined in detail by Anderson (1974).

II. Role of Mandated Disclosure -- Previous Rationale

There have been two common forms of justification for the desirability of disclosure regulation.

The first approach consists of citing a litany of perceived abuses. Several questions can be raised in connection with such an approach. Were the actions in question in fact "abuses?" What one person might label "manipulation" another might label "arbitrage." In particular, what harm was inflicted as a result of such actions? Was inadequate disclosure a contributing factor to the abuses? In other words, will mandating disclosure of some form deter or reduce such activities? What was the frequency of abuses relative to some measure of total activity? This is potentially important because mandated disclosure tends to be imposed on broad classes of corporations, not merely those who committed the perceived abuse. 5/

However, more fundamentally, the point is that perfection is unattainable. Any corporate disclosure system, even one with a mandated portion, will incur some frequency of abuse. It is not clear that there has been a decline in the frequency of abuse over the 44 years since the inception of the Acts, and in the presence of increased regulation of corporate disclosure. Moreover, it is as inappropriate to judge a disclosure system solely on the basis of its perceived abuses as it would

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5/ After analyzing the perceived abuses at time of the enactment of the Securities Act, Benston (1973, 1974) has concluded that they constitute an inadequate basis on which to justify the securities legislation.

be to judge the merits of a public agency, such as the SEC, solely on the basis of its perceived worst regulations. The central issue is whether there is some flaw in the private sector forces that would lead to the conclusion that governmental regulation is a more desirable solution.

A second approach is to define the objectives of the corporate disclosure system and by implication the role of mandated disclosure. For example, "informed, rational investment decisions" is one frequently cited objective However, again the central issue is why is governmental regulation necessary or desirable to achieve this objective?

III. Rationale for Disclosure Regulation

This section will attempt to develop a framework for the consideration of issues regarding disclosure regulation. In order to do so, the nature of economic problems and the purpose of government with respect to those problems will be briefly discussed.

Economic issues fall into two major categories: issues of efficiency and issues of equity. The first category is concerned with the most efficient means of achieving some specified result, where movement to a more efficient solution could in principle result in everyone in the economy being in a more preferred position (or at least as preferred a position) with no one being in a less preferred position (often called a Pareto-optimal solution). The second category

deals with the choice among efficient solutions, where each solution will leave some individuals better off but others worse off. Issues as to how wealth should be distributed among individuals in the economy would be one example of an issue of equity. The government becomes involved in both types of issues. However, the rationale for governmental intervention can vary considerably depending upon the type of issue involved. Therefore it is imperative to state the extent to which the rationale for disclosure regulation rests on efficiency or equity considerations.

In general, the government has a variety of means available to deal with these issues, including the enforcement of private contracts, the definition and enforcement of property rights, taxation, regulation, and direct ownership. The Securities Acts provide two primary methods by which the flow of information to investors is effected. First are the general anti-fraud provisions; the second is the power to explicitly mandate corporate disclosure via the SEC filings and annual reports to shareholders.

With respect to the first method, the Securities Acts provide that it is unlawful to make a false or misleading statement or to omit a material fact in connection with the sale of a security. Laws against fraud are commonplace in the sale of a variety of commodities and they reflect concern over

the pervasive problem that the quality of the product or service being sold is uncertain. Moreover, often one party to the transaction may naturally be in a position of superior information regarding the quality. Under anti-fraud provisions, certain parties to the transaction face the prospect of civil or criminal penalties when and if the quality of the commodity is eventually discovered and their behavior is deemed "fraudulent."

While the deterrence of fraud via legal liability is fairly commonplace, the presence of a regulatory mechanism that explicitly mandates the nature of what must be disclosed is a rather special feature of securities' regulations. For example, neither federal nor state laws require filing a prospectus when an individual sells a home, even though the seller is in a potentially superior position with respect to information regarding the quality of the home.

The subsection III-A deals with arguments that potentially provide a rationale for disclosure regulation, which by implication asserts that reliance solely on the anti-fraud provisions is inadequate. 6/ The arguments fall into three major categories. (1) Corporation disclosures induce externalities and therefore have aspects of a public good. (2) Left unregulated, market forces would lead to an asymmetrical or uneven possession of information among investors. (3) Corporate management has incentives to suppress unfavorable information.

6/ The rationale for the choice between regulation and anti-fraud provisions is discussed in Posner (1972), 156-166.

III-A. Corporate Disclosure Externalities

An externality exists when the actions of one party have effects on other parties, who are not charged (or compensated) via the price mechanism. While in principle it would be possible to conceive of an elaborate price system that would charge or compensate the third parties for these effects, it may be undesirable to do so because it is too costly or simply infeasible.

However, without some form of collective action, the party undertaking the action has no incentive to internalize the effects on third parties, and it may lead to an inefficiency. For example, in the classic public good analysis with positive external effects on third parties, there will be an under-production of the public good in the absence of a collective action that incorporates the third parties, who benefit from the public good but do not participate in the decision to produce or pay for it. For this reason, these third parties are often referred to as "free riders." In this situation, the private incentives are less than the social incentives to produce the public good. 7/

In the disclosure context, two examples are frequently offered. Externalities could occur when information about the

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7/ Arrow's (1971) discussion of the incentives for invention is a well-known application of this analysis.

productive opportunities of one firm convey information about the productive opportunities of other firms. Shareholders in the disclosing firm pay the costs of disclosure but shareholders in the other firms do not, even though they are affected by the disclosure. For example, disclosure by a firm about its success (or lack thereof) with respect to some product development may provide information to other firms about their chances of success in similar product developments. In fact, it might even obviate their having to expend resources on product developments. Thus the familiar objection to disclosure on grounds of competitive disadvantage is one form of externality. In this setting there will be a lack of incentive to fully disclose because of the benefits of disclosure to other firms for which the disclosing firm is not being compensated.

The second example deals with positive external effects on prospective shareholders. Investors demand information in order to assess the risks and rewards (i.e., the array of potential future cash flows) associated with alternative portfolios of securities. In making consumption and investment decisions, the investor finds information about a security useful whether or not that particular security ultimately is one of the securities in the portfolio chosen by the investor. The process of selecting the "best" portfolio inherently involves a consideration of investment alternatives (i.e.,

alternative portfolios). Therefore information on securities in these alternative portfolios may be valuable at the decision making stage, even though after-the-fact some of those securities may not be included in the portfolio chosen. In this setting, current shareholders bear the costs of disclosure, yet prospective shareholders share in the benefits of disclosure (i.e., they are free riders). If the prospective shareholders neither participate in the decision to disclose nor share in bearing the costs, there will tend to be less disclosure than there would be under a collective agreement which included them. They would be willing to pay for additional disclosure such that everyone (both current and prospective shareholders) would be in a more preferred position (i.e., a more efficient solution would be attained). 8/

III-B. Additional Considerations

There are a number of additional issues to be introduced in considering an externality or public good approach to disclosure regulation.

First, what is the materiality of the externality or public good aspects to corporate disclosure? Currently, little empirical evidence exists to assess the importance of potential externalities.

8/ One such collective solution is that suggested by Samuelson (1954) and was recently applied to a corporate disclosure context by Gonedes and Dopuch (1974).

Second, issues of cost must be introduced. These include the direct costs of disclosure, the indirect costs of disclosure, and the costs of regulation. The direct costs of disclosure include the costs of the production, certification, dissemination, processing, and interpretation of disclosures. These costs are borne by the corporations and the analyst community and ultimately by investors. The indirect costs include the adverse effects of disclosure on competitive advantage (e.g., creating a disincentive to innovate or invest in product development) and legal liability, which may induce an inefficient bearing of risk by management and auditors, among others. The costs of regulation include the costs involved in the development, compliance, enforcement, and litigation of disclosure regulations. These costs are borne by taxpayers and by shareholders (and perhaps indirectly by consumers and employees).

Third, there are issues related to the information demanded by the regulatory agency in order to develop and monitor the regulations. In the context of disclosure regulation, the SEC attempts to determine the amount and nature of corporate disclosure that would take place, absent the inefficiencies induced by the externalities. In the case where the prospective shareholders are free riders, this involves an attempt to determine their demand for information. In general, investor demand for information will be influenced by the wealth, risk preferences, and beliefs of

investors, which is a nontrivial demand for information by the regulatory agency. Economic analyses which show the attainment of a more efficient solution via governmental regulation typically assume perfect knowledge on the part of the regulatory body, which is obviously an unrealistic assumption.[9/] Where it is too costly or simply infeasible to obtain the desired information, implementation error by the regulatory agency due to imperfect information may occur.

For example, individuals may not have incentives to honestly reveal their preference for corporate disclosure. They may understate or overstate the desirability of additional disclosure depending on the extent to which they perceive their indication of preference will be used as a basis to assess their share of the costs. A clear illustration is provided when there is no attempt to include the free riders in sharing in the costs of disclosures. In other words, suppose some groups are invited to participate in the process that determines the quantity and nature of corporate disclosure but are not invited to share in bearing the costs of those additional disclosures (e.g., financial analysts). In this situation, the result may be excessive disclosure,

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9/ The determinants of investor demand for information are described in greater detail in Demski (1974). Perfect knowledge by the regulator is needed as necessary or a sufficient condition for the desirability of governmental regulation.

rather than inadequate disclosure as suggested by the standard public good analysis. Issues of efficiency and equity are raised by such a process.

Fourth, there are issues that relate to the incentives of the regulatory agency itself. The economics of regulation offers two primary views of regulatory behavior. 10/ The first is the "public interest" view, which states that regulatory behavior is directed toward furthering the public interest. This view implicitly assumes the incentives of regulators are aligned so as to further the public interest and that the concept of public interest is well-defined. The second view is known as the "capture theory" and states that the prime beneficiaries of regulation are not the public (or investors, in the case of the Securities Acts) but rather those being regulated. This has led critics of the Securities Acts, such as Stigler, to argue that the primary beneficiaries of the Acts are various members in the professional investment industry rather than investors at large. 11/

Fifth, there is the issue of alternatives to governmental regulation, such as private sector collective agreements. For example, many goods with externalities are dealt with in the

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10/ The economics of regulation is reviewed in Posner (1974). Posner develops a more comprehensive model of regulatory behavior, where the two primary views are special cases.

11/ M. Cohen and G. Stigler (1971, pp. 6-9).

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private sector. Newspapers and television are two examples. The issue of whether to deal with the problem collectively in the private or public sector revolves around the issue of relative costs of the alternative approaches. It is generally felt that the government has a comparative advantage in dealing with certain types of collective agreements. In particular, where it would be extremely costly or infeasible to preclude free riders or where it would be extremely costly or infeasible to attempt to charge them, it is intuitively felt the comparative advantage favors governmental action.

III-C. Uneven Possession of Information Among Investors

A second major argument for disclosure regulation is that, left unregulated, market forces would lead to an uneven possession of information among investors. Selective disclosure is one example. In other words, the result would be a continuum of informed investors ranging from well informed to ill informed. It is further argued that such asymmetry of access to information is inherently unfair and violates the meaning of "fair" disclosure under the Securities Acts. Hence the basis of the argument is typically one of equity rather than efficiency. Simply stated, it is only fair that the less informed be protected from the more informed.

Recent economic analysis of the demand for privately held information suggests that considerable incentives exist to expend efforts searching for and obtaining nonpublicly

available information for trading purposes.[12/] Studies described elsewhere in the Report document the existence of a large informal information network, where information flows from management to the analysts. However, the unfairness of such a process is not self-evident.

Presumably, the analysts pass along the benefits of the information search to their clients, either directly or indirectly. In this sense, the clients of analysts become more informed investors. However, they pay for the analysts' services either directly or indirectly. As long as the services are available to anyone willing to pay for them, there is no obvious way in which harm is occurring. At the margin, investors will purchase analysts' services to that point where investors are indifferent between being more informed or less informed, given the costs of becoming more informed. In other words, the expected benefits of being more informed (e.g., in the form of expected superior returns due to better information) are equal to (or offset by) the costs incurred to obtain the additional information.[13/]

12/ The term, information for trading purposes, refers to the demand for information for speculative purposes. In other words, information is demanded for the purpose of earning abnormal returns due to superior information at the expense of uninformed investors. The incentives to search for such information are analyzed in Hirshleifer (1971).

13/ The process is described in greater detail in Grossman and Stiglitz (1976) and Gonedes (1976).

A common argument is that some investors cannot afford to purchase the services of analysts. However, the existence of financial intermediaries makes the force of this argument unclear. Moreover, it ignores several alternatives open to relatively less informed investors. One such alternative is to partially insulate themselves from more informed traders via buy-and-hold strategies and index funds. 14/ Also the actions of the more informed may signal their information to the less informed and as a result prices may partially (in the limit, fully) reflect the information. 15/

The purchase of analysts' information can be viewed as the decision to purchase a higher quality product (in this case, superior information). In general, quality differences exist with respect to any commodity, and usually it is not thought to be unfair when one consumer chooses to purchase a higher quality product while another chooses a lower quality item. The purchase of automobiles is one example, but illustrations could be provided for almost any commodity.

While selective disclosure is commonly cast as an equity issue, there are grounds for considering it on the basis of efficiency. For example, Hirshleifer argues that the social value is zero to the acquisition of private information for

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14/ For a more complete discussion see Marshall (1974).

15/ For a more complete discussion of ability of prices to reveal information, see Grossman (1976).

trading purposes.[16/] If there were no costs to forming private-sector collective agreements, investors would agree among themselves not to privately seek information. Everyone would gain in that society would no longer incur the costs of private search for information, whose sole purpose is to redistribute wealth among investors via trading on superior information. In other words, the trading gains in the form of superior returns due to privately held information net out to zero across all investors. It is a zero-sum game in that every investor with superior returns is offset by other investors with inferior returns. However, to the extent that such search causes investors to incur real costs, it is not a zero-sum game but these costs constitute dead weight losses to investors as a whole. Investors would be better off to avoid such costs.

However reaching and enforcing such a collective agreement might be extremely costly or simply infeasible. In the absence of effective enforcement, the agreement would rapidly deteriorate, because there would always be a private incentive to cheat on the agreement. Therefore the SEC may have a comparative advantage in effectively eliminating private search for information. It could be accomplished by either or

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16/ Hirshleifer (1971); Hakansson (1975) raises a related point and argues that analysts' search for information creates an inefficient redundancy in the information gathering process that could be remedied by public disclosure.

both of its two major means of regulation. (1) It could preempt private search by mandating the disclosure of the item in public filings or annual reports. (2) It could impose sufficient legal liability on transmittal of information from management to analysts such that information flows would be deterred (or in the limit eliminated).

This poses a dilemma. This argument suggests there will be a tendency for an excessive amount of information, as analysts and others privately search for information and disseminate it. 17/ However, this is the converse of the public good argument which implies an inadequate amount of disclosure. There are opposing forces operating. In one case the private incentives for disclosure fall short, while in the second case the private incentives are excessive. To the extent the former exists, it might be desirable to permit a certain amount of private search to compensate for the otherwise inadequate incentives to publicly disclose. 18/ However, permitting too much will lead to the inefficiencies described above.

17/ Once the speculative positions have been taken based on the privately-held information, there will be an incentive to disseminate or "push" the information. This will result in the prices reflecting the information and the benefits of the superior information can be realized as soon as possible. The pushing of information is discussed in Hirshleifer, (1971), Demski, (1974), and Marshall, (1974).

18/ Both Kripke (1976) and Lorie (1974) take the position that a certain amount of private search is socially desirable.

III-D. Management Incentives to Disclose

A third major argument for disclosure regulation is that management has incentives to suppress unfavorable information. While there may be a general awareness of this potential among investors, investors would not know specifically the nature or materiality of the suppressed information. As a result, investors will be unable to distinguish quality differences among stocks to the same extent they would under fuller disclosure. Hence, security prices will not fully reflect quality differences among stocks and there will be uncertainty regarding the quality of each stock. There may be a tendency for lower quality stocks to be selling at a higher price than would prevail under fuller disclosure and conversely for the higher quality stocks.[19/] This can lead to a phenomenon known as adverse selection, where the managements of poorer quality stocks have greater incentives to offer additional shares for sale than the managements of higher quality stocks.

Firms will tend to respond to this problem in a number of ways. (1) Higher quality firms will attempt to signal their higher quality by undertaking actions that would be irrational unless they were in fact of higher quality. The effectiveness of this signaling behavior will be influenced by the extent to which the lower quality firms can imitate

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19/ A lower quality stock is one whose price is overstated relative to the price that would prevail if greater disclosures were available to investors, and conversely for a higher quality stock.

the signaling behavior. Moreover, signaling may be a costly activity with no rewards beyond those of signaling. (2) Managements will offer to have their disclosure system monitored and certified by an independent party, leading to a demand for auditing services. (3) Managements may offer warrantees to shareholders whereby they will incur penalties if it is eventually discovered that unfavorable information was suppressed.[20/] In fact, managements' willingness to be audited and to offer warrantees can be signals in themselves. Obviously both auditing services and warrantee contracts are not costless. One of the most important costs in the warrantee is that management may end up bearing more risk than that associated with failure to disclose.

After-the-fact it may be difficult to disentangle the deterioration in the stock price that was due to correcting inadequate disclosure as opposed to other unfavorable events. As a result, management may become an insurer for events in addition to those induced by management's disclosure policy. This may lead to an inefficient sharing of risks, relative to that that would attain if

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20/ This discussion heavily draws upon a branch of economic theory known as screening or signaling theory. A recent paper by Ross (1977) applies this literature to the disclosure regulation context. The bibliographic references to the signaling literature appear in the Ross paper.

there were no uncertainty about the quality of the stocks.[21/] The costs may be prohibitive that such warrantees would not be offered.

The anti-fraud provisions can be viewed as requiring firms to provide disclosure warrantees to investors, where presumably the legal liability is sufficient to offset the incentives of management to suppress unfavorable information. The argument for governmental intervention as opposed to private sector contracting would be that the SEC has a comparative (cost) advantage in achieving the same result. However, while this argument forms a basis for anti-fraud statutes, it is not clear why a mandated disclosure system is desirable. In other words, why is reliance upon anti-fraud statutes deemed to be inadequate?

III-E. Summary of Previous Discussion

The purpose of the preceding discussion was to identify some of the issues involved in defining the role of mandated disclosures within the corporate disclosure system. Three rationale were provided for the potential desirability of the regulation of corporate disclosures. All three arguments rest on the premise that a public agency, such as the SEC, has a comparative advantage in forming collective agreements

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21/ Managers are unlikely to remain passive if such risk is imposed on them. For example, bearing this risk might distort the risk-reward tradeoffs management makes in investment decisions. They may tend to be more risk adverse because of the legal liability associated with higher risk projects.

of a certain form (i.e., where the potential beneficiaries or affected parties are numerous and difficult to identify and hence where it would be more costly or simply infeasible to attempt to deal with the same issue via private sector collective agreements).

IV. Security Price Research and/or Implications

Whether the potential desirability is likely to be realized depends upon a number of other considerations, including the ability of the regulatory agency to assess investor demand for information. Recent security price research in the areas of portfolio theory and efficient markets provides a framework within which to view the investor demand for information. These areas represent an important part of what is currently known about the investment decision and the environment within which that decision is made. 22/

IV-A. Portfolio Theory

Portfolio theory characterizes the investment decision as a tradeoff between expected return and risk (i.e., as measured by the extent to which the actual return may differ from the expected return). Each portfolio of securities offers the investor a given combination of risk and expected return. Given the risk attitudes of the investor, the best

22/ The rudiments of these theories are summarized in Sharpe (1972), Vasicek and McQuown (1972), Modigliani and Pogue (1974), FASB (1976). The empirical research on the efficient market theory is summarized in Gonedes and Dopuch, (1974), and in Kaplan (1975). The empirical evidence regarding the capital asset pricing theory is summarized by Jensen (1975).

portfolio is one that is the most preferred combination of risk and expected return. There are two immediate implications of portfolio theory for corporate disclosure. (1) Each individual security cannot be viewed in isolation but must be evaluated in the context of its membership in a portfolio consisting of other securities. The individual security is irrelevant, except insofar as it contributes to the overall risk and expected return of the portfolio. (2) The investor is concerned with risk as well as expected return (sometimes referred to as performance). Hence, corporate disclosure is concerned with the assessment of risk as well as the assessment of performance.

However, portfolio theory distinguishes between two types of risk. The first type is called unsystematic or diversifiable risk, because it can be virtually eliminated by diversification. The second type is called systematic or nondiversifiable risk, because it cannot be eliminated via diversification. The basis for this distinction rests on the view that two types of events affect the price of a security. There are economy-wide events, such as changes in anticipated inflation and interest rates, which affect the fortunes (and hence prices) of all securities with varying sensitivity. However, there are other events whose implications are largely firm-specific, such as changes in management, contract awards, and litigation. Unsystematic events by their very nature tend to be uncorrelated among firms at any point in time. To the extent that prices re-

flect only unsystematic or firm-specific events, returns among securities would be uncorrelated, and risk of the portfolio of such securities could be driven to zero via diversification across securities. However, to the extent that prices vary due to systematic events, security returns would be perfectly correlated, and diversification would not reduce the risk. Portfolio theory states that each security's return is subject to both types of risk. However, at the portfolio level only the systematic risk prevails, because the unsystematic risk has been diversified away. The investor is unnecessarily incurring unsystematic risk by failing to diversify. Therefore, there is a basic presumption in favor of diversification, unless the investor has some justification for choosing to remain undiversified. One reason for doing so would be superior information.

IV-B. Investor Demand for Firm-Specific Information

Portfolio theory stresses the importance of diversification in the reduction of much of the risk associated with holding a single security. It is unrealistic to believe that investors hold only one security (e.g., the one being described in a registration statement). In fact, investors have the opportunity to purchase well diversified portfolios through financial intermediaries. The recent trend toward index funds is but one manifestation

of the realization of the desirability of diversification.[23/] If the investor holds a well diverisified portfolio, how, if at all, does this alter the way disclosure is viewed? It has been argued that diversification may substantially reduce the investor's demand for firm-specific information.[24/] The investor is concerned with firm-specific information only insofar as it is useful in assessing the portfolio attributes. While the investor may have considerable uncertainty about the risks and rewards associated with any one security, this uncertainty is considerably reduced at the portfolio level because of the effects of diversificiation. For example, while there may be considerable uncertainty as to the riskiness of any one security, typically the riskiness of the portfolio can be assessed with much greater confidence. In other words, an overestimate of the risk of one security will tend to be offset by an underestimation of the risk of another security. The effects of diversificiation are potentially powerful, and the benefits from incremental improvements in the precision of firm-specific information may be minimal.

In another context, suppose the investor is concerned that the security being purchased is mispriced, relative to the price at which it would sell if additional disclosures were available. From the point of view of the additional disclosure, some of the securities will be overpriced but some will be under-

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23/ See Ehrbar (1976) for a further discussion of the trend toward index funds.

24/ For example, see Kripke, (1976).

priced. A diversified portfolio will likely contain some of each and their effects will tend to be offsetting. Hence, the net effects of additional disclosure may differ considerably from the effects analyzed on a security-by-security basis.

This is not to suggest that portfolio theory implies that additional disclosure is valueless, but only that it can alter the way in which disclosure issues are viewed. 25/ There are a number of obvious additional considerations. (1) Many investors may choose to remain relatively undiversified, even though they have the opportunity to do so. These investors, for one reason or another, perceive that the disadvantages of diversification outweigh the advantages. The SEC faces a social choice question of to what extent to impose disclosure requirements on companies (and hence impose costs on all investors) in order to accommodate investors who have chosen not to diversify. (2) Not all investors may have access to a given item (i.e., a problem of selective disclosure). (3) Management may use nondisclosure to obtain greater compensation than otherwise would be the case. (4) There may be effects on resource allocation that are ignored when the investor setting is narrowly viewed.

IV-C. Efficient Security Markets

A securities market is said to be efficient with respect to some defined information if the security prices in that market "fully reflect" that information. The term, "fully

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25/ Investor demand for information in a portfolio setting has been formally analyzed by Hakansson (1976).

reflect," is not a precise term. Operationally, if prices fully reflect a given set of information, then investors are playing a "fair game" with respect to that information. This means that all trading strategies based on that information will yield only the normal, expected return, commensurate with the risk involved.

A more precise definition is that the market is efficient with respect to a given piece of information if prices act as if everyone possessed that information and were able to interpret its implications for security prices. For example, several empirical studies have examined market efficiency with respect to changes in accounting methods. To say the market is efficient with respect to changes in accounting methods is to say that the stock prices behave as if all investors had knowledge of the change in method and knew how to interpret it.

The term, market efficiency, is unfortunate in some respects, because it may convey normative or value-laden connotations which have nothing to do with the concept itself. The concept of market efficiency refers to a relationship between stock prices and some defined information set. It is not to be confused with other uses of the term, efficiency, such as those which refer to how resources are allocated in the economy. It can also be misleading to use the term, market efficiency, without also specifying the information set. For example, to say simply that the market is efficient is an incomplete statement unless the intended implication

is that the market is efficient with respect to any or all information. However, such an implication usually is not intended. Typically, when market efficiency is used in an unqualified manner, it is intended to imply that the market is efficient with respect to publicly available data, since most of the empirical research has been concerned with market efficiency of this form. Three major forms of market efficiency have been delineated: (1) weak form efficiency, which refers to market efficiency with respect to past security prices, (2) semi-strong form efficiency, which defines market efficiency with respect to publicly available information, and (3) strong form efficiency, which is concerned with market efficiency with respect to all information, including inside information.

There are several potential implications of the [illegible] efficiency with respect to publicly available data. [illegible] closure may still be a substantive issue. Merely because prices fully reflect publicly available information does not imply that prices necessarily reflect nonpublicly available information. (2) Once disclosure is provided, the method of formatting is unlikely to have an impact on stock prices. 26/

26/ This assumes that formatting does not convey any information content. This also assumes that formatting does not induce a "real" effect (e.g., affect ability to access the credit markets).

(3) Given the large, active private sector information system, many items may be reflected in prices even though they are not reported in annual reports, SEC filings, or any publicly available document. Moreover, any one type of data may have a number of substitutes which can provide similar information. Therefore, before proceeding to mandate any given item, it would be appropriate to consider if that item would be a material addition given the other data effectively being disseminated to the investment community and reflected in prices.

There is one nonimplication of the efficient market that deserves explicit recognition. Merely because prices reflect a broad information set does not preclude or presume the desirability of mandated disclosures. With respect to certain types of information, there still may be inadequate private incentives to gather and disseminate such data. Moreover, even it if is being disseminated via the private sector system, it may be deemed more efficient (i.e., less costly) to have it disseminated via public disclosure by the corporation rather than via the private search activities for the reasons discussed earlier. 27/

IV-D. Empirical Evidence On The Effects Of Disclosure Regulation

The empirical evidence falls into two major categories. The first deals with attempts to assess the immediate effects

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27/ The implications and nonimplications of market efficiency are discussed in Dyckman, et al. (1975); Gonedes (1976); Kaplan (1975); Lev (1974); and Beaver (1973, 1976).

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of the '33 and '34 Acts. The second type deals with attempts to assess the effects of some specific disclosure requirement imposed subsequent to the initial period.

Two prominent studies in the first category are Stigler's (1964a) analysis of the effects of the '33 Act on the return distributions of new issues, and Benston's (1973) analysis of firms affected by the initial disclosure regulations of '34 Act. Both Stigler and Benston concluded that the securities legislation had little or no effect on the distribution of security price returns. The findings and the interpretations placed on the findings were highly controversial and have evoked a number of criticisms. 28/ The criticisms fall into three general categories. (1) The tests that were conducted are not appropriate tests of the effects. In other words, there was the lack of the development of a theory as to what security price return effects would be theoretically expected if the Securities Acts were or were not effective. Hence the tests are not capable of distinguishing whether the legislation was effective. (2) Even assuming that the tests were appropriate, a closer or more careful analysis of the findings would reveal that some effects were in fact observed in these studies. (3) Even assuming the tests were appropriate, the research design

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28/ See Gonedes and Dopuch (1974); Friend and Herman (1964); Robbins and Werner (1964); Stigler (1964b); Friend and Westerfield (1975); Friend (1972); Friend (1975); and Sommer (1974).

used was not powerful enough to detect the effects. Hence the finding of no effects may be due to inadequacies in the research design rather than the lack of any effects. The latter issue was of concern to Deakin (1976), who reexamined the period studied by Benston and concluded that there was a statistically significant effect to the '34 Act although his estimates of the effects were small.

The second class of studies deal with specific disclosure requirements subsequent to the passage of the Acts. Collins (1975) examined the security price behavior associated with segment reporting requirements and concluded that such information was not fully reflected in prices prior to the requirement to disclose such data. Hagerman (1975) investigated the effects of the 1964 amendments to the '34 Act on bank stocks and concluded there was little or no effect.

IV-E. The Griffin Study

In order to further examine the potential applicability of security price research to assess the effects of disclosure, the Advisory Committee commissioned Professor Griffin to conduct a study of the effects of sensitive payment disclosure on the stock prices of the disclosing firms relative to a sample of nondisclosing firms.

The study examined the stock price behavior of 74 firms who disclosed sensitive payments sometime during the period, April, 1975 through May, 1976. Their stock price behavior was compared with a control group of 65 firms who did not

disclose any sensitive payments during that period. The control group was selected to be similar to the disclosing group with respect to security risk, size, and industrial composition. The price variability of the disclosing group was generally greater than that of the control group in the week of and week following the sensitive payment disclosure. Moreover, the effect was greater for firms that disclosed during the earlier part of the period and for firms that reported larger dollar amounts of sensitive payments. There was no effective systematic difference however, on the average price change between the two groups. Thus while the disclosure appears to be associated with changes in the equilibrium prices of the stocks, there is no systematic pattern in terms of the direction of the effects. In simplest terms, while price changed at the time of the disclosure to a greater extent than would be expected otherwise, the effect of the disclosure was to increase the stock price of some but decrease the price of others so that the average price change was not different from that of the control group.

V. Concluding Remarks

Empirical research of the sort described above may be useful in dealing with some aspects of mandated disclosure. If the particular item is being mandated because it is expected to add to the information used by the market, it seems reasonable to expect the disclosure of such data to impact on stock prices. If no stock price reaction is observed, then the question must be asked -- what are the

effects, if any, of requiring disclosure of that item? For example, one effect could be a lower cost to investors via mandating disclosure rather than relying on the private sector's informal information network (Beaver (1973)).

In other words, it is virtually inconceivable that the SEC would not be able to find some disclosures that would have a price effect. In fact, findings of the Collins' study tentatively suggest they have in the case of segment disclosure. However, this is not the issue. Merely because the private sector has chosen not to disseminate a given item cannot be taken as prima facie evidence that the incentives to disclose are inadequate. It may be that the "benefits" of disclosure of that item are perceived to be not commensurate with the costs, such that disclosure is not worthwhile. The crucial issue is how to distinguish nondisclosure on the basis of perceived insufficient benefits from nondisclosure due to some inadequacy in the market system.

Similarly, the observation that the current system incurs a certain level of abuse is a slim basis on which to justify the desirability of mandated disclosure. Other issues must be considered. (1) To what extent, if any, would abuse be reduced by mandating additional disclosure? (2) What are the additional costs associated with mandated disclosure? (3) Are there alternative methods of dealing with the problem that might be more effective and/or less costly? Reliance on anti-fraud statutes and private sector

collective agreements are two possibilities. In any event, no system, even a mandated one, is likely to drive the level of abuse to zero nor is it likely such a result would be desirable, even if it were feasible, because of the costs of achieving that result. Implementation error caused by a lack of evidence on investors' demand for information and/or biases induced by reliance on vested interests must also be considered.

Currently, there is little or no evidence that bears on these questions. As a result, the desirability of a mandated disclosure system is still an open issue. However, the issues raised here provide a framework within which to structure future research by the Commission and others. Elsewhere (Beaver (1977)) I have called for an increased reporting by the SEC as to the intended and actual effects of disclosure regulations. This proposal was based on the notion that the SEC, as a public agency, has a stewardship responsibility at least as great as any corporation and hence has a commensurate reporting responsibility. While it is premature to conclude that such a proposal is clearly desirable, it is not unreasonable to suggest that an effort be made, at least on an experimental basis. Such efforts may provide some evidence on the fundamental issue of the desirability of a public agency that has been regulating disclosure for over forty years.

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CHAPTER XXII

LIABILITY PROVISIONS OF THE 1933 AND 1934 ACTS*

A determination to integrate the filing requirements of the Securities Act of 1933 [1/] and the Securities Exchange Act of 1934 [2/] requires an examination of the question of the standards of civil liability for breach of the integrated filing requirement. In setting the standard of liability for integrated filings it is important to consider that while the Acts are often described as "a single comprehensive scheme of regulation," [3/] the existing standards for imposition of civil liability depend upon the particular provision under which liability is sought to be imposed. Moreover, some provisions of the Acts have been held to

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1/ 15 U.S.C. §§ 77a-aa (1976) (hereinafter referred to as "the 1933 Act").

2/ 15 U.S.C. §§ 78a-jj (1976) (hereinafter referred to as "the 1934 Act").

3/ Globus v. Law Research Service, Inc., 418 F.2d 1276, 1286 (2d Cir. 1969), cert. denied, 397 U.S. 913 (1970).

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imply private causes of action thereby creating a host of judicially imposed and refined standards. The ultimate question these differences present the Advisory Committee is whether civil liability for misleading 1934 Act filings incorporated by reference in 1933 Act filings should be based upon the stricter standards of liability of the 1933 Act, the more relaxed standards of the 1934 Act, or another standard somewhere between them. This chapter will set forth the various standards of liability presently contained in the Acts.

A. Liability under the 1933 Act

The principal civil liability provisions of the 1933 Act are Sections 11 and 12, [4/] both of which expressly provide for private causes of action by purchasers of securities. Section 15 [5/] of the 1933 Act extends Section 11 and 12 liability to persons who "control" the Section 11 or 12 defendant, subject to a "good faith" defense. In addition, some courts have held that a private cause of action can be implied in favor of a purchaser under Section 17(a) of the 1933 Act. [6/]

4/ 15 U.S.C. §§ 77k and 1 (1976).

5/ 15 U.S.C. § 77o (1976).

6/ 15 U.S.C. § 77q(a) (1976).

Section 11. Section 11 of the 1933 Act is the basic section providing for a civil remedy for a false or misleading statement in a registration statement. It permits private actions for damages when any part of a registration statement contains, at the time it becomes effective, an untrue statement of a material fact or omits to state a material fact required to be stated or necessary to make the statements therein not misleading. 7/ Section 11 specifically imposes liability on the issuer, signers of the registration statement, directors of, or partners in, the issuer who were such at the time of the filing of the portion of the registration statement with respect to which liability is asserted, persons named with their consent as being or about to become directors or partners, accountants or other experts who certify or prepare material appearing in the registration statement, and underwriters. Under Section 11(f), liability is both joint and several for all defendants. Since Section 11 specifically prescribes those who may be held liable under Section 11, it has been held that Section 11 liability cannot be extended, under a theory of "aiding and abetting," to those not falling within the enumerated categories of defendants. 8/

Plaintiff's burden of proof is easier to establish in an action brought under Section 11 than under Sections 12(2)

7/ See Ernst & Ernst v. Hochfelder, 96 S.Ct. 1375, 1388 (1976).

8/ See In re Equity Funding Corp. of America Securities Litigation, 416 F. Supp. 161, 181 (C.D. Cal. 1976).

or 17(a) of the 1933 Act or Section 10(b) of the 1934 Act.[9/] The Section 11 plaintiff need not demonstrate scienter[10/] -- defendant's fraudulent intent -- or privity to impose Section 11 liability. That the purchaser relied to his detriment on the misstated or omitted information is conclusively presumed under Section 11.[11/] Plaintiff must prove, however, that he purchased the security, that the security was issued pursuant to a registration statement, and that the registration statement was false or misleading in a material respect.[12/] Bringing a claim under Section 11 does not preclude the plaintiff from suing under another section as well, provided he is able to allege the necessary ingredients of a cause of action under such other section.[13/]

9/ 15 U.S.C. § 78j(b) (1976).

10/ See, e.g., Lorber v. Beebe, 407 F. Supp. 279, 285 (S.D.N.Y. 1975); Stewart v. Bennett, 359 F. Supp. 878, 880 (D. Mass. 1973) (Issuer is liable without fault).

11/ See, e.g., Barnes v. Osofsky, 373 F.2d 269, 272-73 (2d Cir. 1967); Unicorn Field, Inc. v. Cannon Group, Inc., 60 F.R.D. 217, 227 (S.D.N.Y. 1973). Such presumption is not applicable, however, if the purchaser acquired the security after the issuer made generally available to its security holders an earnings statement covering at least 12 months of post-effective date operations, Section 11(a).

12/ See, e.g., Barnes, supra, at 272-73; Lorber v. Beebe, 407 F. Supp. 279, 285 (S.D.N.Y. 1975).

13/ Fischman v. Raytheon Mfg. Co., 188 F.2d 783, 786-87 (2d Cir. 1951); Morse v. Peat, Marwick, Mitchell & Co., [1975-76 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,492 at 99,493 (S.D.N.Y. 1976).

Material information has been defined by the SEC as information of "which an average prudent investor ought reasonably to be informed before purchasing the security registered." [14/] The Supreme Court recently defined materiality in the context of a proxy statement -- a definition which Jennings and Marsh believe "presumably will be equally applicable to a Section 11 action" [15/] -- in TSC Industries, Inc. v. Northway, Inc. [16/] as follows:

> an omitted fact is material if there is a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote . . .. [This standard] does not require proof of a substantial likelihood that disclosure of the omitted facts would have caused the reasonable investor to change his vote. What the standard does contemplate is a showing of a substantial likelihood that, under all the circumtances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the "total mix" of information made available. 17/

14/ 17 C.F.R. § 230.405 (1977).

15/ R.W. Jennings & H. Marsh, Jr., Securities Regulation 826 (4th ed. 1977).

16/ 96 S.Ct. 2126, 2133 (1976) (emphasis added).

17/ The requirement that the omitted or misstated fact be one which would have been significant is more difficult for a plaintiff to meet and more protective of defendants than the standard wich the Supreme Court appeared to articulate in Affiliated Ute Citizens v. United States, 406 U.S. 128, 153-54 (1972), which appeared to embrace a "might" rather than "would" formulation.

A Section 11 defendant can avoid liability by proving any one of five principal possible defenses:

1) that the statements were true,

2) that, if untrue, the statements were immaterial,

3) that at the time of purchase the plaintiff knew of such untruth or omission, 18/

4) that plaintiff's damages resulted from circumstances unrelated to the misstatement or omission (i.e., market conditions), 19/ or

5) that the defendant (other than the issuer) met the standard of care required of him by Section 11. 20/

(This is the so-called "due diligence" defense, and is not available to the issuer.)

The standard of care required in order for a defendant to avoid Section 11 liability depends upon whether the portion of the registration statement in question has been prepared on the authority of an expert and whether the defendant is himself an expert with respect to such portion. With respect to non-expertised portions, the defendant, in order to avoid liability, must make a "reasonable investigation" and have "reasonable grounds" to believe, and in fact believe, that such portion did not contain any misstatement or material omission. The statute prescribes essentially

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18/ § 11(a).

19/ § 11(e).

20/ § 11(b)(3).

the same standard for an expert with respect to portions expertised by him. With respect to portions of the registration statement expertised by someone other than the defendant, the defendant need not make an investigation but must have no reasonable ground to believe, and must not believe, that such portion contained an untrue statement or material omission. 21/

The statutory "standard of reasonableness" to be applied in determining what constitutes a "reasonable investigation" or "reasonable grounds" for belief for purposes of establishing the Section 11 due diligence defense is that "required of a prudent man in the management of his own property." 22/ This standard of care is presumably designed to be more protective of investors than the standard of care generally applicable in tort cases; thus it speaks in terms of a "prudent," not an "average" man. While the statute makes the standard of reasonableness equally applicable to all persons and does not draw distinctions based on the defendants' degree of association with the issuer, the courts have done so. 23/ The leading cases standing for

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21/ § 11(b)(3).

22/ § 11(c).

23/ See Comment, BarChris: Due Diligence Refined, 68 Colum. L. Rev. 1411, 1416 (1968).

this proposition are Feit v. Leasco Data Processing Equipment Corp.[24/] and Escott v. BarChris Construction Corp.[25/]

In the BarChris case, the court held that two of the outside directors, a partner in the law firm which was counsel to the issuer and a partner in the investment banking firm which was underwriting the issue, would be held to a much higher standard of care than that applicable to the ordinary outside director. In essence, the court found that by undertaking the "laboring oar" in connection with the preparation of the registration statement they made themselves liable when their performance failed to meet that expected of an attorney and investment banker. Essentially, the court apparently judged them by the standards applicable to their professions and not to a standard which might be applied to a director who had no expertise in the registration process and did not undertake to carry the burden in the preparation thereof. Similarly in Feit, and in BarChris, the inside directors and officers were held to a higher standard of care than the outside directors.

Both Feit and BarChris found directors of the issuer liable to purchasers of the issuers' securities, but drew an important distinction between the standard of care expected of "inside" and "outside" directors. An insider, with intimate knowledge of corporate affairs, is understand-

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24/ 332 F. Supp. 544 (E.D.N.Y. 1971).

25/ 283 F. Supp. 643 (S.D.N.Y. 1968).

ably expected to conduct a more complete investigation of the facts underlying a registration statement than is an outsider.[26/]

An expert is liable under Section 11 only with respect to material misstatements or omissions in those portions of a registration statement which are expressly stated as made on his authority as an expert. In BarChris, the court rejected the contention that an attorney was liable as an expert for the entire registration statement simply because he wrote it and likewise rejected the contention that the auditors were liable for all of the figures appearing in the registration statement. In addition to the statutory standard referred to above, it would seem that the investigation required of an expert with respect to the portion for which he is responsible would have to conform to the standards generally considered applicable to his profession. Accountants -- experts under Section 11(b)(3) -- while "not [to] be held to a standard higher than recognized in their profession," must make appropriate investigation when "red flags" are visible.[27/] Failure to make reasonable investigation may result in civil liability.

26/ See also Lanza v. Drexel & Co., 479 F.2d 1277 (2d Cir. 1973).

27/ BarChris at 703. See also Herzfeld v. Laventhol, Krekstein, Horwath & Horwath, 378 F. Supp. 112, 121-23 (S.D.N.Y. 1974), aff'd in part and rev'd. in part, 540 F.2d 27 (2d Cir. 1976).

United States v. Simon,[28/] however, held that compliance with professional standards does not necessarily insulate an accountant from criminal liability, and, accordingly, it would seem that such compliance would not necessarily insulate him from civil liability under Section 11.

Similarly, underwriters must do more than report information presented to them by an issuer; they must make "some reasonable attempt" to verify that information.[29/]

Though those connected with the issuance and registration of a security are held to a rigorous standard of care which at the least approximates negligence, "[s]ection 11 creates almost absolute liability in the issuer."[30/] The issuer, unlike other defendants, is not protected by the due diligence defense.[31/] Thus it can only avoid liability by showing that the statements sued on were true, immaterial or previously known to the plaintiff, or that extraneous circumstances caused plaintiff's damages.

28/ 425 F.2d 796 (2d Cir. 1969), cert. denied 397 U.S. 1006 (1970). See also Herzfeld v. Laventhol, Krekstein & Horwath & Horwath, 378 F. Supp. 112, aff'd in part and rev'd in part, 540 F.2d 27 (2d Cir. 1976).

29/ Escott v. BarChris Construction Corp., 283 F. Supp. 643, 697 (S.D.N.Y. 1968).

30/ Feit v. Leasco Data Processing Equipment Corp., 332 F. Supp. 544, 575 (E.D.N.Y. 1971).

31/ § 11(b).

Despite the fact that the civil liability provisions of Section 11 are extremely broad, litigation under Section 11 has been fairly sparse, in part perhaps because of the short statute of limitations provided for in Section 13 of the 1933 Act and the provisions of Section 11(e) concerning undertakings for costs and the awarding of costs and attorneys' fees. These restrictive provisions apply equally to actions brought under Section 12.

Section 12. Section 12(1) [32/] imposes absolute liability for violations of Section 5. A seller or offeror will be held liable under Section 12(1) if the purchaser establishes that no registration statement covering the security was in effect at the time of offer or sale, that the defendant sold or offered to sell the security, that a registration statement was required in connection with the offer or sale and that the defendant used the mails or interstate commerce in effecting the sale or extending the offer. [33/] Plaintiff need not demonstrate scienter or even negligence; simple proof of the sale of an unregistered security is sufficient to hold defendant liable unless defendant can prove the presence of

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32/ 15 U.S.C. § 1(1) (1976).

33/ See, e.g., Lewis v. Walston & Co., Inc., 487 F.2d 617, 621 (5th Cir. 1973); Wassel v. Eglowsky, 399 F. Supp. 1330, 1360 (D. Md. 1975).

an applicable exemption from the registration requirements of Section 5.[34/] The exemptions are generally construed very narrowly. Plaintiff need not show that had he access to material information about the security or issuer he would have relied on it.[35/]

Section 12(2)[36/] is a general anti-fraud section. It is not limited to the sale of registered securities and also applies to securities transactions exempt from the registration provisions of Section 5. An offeror or seller will be held liable under Section 11(2) if he misstates or fails to state material facts in a prospectus or in oral communication. In an action under the Section, a plaintiff must prove that (1) the defendant offered to sell or sold the security to him, (2) by the use of the mails or interstate commerce, (3) through a prospectus or oral communication, (4) which misstated or omitted to state a material fact necessary in order to make the statements therein not misleading. The first requirement -- privity of plaintiff and defendant -- severely restricts the effectiveness of Section 12(2). The third requirement,

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34/ See, e.g., Ingenito v. Bermec Corp., 376 F. Supp. 1154, 1176-77 (S.D.N.Y. 1974).

35/ See, e.g., Mason v. Marshall, 412 F. Supp. 294, 300 (N.D. Tex. 1974), aff'd, 531 F.2d 1274 (5th Cir. 1976).

36/ 15 U.S.C. § 1(2) (1976).

however, -- use of a prospectus or oral communication -- enlarges the scope of the Section because Section 2(10) of the 1933 Act defines "prospectus" very broadly. 37/ The defendant can escape liability by proving that he did not know, and in the exercise of reasonable care could not have known, of the untruth or omission.

Negligence is the standard of liability in suits brought under Section 12(2); the defendant will be held liable unless he demonstrates reasonable care. 38/ Thus the section is more protective of purchasers in this regard than Section 10(b) of the 1934 Act, which requires a showing of scienter, 39/ but less protective than the absolute issuer liability imposed by Section 11 of the 1933 Act. In a recent decision applying Section 12(2), for example, the Second Circuit Court of Appeals held an underwriter to a standard of "reasonable professional care" in assembling and evaluating financial

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37/ § 2(10) provides *inter alia*:

> The term "prospectus" means any prospectus, notice, circular, advertisement, letter or communication, written or by radio or television, which offers any security for sale or confirms the sale of any security. . ..

38/ See Odette v. Shearson, Hammill & Co., Inc., 394 F. Supp. 946, 956-57 (S.D.N.Y. 1975). Note that § 12(2) does not impose the stricter standard of § 11(c).

39/ See pp. 681-84 *infra*.

data as a basis of rendering an opinion regarding commercial paper.[40/]

The plaintiff in a suit under Section 12(2) need not expressly prove that he relied on the misstated information.[41/] He does have to prove materiality.[42/] Because material information, by definition, would be significant in investor decision-making, a showing that information sued on was material embodies the conclusion that the information stood in some casual connection to the purchaser's decision to buy, even if it was not decisive.[43/]

As a general proposition, recovery of consideration or damages under Section 12(2) has been permitted only against the immediate seller.[44/] This rule is broadened by exceptions, however, for liability has also been extended against "controlling persons" of issuers, offerors, or sellers

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40/ Franklin Savings Bank of New York v. Levy, [1976-77 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,902 at 91,352 (2d Cir. 1977).

41/ See, e.g., Jackson v. Oppenheim, 533 F.2d 826, 829 (2d Cir. 1977).

42/ See, e.g., Demarco v. Edens, 390 F.2d 836, 840 (2d Cir. 1968). See generally TSC Industries, Inc. v. Northway, Inc., 96 S.Ct. 2126, 2133 (1976), p. 671 supra.

43/ See Jackson v. Oppenheim, 533 F.2d at 830.

44/ See Lorber v. Beebe, 407 F. Supp. 279, 289 (S.D.N.Y. 1975).

as defined by Section 15,[45/] and against other defendants, such as attorneys, officers, partners, and others connected with the issuance and sale of a security.[46/] The language of Section 12, like Section 11, makes clear that its remedy is available only to aggrieved purchasers as opposed to aggrieved sellers.[47/] In determining whether a defendant "sold" securities within the meaning of the Section and hence is subject to liability, courts examine whether the defendant was the "proximate cause" of, or "substantial factor" in, the sale.[48/] As a remedy, the Section gives the purchaser recovery of "the consideration paid for such security with

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45/ 15 U.S.C. § 77o (1976). See Johns Hopkins University v. Hutton, 422 F.2d 1124, 1130 (4th Cir. 1970), cert. denied 416 U.S. 916 (1973); Lorber v. Beebe, 407 F. Supp. 279, 289 (S.D.N.Y. 1975).

46/ Katz v. Amos Treat & Co., 422 F.2d 1046 (2d Cir. 1969); Pederman v. Empire Fire and Marine Insurance Co., [1974-75 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 94,822 at 96,750-52 (S.D.N.Y. 1974); see also Ruder, Multiple Defendants in Securities Law Fraud Cases: Aiding and Abetting, Conspiracy, In Pari Delecto, Indemnification and Contribution, 120 U. Pa. L. Rev. 597 (1972). But see Grimm v. Whitney-Fidalgo Seafoods, Inc., [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,029 at 91,607 (S.D.N.Y. 1976) (accountant held not liable for a misrepresented fact). See generally Rochez Brothers v. Rhoades, 527 F.2d 880, 887-89 (3rd Cir. 1975); Woodward v. Metro Bank of Dallas, 522 F.2d 84, 94-100 (5th Cir. 1975).

47/ See, e.g., Thomas v. Roblin Industries, Inc. 520 F.2d 1393, 1396 (3rd Cir. 1975); Leonard v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 64 F.R.D. 432, 433 (S.D.N.Y. 1974).

48/ See Lewis v. Walston & Co., Inc., 487 F.2d 617, 622 (5th Cir. 1973); Hill York Corp. v. American International Franchises, Inc., 448 F.2d 680, 693 (5th Cir. 1971).

interest thereon, less the amount of any income received thereon, upon the tender of such security, or . . . damages if he no longer owns the security." 49/ Punitive damages are not available under Section 12. 50/

Implied Civil Liability Under Section 17(a). Section 17(a) is the 1933 Act counterpart to the more well-known Section 10(b) of the 1934 Act. The section provides:

> It shall be unlawful for any person in the offer or sale of any securities . . ., directly or indirectly --
>
> 1) to employ any device, scheme, or artifice to defraud, or
>
> 2) to obtain money or property by means of any untrue statement of a material fact or any omission to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or
>
> 3) to engage in any transaction, practice, or course of business which operates or would operate as a fraud or deceit upon the purchaser. 51/

Section 17(a) on its face is broader than 10(b) in that it reaches offers to sell -- uncompleted fraudulent trans-

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49/ Section 12. See, e.g., Aronson v. TPO, Inc., 410 F. Supp. 1375, 1379 (S.D.N.Y. 1976).

50/ Hill York Corp. v. American International Franchises, Inc., 448 F.2d 680, 697 (5th Cir. 1971). Punitive damages are generally not available in actions arising solely out of violations of the securities laws. de Haas v. Empire Petroleum Co., 435 F.2d 1223, 1229-32 (10th Cir. 1970); Globus v. Law Research Services, Inc., 418 F.2d 1276, 1283-86 (2d Cir. 1969), cert denied, 397 U.S. 913 (1970); Green v. Wolf Corp., 406 F.2d 291 (2d Cir. 1968), cert. denied 395 U.S. 977 (1969). See also Einhorn & Gray, Punitive Damages in Pendent Claims, 9 Sec. Reg. Rev. 823 (1976).

51/ 15 U.S.C. § 77q(a) (1976).

actions [52/] -- but is significantly narrower in that it does not confer standing upon defrauded sellers. [53/]

Although Section 17(a), like Section 10(b), does not expressly provide for private civil suits, some courts have read it as implying a private cause of action for defrauded purchasers seeking damages. [54/] It is well established that an implied cause of action exists under Section 10(b). [55/] The Supreme Court, however, has avoided deciding whether a private action may be brought under Section 17(a), [56/] and lower courts are divided on the question. [57/] The main argument against recognition of the action is that it would

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52/ Compare WULC v. Gulf & Western Industries, Inc., 400 F. Supp. 99, 103 (E.D. Pa. 1975), with Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723, 731-32 (1975). But see note 87 infra.

53/ See Simmons v. Wolfson, 428 F.2d 455, 456 (6th Cir. 1970), cert. denied, 400 U.S. 999 (1971). See also Kogan v. National Bank of North America, 402 F. Supp. 359, 361 (E.D.N.Y. 1975) (fraudulent conduct must appear in the offer or sale itself, rather than "in connection" therewith).

54/ See Dorfman v. First Boston Corp., 326 F. Supp. 1089, 1095 (E.D. Pa. 1972); WULC v. Gulf & Western Industries, Inc., 400 F. Supp. 99, 103 (E.D. Pa. 1975).

55/ The seminal case is Kardon v. National Gypsum Co., 69 F. Supp. 512, 513-14 (E.D. Pa. 1946).

56/ Ernst & Ernst v. Hochfelder, 96 S.Ct. 1375, 1381 n.13 (1976).

57/ See generally Welch Foods Inc. v. Goldman Sachs & Co., 398 F.Supp. 1393 (S.D.N.Y. 1974), for a general synopsis of the cases pertaining to this issue. Among the cases denying the existence of a private cause of action under § 17(a) are Lincoln National Bank v. Lampe; 414 F. Supp. 1270, 1276 (N.D. Ill. 1976) and Architectural League of New York v. Bartos, 404 F. Supp. 304, 313 (S.D.N.Y. 1975).

enable a plaintiff to circumvent "the express limitations placed on civil remedies by the specific civil liability sections of the Securities Act,"[58/] an argument which applies with equal force to Rule 10b-5. Nevertheless, the trend among federal courts is to recognize an implied private action under Section 17(a), if for no other reason than that the existence of a similar action under Section 10(b) makes it appear impractical, if not illogical, to deny its existence.[59/]

The elements of a private action under Section 17(a) are generally similar to those of a 10(b) action.[60/] The plaintiff must establish that the defendant, acting with scienter,[61/] violated his affirmative duty to make full and accurate disclosure of material information.[62/]

58/ Dorfman v. First Boston Corp., 336 F. Supp. 1089, 1093 (E.D. Pa. 1972) (footnote omitted). See also 3 L. Loss, Securities Regulation 1785 (2d ed. 1961).

59/ See 6 L. Loss, Securities Regulation 3913-14 (2d ed. 1969); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 867 (2d Cir. 1968), cert. denied, 404 U.S. 1005 (1971) (Friendly, J., concurring); Dorfman v. First Boston Corp., 336 F. Supp. at 1095.

60/ See Vacca v. Intra Management Corp., 415 F. Supp. 248, 250 (E.D. Pa. 1976); Jackson v. Oppenheim, 411 F. Supp. 659, 665-66 (S.D.N.Y. 1974); Odette v Shearson, Hammill & Co., Inc., 394 F. Supp. 946, 955-56 (S.D.N.Y. 1975).

61/ See Vacca v. Intra Management Corp., 415 F. Supp. at 250.

62/ See SEC v. Senex Corp., 399 F. Supp. 497, 507 (E.D. Ky. 1975).

As in a suit under Section 12(2), plaintiff need not show reliance because reliance is subsumed by the concept of materiality.[63/]

A plaintiff bringing a private action under Section 17(a) may either rescind the transaction sued upon or recover his actual economic damages.[64/] SEC proceedings, and even criminal prosecutions, are the accepted means of enforcing Section 17; certainly they are the mechanisms expressly anticipated by Congress.[65/] The SEC may proceed by injunction, and may obtain an accounting and disgorgement of profits realized by any defendant in the course of violating Section 17.[66/] Thus the defendant is exposed to substantial monetary liability. An action may be brought under Section 17(a) even if the applicable transaction is exempted from the registration provisions of Section 5 of the Act.

B. Liability Under the 1934 Act

Unlike the 1933 Act, the 1934 Act protects both aggrieved buyers and sellers. It focuses not on the initial

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63/ See Branham v. Material Systems Corp., 354 F. Supp. 1048, 1056 (S.D. Fla. 1973).

64/ Burkhart v. Allson Realty Trust, 363 F. Supp. 1286, 1290 (N.D. Ill. 1973) (damages).

65/ See § 20 of the Act, 15 U.S.C. § 77t (1976).

66/ See SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1104 (2d Cir. 1972); SEC v. Galaxy Foods, Inc., 417 F. Supp. 1225, 1249 (E.D.N.Y. 1976).

issuance of securities, but on their continuous trading. The 1934 Act expressly creates civil liabilities for violations of Sections 9(e), [67/] 16(b) [68/] and 18(a) [69/] of the 1934 Act, though Sections 9(e) and 16(b) do not, strictly speaking, involve the filing of documents and the disclosure of information in a manner similar to the other disclosure provisions of the 1933 and 1934 Acts and accordingly will not be dealt with herein. In addition, although Section 10(b), [70/] and Rule 10b-5 [71/] promulgated thereunder, and analogous provisions in the proxy and tender offer contexts [72/] do not expressly establish civil liabilities, it is now well established that they imply private rights of action against fraud in connection with the purchase or sale of securities, proxy solicitations, and tender offers. Until quite recently, Rule 10b-5 served as a catch-all for cases which had ingredients of fraud but which could not be pigeon-holed in any express liability provision of either Act.

67/ 15 U.S.C. § 78i(e) (1976).

68/ 15 U.S.C. § 78p(b) (1976).

69/ 15 U.S.C. § 78r(a) (1976).

70/ 15 U.S.C. § 78j(b) (1976).

71/ 17 C.F.R. § 240.10b-5 (1977).

72/ Securities Exchange Act §§ 14(a) and (e), 15 U.S.C. §§ 78n(a) and (e) (1976).

Section 18(a). Section 18(a) of the 1934 Act provides in pertinent part:

> Any person who shall make or cause to be made any statement in any application, report, or document filed pursuant to this chapter or any rule or regulation thereunder . . ., which statement was at the time and in light of the circumstances under which it was made false or misleading with respect to any material fact, shall be liable to any person (not knowing that such statement was false or misleading) who, in reliance upon such statement, shall have purchased or sold a security at a price which was affected by such statement, for damages caused by such reliance, unless the person sued shall prove that he acted in good faith and had no knowledge that such statement was false or misleading. 73/

The Section creates liability for damages resulting from the misstatement or omission of material information in applications, reports, or documents an issuer must file with the SEC under the 1934 Act and the rules and regulations promulgated thereunder. Courts applying Section 18(a) have consistently held that its coverage "is no broader than that indicated by the plain meaning of its language," and that only an actual purchaser or seller of the security can bring a suit under it. 74/ Although the section expressly creates

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73/ 15 U.S.C. § 78r(a) (1976).

74/ Meer v. United Brands Company, [1976-1977 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,648 (S.D.N.Y. 1976); Myers v. American Leisure Time Enterprises [1975-1976 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,286 (S.D.N.Y. 1976); Hoover v. Allen, 241 F. Supp. 213, 221 (S.D.N.Y. 1965).

a private remedy, it is rarely litigated because plaintiffs must satisfy its strict "double-barreled" causation requirement.[75/] Not only must the Section 18(a) plaintiff demonstrate that he bought or sold the security and that the statement or omission sued upon was false or misleading, he must also shoulder the heavier burden of proving (1) that his damages resulted from reliance on the false or misleading information, and (2) that the purchase or sale price was affected by that information.[76/] The latter requirement is particularly difficult for a plaintiff to satisfy, so difficult, in fact, that in 1941 the SEC proposed, unsuccessfully, its deletion from Section 18(a).[77/]

A defendant -- who can be an issuer, officer, director, accountant or other person involved in the filing of the statement sued upon -- may escape liability if he proves that "he acted in good faith and had no knowledge that such

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75/ 3 L. Loss, Securities Regulation 1752 (2d ed. 1961). See, Britten v. Schweikart, [1957-61 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 91,029 (S.D.N.Y. 1961).

76/ See, e.g., Rich v. Touche Ross & Co., 415 F. Supp. 95 (S.D.N.Y. 1976).

77/ SEC, Report on Proposals for Amendments to the Securities Act of 1933 and the Securities Exchange Act of 1934, H.R. Comm. Print., Committee on International and Foreign Commerce, 77th Cong., 1st Sess. 38 (1941).

statement was false or misleading." [78/] The Supreme Court on the basis of the legislative history of Section 18 recently suggested that something more than negligence would be necessary to incur liability under Section 18(a). [79/] Thus, the standard of liability established by the Section is more protective of defendants than those enumerated in Sections 11 and 12 of the 1933 Act. [80/] Furthermore, the burden of proving good faith will not shift to the defendant until after the plaintiff has established "that the statement was false and misleading . . . [and] that he relied on the statement." [81/] The result of these procedural and evidentiary requirements was, until quite recently, [82/] that plaintiffs were driven to seek relief from the effects of false or misleading statements under Section 10(b) and Rule 10b-5. Section 18(a) is nonetheless significant for the purpose of formulating a liability

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78/ 15 U.S.C. § 78r(a) (1976).

79/ Ernst & Ernst v. Hochfelder, 96 S.Ct., 1375, 1390 n.31 (1976).

80/ See Section A supra.

81/ 78 Cong. Rec. 8039 (1934) (remarks of Representative Rayburn).

82/ See discussion of Ernst & Ernst v. Hochfelder, 96 S.Ct. 1375 (1976), at pp. 692-94 infra.

standard for an integrated filing because it expressly sets the standard of liability for filings under the 1934 Act.

Implied Civil Liability Under Section 10(b) and Rule 10b-5. Section 10(b) of the 1934 Act makes it unlawful for any person

> [t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors. 83/

The SEC promulgated Rule 10b-5, 84/ a general antifraud provision, pursuant to Section 10(b) in 1942. A private cause of action for damages resulting from fraudulent statements or omissions was first recognized under the Section and the Rule in the landmark case of Kardon v. National Gypsum Co. 85/ The availability of that remedy is now unquestioned. Moreover, a suit maintainable under Section 11 of the 1933 Act may be brought under Rule 10b-5 if the plaintiff shows an "added ingredient of fraud." 86/

83/ 15 U.S.C. § 78j(b) (1976).

84/ 17 C.F.R. § 240.10b-5 (1977).

85/ 69 F. Supp. 512, 514 (E.D. Pa. 1946).

86/ Fischman v. Raytheon Mfg. Co., 188 F.2d 783, 787 n.2 (2d Cir. 1951). Perhaps even an ingredient of recklessness will suffice. See pp. 692-93 infra.

To maintain a private cause of action under Rule 10b-5 a plaintiff must first allege that he actually bought or sold the security to which the fraudulent misstatement or omission related. 87/

Next, as the Supreme Court recently held in Ernst & Ernst v. Hochfelder, 88/ a plaintiff may not bring a private action for damages under 10b-5 "in the absence of 'scienter' -- intent to deceive, manipulate, or defraud." The Court explained that

> [t]he words "manipulative or deceptive" used in conjunction with "device and contrivance" strongly suggest that § 10(b) was intended to proscribe knowing or intentional misconduct. 89/

Thus Section 19(b) and Rule 10b-5 require a showing of something greater than negligent wrongdoing to establish liabil-

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87/ See Blue Chip Stamps v. Manor Drug Stores, 421 U.S. 723 (1975); Birnbaum v. Newport Steel Corp., 193 F.2d 461 (2d Cir.), cert. denied, 343 U.S. 956 (1952). There is some question as to the applicability of the strict "purchase or seller" requirement enunciated in Birnbaum and reaffirmed in Blue Chip in situations where injunctive relief is sought. See Kahan v. Rosenstiel, 424 F.2d 161 (3d Cir.), cert. denied, 398 U.S. 950 (1970); Tully v. Mott Supermarkets, Inc. 540 F.2d 187 (3d Cir. 1976).

88/ 96 S.Ct. 1375 (1976).

89/ Id. at 1383.

ity. The Court reasoned that were the Section and the Rule extended to negligence, the effect would be to "nullify the effectiveness of the carefully drawn procedural restrictions on [the] express [liability] actions." 90/ Not only must plaintiff allege fraudulent intent, he must also allege that defendant committed a manipulative or deceptive act. 91/

The effect of these requirements is to significantly restrict the number and scope of suits brought under 10b-5, 92/ thereby insulating potential defendants against civil liability under the federal securities laws. Damages are still available under a 10b-5 implied right of action, but the plaintiff must now show fraudulent intent and deception. 93/

It remains possible, however, for a plaintiff alleging recklessness to bring a 10b-5 suit. The Supreme Court left that precise issue open in Hochfelder 94/ and, in fact, intimated that such a remedy might have been intended. The

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90/ Id. at 1389.

91/ See Santa Fe Industries, Inc. v. Green, 97 S.Ct. 1292, 1300-01 (1977).

92/ And under analogous provisions, such as § 17(a) of the 1933 Act. See, Vacca v. Intra Management Corp., 415 F. Supp. 248, 250 (E.D. Pa. 1976).

93/ Plaintiff must also show that the statement sued upon was material. Presumably, the definition of materiality applied in TSC Industries, Inc. v. Northway, 96 S.Ct. 2126, 2133 (1976) applies in 10b-5 actions as well.

94/ Ernst & Ernst v. Hochfelder, 96 S.Ct. 1375, 1381 n.12 (1976).

Court stated that "[t]here is no indication that Congress intended anyone to be made liable for such [manipulative and deceptive] practices unless he acted other than in good faith." [95/] Sanders v. John Nuveen & Co., Inc. [96/] utilized this language to justify a holding that recklessness could constitute scienter because, in some circumstances, "'reckless' [behavior] . . . comes closer to being a lesser form of intent than merely a greater degree of ordinary negligence. We perceive it to be not just a difference in degree but also in kind." [97/]

The Supreme Court in Hochfelder did not consider whether scienter is a necessary element in an action for injunctive relief brought under 10b-5, although Justice Blackmun in his dissent stated that he could see no distinction between an injunction brought by the SEC and a private damage action. Prior to the Hochfelder decision courts had consistently held negligent action or inaction sufficient to find liability in the context of enforcement proceedings seeking equitable or

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95/ Id. at 1387 (emphasis added).

96/ [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,030 (7th Cir. 1977). See also Herzfeld v. Laventhol, Krekstein, Horwath & Horwath, 540 F.2d 27 (2d Cir. 1976); McLean v. Alexander, 420 F. Supp. 1057 (D. Del. 1976).

97/ Sanders, supra at 91,613.

prophylactic relief.[98/] Subsequent to the Hochfelder case, at least two cases have impliedly held that negligence is a sufficient basis for liability in SEC enforcement proceedings.[99/] Prior to Hochfelder the cases generally required some showing of scienter, albeit not an intent to defraud, in civil actions seeking money damages.[100/]

Several recent cases, decided before the Hochfelder decision, hasve suggested that liability under Section 10(b) and Rule 10b-5 may depend on the nature of the duty owed to the plaintiff by the individual sought to be charged with a violation thereof. In Lanza v. Drexel & Co.,[101/] the court found certain "inside" directors of the BarChris Corporation

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98/ See, e.g., SEC v. Management Dynamics, Inc. 515 F.2d 801 (2d Cir. 1975); SEC v. Rega, [1975-76 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,222 (S.D.N.Y. 1975); SEC v. Manor Nursing Centers, Inc., 458 F.2d 1082, 1096 (2d Cir. 1972); SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 854-55 (2d Cir. 1968) (en banc), cert. denied, 404 U.S. 1005 (1971).

99/ SEC v. World Radio Mission, Inc., 544 F.2d 535 (1st Cir. 1976); SEC v. Universal Major Industries Corp., [1976-77 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,804 (2d Cir. 1976). But see SEC v. Bausch & Lomb, Inc., [1976-77 Transfer Binder] Fed. Sec. L. Rep. (CCH) ¶ 95,722 (S.D.N.Y. 1976).

100/ See, e.g., Mariash v. Morrill, 496 F.2d 1138, 1145 n.13 (2d Cir. 1974); Chris-Craft Indus., Inc. v. Piper Aircraft Corp., 480 F.2d 341 (2d Cir.), cert. denied, 414 U.S. 910 (1973).

101/ 479 F.2d 1277 (2d Cir. 1973).

liable to purchasers of the company's securities for misrepresentations and nondisclosures, many of which were contained in a prospectus, but exonerated an "outside" director who had had no personal contact with the purchaser. The court found that the "outside" director lacked any actual knowledge of the false statements and had no duty to investigate. This duty analysis was refined in White v. Abrams [102/] wherein the court articulated five factors deemed relevant to the duty imposed by Rule 10b-5 upon persons in connection with the purchase or sale of securities:

1) The nature of the relationship between the person sought to be charged with a duty and the purchaser or seller of the securities;

2) The benefits obtained by the duty-bound individual as a result of the challanged transaction;

3) The access of such individual to the information said to have been misstated or omitted;

4) The extent of the participation of such individual in the challenged transaction; and

5) The extent to which the allegedly injured party relied upon such individual.

It should be noted that to the extent that White v. Abrams, adumbrates essentially a "negligence" standard it has been specifically overruled by the Supreme Court, at least with

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102/ 495 F.2d 724 (9th Cir. 1974).

respect to private damage actions.[103/] However, to the extent that it differentiates between various classes of potential defendants depending on differing circumstances, the holding may have some viability, albeit that the threshold for liability, after which the differentiation can commence, has been raised to the level of the Supreme Court's concept of scienter.

The Hochfelder case also impacted the defense that the plaintiff did not exercise due diligence. In Holdsworth v. Strong,[104/] the court noted that the imposition of a due diligence requirement on the plaintiff might have been tenable in the context of the application to the defendant of a negligence standard but where the liability of the defendant requires proof of intentional misconduct, "the exaction of a due diligence standard from the plaintiff becomes irrational and unrelated."[105/]

There seems to be a belief among practitioners that a higher degree of exposure to liability under the 1934 Act is undertaken in connection with statements contained in or omissions from documents "filed" pursuant to the provisions

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103/ Hochfelder, supra at n.12.

104/ 545 F.2d 687 (10th Cir. 1976).

105/ Id. at 692. See also Straub v. Vaisman and Co., 540 F.2d 591 (3d Cir. 1976); Dupuy v. Dupuy, Fed. Sec. L. Rep. (CCH) ¶ 96,048 (5th Cir. 1976). But see NBI Mortgage Investors Group v. Chemical Bank, [Current Binder] Fed. Sec. L. Rep. (CCH) ¶ 96,066 (S.D.N.Y. 1977).

of the 1934 Act as opposed to statements contained in or omissions from documents or oral communications which are not deemed to be so filed. This belief is a misconception. The standard of liability for a material omission or misstatement in a "filed" document under Section 18(a) of the 1934 Act is virtually the same as for a material omission or misstatement under Rule 10b-5. In each case at least something more than mere negligence would have to be proven in order to establish liability.[106/] In each case the absolute "purchaser-seller" requirement enunciated in Blue Chip, supra, would have to be met.[107/] If anything, as set forth elsewhere herein[108/] the "double-barrelled" privity requirement of Section 18(a) makes civil liability under that Section more difficult to establish than under Rule 10b-5.

Section 14(a). Section 14(a) of the 1934 Act makes it unlawful for any person to solicit a proxy "in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate for the protection of in-

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106/ Ernst & Ernst v. Hochfelder, 96 S.Ct., 1375, 1390 n.31 (1976).

107/ See note 74 supra.

108/ See pp. 677-82.

vestors."[109] Rule 14a-9(a),[110] promulgated by the SEC pursuant to this authorization, prohibits the use of false or misleading proxy statements, and requires the correction of previous statements which have become false or misleading. The language of the rule resembles that used in Section 12 of the 1933 Act,[111] except that Section 12 uses the word "untrue" while the Rule uses the word "false." Unlike Section 11 of the 1933 Act, neither the statute nor the rule identifies the parties subject to liability thereunder.

An implied private right of action under Section 14(a) was first recognized by the Supreme Court in J.I. Case Co. v. Borak.[112] The Court failed, however, to state what a plaintiff suing under Rule 14a-9 must prove in the way of defendant's culpability. The Second Circuit addressed this problem in Gerstle v. Gamble-Skogmo, Inc.,[113] explaining that:

109/ 15 U.S.C. § 78n(a) (1976).

110/ 17 C.F.R. § 240.14a-9(a) (1977).

111/ See pp. 677-82 supra. It also resembles Rule 10b-5, but the resemblance with Section 12 is greater.

112/ 377 U.S. 426 (1964). Accord Mills v. Electric Autolite Co., 396 U.S. 375 (1970).

113/ 478 F.2d 1281, 1299 (2d Cir. 1973).

> [a]lthough the language of Rule 14a-9(a) closely parallels that of Rule 10b-5 and [does not say] in so many words that scienter should be a requirement . . . [the] language suggests that rather than emphasize the prohibition of fraudulent conduct on the part of insiders to a securities transaction, as we think section 10(b) does, in section 14(a) Congress was somewhat more concerned with protection of the outsider whose proxy is being solicited.

The Court therefore concluded that "a reading of Rule 14a-9 as imposing a liability without scienter . . . is completely compatible with the statutory scheme." 114/ Given the remedial purpose of Congress in enacting the section, and considering that Section 12 of the 1933 Act, which Rule 14a-9(a) tracks, applies a negligence standard, 115/ the Second Circuit's holding that negligence is the standard of liability under Section 14(a) appears to be the correct interpretation. Indeed, the Supreme Court noted the holding -- and did not comment on it -- in Hochfelder. 116/

Section 14(e). In response to the increasing use of cash tender offers as a means of effecting corporate takeovers, Congress

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114/ Gerstle v. Gamble-Skogmo, Inc., supra, at 1299. See also Gould v. American Hawaiian Steamship Company, 351 F. Supp. 853 (D. Del. 1972), vacated on other grounds, 535 F.2d 761 (3d Cir. 1976).

115/ See pp. 675-80 supra.

116/ Ernst & Ernst v. Hochfelder, 96 S.Ct. 1375, 1389 n.28, 1391 (1976).

passed the Williams Act [117/] in 1968. Section 14(e) of the Williams Act, amending the 1934 Act, is a broad anti-fraud provision. It reads:

> [i]t shall be unlawful for any person to make any untrue statement of a material fact or omit to state any material fact necessary in order to make the statements made, in light of the circumstances under which they are made, not misleading, or to engage in any fraudulent, deceptive, or manipulative acts or practices, in connection with any tender offer or request or invitation for tenders, or any solicitation of security holders in opposition to or in favor of any such offer, request, or invitation. 118/

Section 14(e) essentially prohibits the same type of conduct as do Rule 10b-5 and Rule 14a-9(a). [119/] The first portion of Section 14(e) resembles Rule 14a-9(a), while the second resembles 10b-5. Thus, one might conclude that the standard of liability set by Section 14(e) is somewhat more than simple negligence, and somewhat less than fraudulent intent; perhaps recklessness is an appropriate middle ground. Indeed Judge Friendly suggested as much in Electronic Spe-

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117/ P.L. 90-439, § 3, 82 Stat. 455 (1968), 15 U.S.C. §§ 14n(d-f) (1976).

118/ 15 U.S.C. § 78n(e) (1976).

119/ See pp. 690-94 supra.

cialty Co. v. International Controls Corp., [120] when he commented that

> the participants on both sides [of a contested tender offer] act, not "in the peace of a quiet chamber," . . . but under the stresses of the market place. They act quickly, sometimes impulsively, often in angry response to what they consider, whether rightly or wrongly, to be low blows by the other side . . .. Congress intended to assure basic honestly and fair dealing, not to impose an unrealistic requirement of laboratory conditions . . .. These considerations bear on the kind of jugment to be applied in testing conduct - of both sides - and also on the issue of materiality. [121]

That simple negligence does not suffice to establish liability under Section 14(e) is also implied by the Supreme Court's holding in Rondeau v. Mosinee Paper Corp. [122] In Rondeau, the Court refused to enjoin a purchaser, who had neglected to file a Schedule 13D within the statutory deadline but who had acted "in good faith," [123] from pursuing potential merger plans.

120/ 409 F.2d 937, 948 (2d Cir. 1969).

121/ For a discussion of materiality under § 14(a) and Rule 14a-9(a), see TSC Industries, Inc. v. Northway, Inc., 96 S.Ct. 2126, 2133 (1976).

122/ 95 S.Ct. 2069 (1975).

123/ Id. at 2077.

Section 14(e) does not explicitly create a private cause of action, and the Supreme Court, in Piper v. Chris-Craft Industries, Inc.,[124/] declined the opportunity to take a position on the issue. Lower courts have recognized the implied right of a private plaintiff to bring an action for damages under Section 14(e).[125/]

C. Conclusion

The standards of liability established by the 1933 Act range from absolute liability for the failure to file a registration statement (Section 12(1)), through near absolute liability for issuer misstatements and omissions in a registration statement (Section 11), to liability for negligence in registration statements and in the offer or sale of securities (Sections 11 and 12(2)), and ultimately to liability for fraud and recklessness in the offer or sale of securities (Section 17(a)).

Civil liability under the 1934 Act subsequent to Hochfelder is not as extensive. There is no absolute liability for an omission of misstatement of material information.

124/ 97 S.Ct. 926, 949 n.28 (1977).

125/ H.K. Porter Company, Inc. v. Nicholson File Company, 482 F.2d 421 (1st Cir. 1973); Chris-Craft Industries, Inc. v. Bangor Punta Corp., 480 F.2d 341 (2d Cir.), cert. denied, 414 U.S. 910 (1973). By deciding Rondeau, supra, the Court implicitly recognized that Section 14(e) implies a private right of action. See Rondeau v. Mosinee Paper Corp., 95 S.Ct. 2069, 2078 (1975).

Only one provision, Section 14(a), appears to make negligence actionable. The other civil liability provisions, Sections 10(b), 14(e) and 18(a), require proof of some form of scienter for a plaintiff to prevail. Although it is an open question at this time, scienter probably encompasses recklessness, as well as fraudulent intent.

Congress, in enacting the 1933 and 1934 Acts, and courts, in interpreting them, struck a series of balances between the competing public needs for investor protection and economic growth. The liability provisions of the 1933 Act, generally speaking, are more stringent than those of the 1934 Act because Congress recognized that the investing public knew less about new issuers and new securities than about existing issuers and securities. Given this public ignorance, the failure to register securities and the dissemination of inaccurate or incomplete information about them at this stage is particularly dangerous. Therefore the civil liability established by the 1933 Act is generally speaking broader than that of the 1934 Act.

The 1934 Act reflects Congress' understanding that the investing public presumably has more extensive information about issuers and securities already trading in the marketplace, and thus there is less of a need to punish and prevent negligent omissions or misstatements about those issuers and their securities.

CHAPTER XXII

SENSITIVE FOREIGN PAYMENT DISCLOSURES: THE SECURITIES MARKET IMPACT*

A. Abstract

The purpose of this chapter is to assess whether sensitive foreign payment disclosures convey information pertinent to the establishment of equilibrium security prices. Several tests concerning series of market-adjusted transactions volume and stock price changes, over and above what is

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*This chapter was prepared by Paul A. Griffin, Assistant Professor of Accounting, Graduate School of Business, Stanford University. The author acknowledges the helpful comments and constructive criticism of his colleague William H. Beaver and the participants of The Ohio State University Accounting Research Colloquium, the Purdue University Workshop and the Stanford Summer Accounting Research Workshop (August, 1977) where earlier versions of this chapter were presented. Comments provided by Nicholas J. Gonedes, Jerald L. Zimmerman and an anonymous referee have been incorporated also. An acknowledgment of gratitude is expressed to the Staff of the Advisory Committee on Corporate Disclosure, Securities and Exchange Commission and to the Interactive Data Corporation. The assertions embodied in this chapter remain those of the author alone.

normal for the firm, were performed. Seventy-four firms (the experimental sample) that disclosed payments during April, 1975 through May, 1976 were examined relative to a control sample of equivalent relative risk, asset size and industrial composition. The transactions volume during the weeks surrounding the disclosure of sensitive foreign payments for the experimental sample was greater than the transactions volume for the control sample. Also, the variability of price changes was greater for firms that disclosed foreign transactions than those that did not. Firms disclosing sensitive foreign payments appeared to experience a small decline in the value of their common shares. Within two to three weeks, security prices reverted back to normal levels.

B. Introduction

In recent times, unparalleled attention has been given to financial, environmental and other socially relevant disclosures by U.S. corporations. But having received the most emphasis of all, at least as indicated by exposure given in the financial press, are those disclosures which relate to the extent of a firms involvement in illegitimate and potentially illegitimate activities overseas.[1/]

1/ In its report submitted to the Senate Banking, Housing and Urban Affairs Committee, May 12, 1976, the Securities and Exchange Commission (SEC) called "the

These activities have usually centered around transactions reported as payments to foreign officials in order to (1) secure or retain government contracts, (2) obtain favorable legislation or advantageous application of tax statutes, or (3) insure that overseas government officials perform their duties in a highly "predictable" manner. In this study, transactions of this nature are called "sensitive foreign payments." The objective is to assess empirically the impact of the disclosure of "sensitive foreign payments" upon the equilibrium holdings of common shares held by individuals in the securities market and upon assessments of the distribution of returns associated with the common shares of firms that have made these payments.

1/ (con't.) treatment of questionable or illegal payments . . . one of the most troublesome and pervasive circumstances" and the "most devastating disclosure" in its recent experience. Others have noted that the disclosure of involvement in this payments episode of governments in Bolivia, Honduras, Italy, Japan and the Netherlands has had adverse effects on the local political structure and may have caused serious damage to U.S. foreign relations (Blumberg (1977)). On the other hand, a poll of American business executives indicated that nearly 50% saw nothing wrong with paying foreign officials in order to attract or retain contracts (Opinion Research Corporation (1975)). A general discussion of the sensitive payments disclosure issue is contained in Sommer (1976).

C. Background

A brief history of the sensitive payments issue would most likely commence in April, 1975 when, during the course of a routine investigation which followed the death of the chief executive for United Brands Corporation, the Securities and Exchange Commission (hereafter SEC) became aware that a substantial illegal payment had been made to the President of Honduras and that further cash had been promised in return for preferential tax treatment. In the same month, reports of sensitive foreign payments arose in congressional oversight hearings related to Lockheed Corporation's loan guarantee program. Shortly afterwards, Gulf Oil Corporation, explaining certain of the outlays involved in an SEC suit, admitted to the payment of $4.2 million to foreign officials to shield assets.

Applying an evolving set of materiality criteria, the SEC brought enforcement proceedings against several firms for failing to disclose information about which the average prudent investor ought to be informed before buying or selling the securities. Further, in September, 1975, the SEC initiated an alternative means of bringing sensitive payments information into the public domain. This was called the "voluntary program." At first, few firms accepted the SEC's offer to admit voluntarily to improper or questionable payments. But as it became evident that only

in the extreme case would litigation succeed the voluntary disclosure, more and more firms came forward usually reporting such activities in their Form 8-K or 10-K filings with the SEC. Most disclosures were based on an internal investigation of the firm's foreign business and internal accounting control procedures. Inadequate corporate records were involved in most of these instances of improper activity.

The sensitive foreign payment quickly became a highly publicized political issue culminating in President Ford's ordering an investigation of U.S. practices abroad (February, 1976). This was followed by the establishment of a cabinet level commission (the Richardson Task Force) to investigate the ramifications of these sensitive payments (March, 1976). As early as January, 1976, SEC officials were engaged in Senate testimony which included: Senator Proxmire's Subcommittee on Priorities and Economy in Government, Senator Proxmire's Committee on Banking, Housing and Urban Affairs, and Senator Church's Multinational Corporation Subcommittee of the Senate Foreign Relations Committee. In April, 1976, the Internal Revenue Service announced that it would question the officers of all major U.S. corporations about their knowledge of sensitive foreign payments. Presently, proposed legislation includes Senate Bill S.305, "The Foreign Corrupt Practices Act of 1977"--

Title I, H.R. 3815, "The Unlawful Corporate Payments Act of 1977" and SEC Release No. 34-13185 which adds to Rule 13b and amends Schedule 14A of the 1934 Act.[2/]

D. Consequences of Disclosure

A disclosure rule or policy may be viewed as an institutional mechanism for providing information potentially pertinent to the allocation of real resources. Changes in these resource allocations due to information are termed the economic consequences of that policy. Moreover, depending on the policy-maker's preferences as to social desirability, the consequences of the policy imply that certain benefits and costs are imposed upon members of society. Expected consequences may, of course, differ from actual consequences. In addition, given the heterogeneous character of individuals that comprise the investment community, the benefits and costs assessed by a policy-making body may parallel exactly only by coincidence those of the individuals in the securities market. In a list of potential consequences, Beaver (1977) includes the following: (1) effects on the rate of capital formation and individuals' time-dated sequences of consumption, (2) changes in the allocation of invested capital among firms and the distribution of wealth among investors,

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2/ Williams (1977) traces the earlier developments in the sensitive foreign payments legislation.

(3) differential costs of production, dissemination and and interpretation of disclosures, (4) differential costs of compliance, enforcement and litigation of disclosures, (5) changed resource utilization in the search for privately versus publicly disclosed information and (6) altered management behavior stemming from incentives to operate and attitudes toward risk sharing.

Without question, it seems that potential economic consequences of the above type surround the sensitive foreign payments disclosure policy. At the one extreme there are direct cash consequences of the SEC investigations, firms' internal investigations and the additional income taxes that firms may have to pay. At the other extreme, the potential set of consequences involves the ability to do business abroad, thereby affecting overall U.S. economic and foreign policy. Fortunately, one consequence having a capacity to induce most, if not all, of the above outcomes is that probability assessments made by individuals concerning the distribution function of return are altered on receipt of the disclosure. Not only may beliefs change in aggregate, but also, given differential terms of trade between present and future stockholders as well as between the financial intermediaries (such as analysts and brokers) that produce, interpret and disseminate the information, disclosure may change the configurations of individuals'

beliefs about security returns.[3/]

Thus far, despite widespread debate, no comprehensive evidence has yet to be brought into the public domain to establish the extent to which the beliefs held in the securities market have been altered. Indeed, a finding that assessments of the distribution function of security return have not changed would unquestionably point to a potential divergence in the attitudes of the presumed beneficiaries of this regulatory activity (securities market participants) and those government officials who purport to act on their behalf. Any major difference in the degree of concern between investors and the regulatory agencies might well lead to the exposure of major deficiencies in the whole regulatory disclosure process itself.[4/]

In the spirit of the above remarks, it is the

3/ Griffin and Ng (1977) demonstrate analytically that, given sufficient structure, time series of the volume of transactions and changes in security price may be used to reflect meaningfully the flow of information to investors. The assumptions of the Griffin and Ng structure are restrictive, however, in that individuals assess the same covariance matrix of returns and acknowledge firm-specific information only.

4/ For an elaboration of the role of research in actual regulatory policy decisions, refer to May and Sundem (1976). Two primary inputs to policy decisions are delineated by the authors: (1) forecasts of the consequences to individuals of policy alternatives, and (2) forecasts of individual preferences over those consequences. Most certainly, forecasts of this type are impounded in the sensitive foreign payments disclosure policies. By concentrating on equilibrium

purpose of this study to determine whether sensitive foreign payment disclosures convey information pertinent to the equilibrium holdings of common shares, the assessment of return by market participants, and through these assessments, the structure of security prices, hence the value of the firm. Specifically, several tests concerning the level of transactions volume and price variability over and above what is considered normal for the firm are carried out. Seventy-four firms (the experimental sample) are examined relative to a control sample of equivalent relative risk and similar asset size and industrial composition over a 17-week period surrounding the week of sensitive payment disclosure. Certain controls are employed to isolate the confounding effects of contemporaneous earnings announcements and to examine differential effects due to the absolute dollar amount of the payment and the timing of its disclosure.[5/]

4/ (con't.) security prices and transactions volume, this research measures two important policy consequences. But it is unwise to judge the efficacy of any policy on one or both combinations of these variables. Inherently, the examination of a regulatory policy requires a social (collective) choice mechanism, something which turns out to be impossible to construct even under a minimally restrictive set of conditions.

5/ In the absence of a general equilibrium theory to predict differential behavior between firms who engage and those who do not engage in public disclosure of their illegitimate and potentially

The remaining introductory discussion identifies some related literature on the subject of SEC required disclosure. Sections F-G outline the empirical methodology, the sample section criteria and data sources. The empirical findings are reported in Sections H-J. Tentative conclusions are discussed in the final section.

E. Relevant Prior Research

Much of the evidence on the overall effects of the SEC's disclosure requirements is contained in studies by Stigler (1964a) and Friend and Herman (1964) of the Securities Act of 1933,[6/] and in research by Benston (1969a, 1969b, and 1973) and Deakin (1976) on the Securities Exchange Act of 1934. Some support for the proposition that the allocational efficiency of the market for new issues improved in the post-SEC-act period is documented by the Stigler and the Friend and Herman analyses. On the other hand, Benston's articles conclude that there is no support for the belief that the 1934 Act had a measurable effect on the market for outstanding

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5/ (con't.) illegitimate overseas activities, the hypothesis tests are mostly descriptive. Primarily, they seek to detect the presence of permanent and/or transitory change in specified parameters of a process said to characterize security return behavior. A control group and various partitions of the primary sample are utilized to isolate these differences.

6/ See also Stigler (1964b) and Friend and Herman (1965).

issues.[7/] Officer (1973) reports a similar finding based on the variability of market return indexes. But using a simplified "Box and Jenkins" transfer function approach, Deakin concludes that the 1934 accounting disclosure interventions do appear to be associated contemporaneously with change in market-wide returns.

A suprisingly small number of studies relevant to specific SEC accounting disclosures have been conducted. These include Collins (1975), Gonedes (1975) and Hagerman (1975). Collins tests the efficiency of the securities market with respect to segment earnings data first made public by many firms in their 1970 Form 10-K filings. His findings reveal, that for the 1968-1969 period only, security prices did not fully reflect the segment data unreported prior to the 1970 Form 10-K reports. Gonedes, in his study of annual special accounting items disclosed by firms in their Form 8-K and 10-K filings with the SEC, indicates that his tests are not inconsistent with the statement that special accounting items convey information pertinent to establishing firms' equilibrium values. Hagerman concludes, however, that the increased regulation of state bank reporting was not accompanied by increased informational content of these statements.

7/ An extensive debate focusing on the Benston methodology is documented in Friend and Westerfield (1975), Benston (1975) and Friend (1976).

Evidence on the consequences of disclosure regulation is viewed as an important element of its justification. It is hoped that the assessments of lawmakers implicit in the legislation and disclosure rules which may eventually be imposed upon firms concerning sensitive foreign payments vary directly with the empirical assertions in this report.

F. Methodology

The following variables are defined for each firm, i =1,...,N, on a weekly basis for 295 weeks from January 11, 1971 (Week 2) to September 1, 1976 (Week 296) using Wednesday as the end of each weekly period.

$$R_{it} = [(\text{Price}_{it} - \text{Price (adjusted for capital changes)}_{i,t-1})/\text{Price (adjusted for capital changes)}_{i,t-1}$$

$$R_{mt} = [(\text{Standard \& Poor's 425 Industrials Price Index}_{t} - \text{Standard \& Poor's 425 Industrials Price Index}_{t-1})/\text{Standard \& Poor's 425 Industrials Price Index}_{t-1}]$$

$$V_{it} = \frac{\left(\dfrac{\text{Number of Shares Traded for Firm i in Week t}}{\text{Number of Trading Days in Week t}}\right)}{\text{Number of Shares outstanding for firm i at beginning of fiscal year t}}$$

$$V_{mt} = 1/N\sum_{i=1}^{N} V_{it} \quad \text{where N = Number of firms in the combined sample}$$

Note that R_{it} is a measure of percentage price change only and, since it excludes dividend payments, does not measure precisely the *ex post* return that accrues to the stockholder. The market index is defined similarly. The index of volume of shares traded is constructed from the combined sample and should be viewed only as an approximation to a measure of market-wide transactions volume. The index attempts to weight equally the contribution of each firm to the index by deflating each calculation of average weekly shares traded by the number of shares outstanding at the beginning of each fiscal year.

To assess the effects of sensitive foreign payment disclosures on the beliefs of individuals in the securities market, it is necessary to control for the effects of other information (e.g., earnings information) flowing to the market at the same time. However, this is not a straightforward exercise in view of the fact that the disclosures by any single firm may be staggered over several points in time. Also, the disclosure of one firm's sensitive payment may reveal information about the probable participation of other firms (e.g., firms in the same industry) in potentially illegitimate foreign activities.[8/]

8/ The so-called quasi-experimental design technique (Campbell and Stanley (1963)) is used in which market impact is examined 8 weeks before and 8 weeks after the disclosure for experimental and control samples for two kinds of disclosures (annual earnings and foreign sensitive payments). Three different measures of market impact are used.

First, the impact of the sensitive foreign payment disclosure is examined as a comparison of the variability of weekly percentage price changes adjusted for the influence of market-wide events for a period of 8 weeks before and 8 weeks after the first public disclosure (the report period).[9/] Increased variability during this report period may be determined relative to a prior nonreport period assumed to reflect normal activity for the firm.[10/] Price change variation

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9/ Of course, it is not always the case that the greatest impact of the sensitive foreign payment disclosure accrues to a firm's first annoucement of such activities. Market-wide and industry effects (due, for example, to the economic consequences of anticipated legislation and the correlated nature of security returns) may cause investors to respond well before a firm's first formal announcement. But having eliminated market effects and controlled explicitly for industry effects, the methodology, by design, captures firm-specific effects, if in fact the occur.

10/ Two measures of variability are computed for each firm i based on residuals from the linear regression $R_{it} = \alpha_i + \beta_i R_{mt} + \mu_{it}$, $t \in$ nonreport period (assuming the joint distribution of returns to be stationary through time, $E(\mu_{it}) = 0, \sigma(R_{mt}, \mu_{it}) = 0, \sigma(\mu_{it}, \mu_{is}) = 0$ for $t \neq s$ and $\sigma(\mu_{it}, \mu_{is}) = \sigma_i$ for $t = s$):

(1) standardized residual percentage price change variability for week t* surrounding disclosure date = $(\epsilon_{it*} / \hat{\sigma}(\hat{\mu}_{it}))2$

due to annual earnings announcements was excluded from this prior (nonreport) period. Aggregate or systematic market-adjusted percentage change in price surrounding disclosure may also be determined in this manner since the nonreport period is constructed so that the mean market-adjusted price change is zero.[11/] Additionally, increased variability and systematic price change may be observed by comparing such measures to equivalent measures for a control sample.

Given that the control sample comprises firms that

10/ (con't.)

(2) unstandardized residual percentage price change variability for week t* surrounding disclosure date = $|\hat{\varepsilon}_{it*}|$

where $\hat{\varepsilon}_{it*} = R_{it*} - \left\{\hat{\alpha}_i + \hat{\beta}_i R_{mt*}\right\}$, $t^* \in$ report period, and

$\hat{\mu}_{it} = R_{it} - \left\{\hat{\alpha}_i + \hat{\beta}_i R_{mt}\right\}$, $t \in$ nonreport period.

11/ A measure of aggregate or systematic price response is computed on a cumulative basis using the linear regression stated in footnote 10. The standardized cumulative residual percentage price change for week T surrounding earnings announcement date = $\sum_{t^*=t_1}^{T} \left[\hat{\varepsilon}_{it*}/\hat{\sigma}(\hat{u}_{it})\right]$ for t_1=-8 and -4 where $\hat{\varepsilon}_{it*}$ and $\hat{u}_{it}$ are defined as in footnote 10. The cumulative residual technique has been used in a wide variety of contexts (e.g., disclosures of merger, tender offers, dividends, insider trades, management forecasts, accounting method changes, etc.). A statistical comparison of several versions of this metric is contained in Brenner (1974). Justifications for such measures are discussed in Marshall (1975) and Ohlson (1977).

did not disclose sensitive payments during the study period, yet had the same relative risk, asset size and industry composition, then the comparison should isolate all effects other than those specific to the firm's disclosure of participation in foreign payments activity.[12/]

Second, the weekly volume of shares traded surrounding the date of disclosure of the sensitive payment may be examined in a manner similar to the above. In other words, the specific volume reaction to a firm's disclosure of foreign payments may be detected by adjusting a firm's transactions volume for market-wide events and assessing this relative to transactions volume in a nonreport period as well as relative to a control sample of equivalent risk and industrial composition.[13/]

12/ The extent to which the control sample actually extracts extraneous variables is a key determinant in the quasi-experimental design. The homogeneity of the two samples is analyzed extensively in the results section of this paper.

13/ Weekly volume adjusted for market-wide influences is calculated from the linear regression $V_{it} = \gamma_{1i} + \gamma_{2i} V_{mt} + \gamma_{3it}$, $t \in$ nonreport period (ordinary least squares assumptions are invoked and the nonreport period comprises 140 observations). Two forms of the measure are computed:

(1) standardized residual volume for week t* surrounding disclosure date =

$$\hat{\nu}_{it*} / \hat{\sigma}(\hat{\gamma}_{3it})$$

Third, the experimental sample (those firms that disclosed sensitive foreign payments during the study period) may be examined to detect the presence of (1) differential response associated with the dollar amount of the payment reported and (2) differential response associated with the timing of the payments disclosed. The former differential response is an attempt to confirm the fact that agents are responding to at least one of the stated SEC materiality criteria. The May 12, 1976, SEC Report to the Senate Committee on Banking, Housing and Urban Affairs presents several informal views on materiality. The guidelines appear to mandate disclosure when the amount of the payment is significant in an absolute sense or in relation to total revenues, assets or income.

The latter differential response is based on the

13/ (con't.)

(2) unstandardized residual volume for week t* surrounding disclosure date = $\hat{\nu}_{it*}$

where $\hat{\nu}_{it*} = V_{it*} - (\hat{\gamma}_{1i} + \hat{\gamma}_{2i} V_{mt*})$, $t* \in$ report period; and

$\hat{\gamma}_{3it} = V_{it} - (\hat{\gamma}_{1i} + \hat{\gamma}_{2i} V_{mt})$, $t \in$ nonreport period

Beaver (1968), applying this technique to announcements of earnings, states that "volume relfects a lack of consensus regarding the price." (p. 69). A detailed justification for the use of transactions volume to measure informational content is contained in Griffin and Ng (1977).

proposition that one firm's early disclosure will most likely influence investors' expectations about the existence of activities in other firms that comprise the industry to which it belongs. This effect may be strengthened given that the first announcement of a firm disclosing early in the study period is less ambiguous than the date of first announcement for a firm disclosing late and possibly at a time when other information (e.g. annual earnings) is released. Additionally, one might expect that effects of this nature are more pronounced for firms that disclosed seemingly very large dollar payments than those that did not. In short, the experimental sample may be examined not only in terms of the control sample, but also on the basis of the significance of dollar amounts disclosed and timing of the disclosure.

The fourth stage of the analysis is an attempt to account for the impact of earnings performance on the securities market reaction to sensitive foreign payments. To accomplish this, each firm in the combined sample (the experimental and the control sample) is classified as either announcing earnings-per-share above (favorable) or below (unfavorable) what was expected by analysts three months prior to the firm's fiscal year-end. This aspect of the experimental design was considered useful for three reasons. First, the capital market response to earnings-per-share, having been studied most comprehensively, should provide a valuable benchmark against which to compare the response to sensitive

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payment disclosures. The benchmark is viewed solely in terms of a capacity of the signal to induce probability revisions in distributions of future price changes. Second, sensitive payment disclosures and annual earnings announcements may be released contemporaneously for some firms. Hence, the marginal effect of one signal may be obscured by the presence of the other. The use of the Form 10-K filing to report sensitive payments would appear to be an example of this kind. Third, the sensitive payment disclosure may be part of a complementarity relationship. That is, taken by itself, the sensitive payment disclosure may have no unambiguous implications, for the revision of expected security returns. But taken with other relevant signals, the joint signal may have nontrivial implications, and these may differ from the implications of the other signal taken by itself (Gonedes (1976)). One might easily envisage this kind of relationship to exist between the sensitive payments disclosure and a related annual earnings report since the extent to which sensitive payments and competitive position are related may be made explicit at this time. Also, earnings performance would appear to be a good candidate for the evaluation of these complementarity effects since it is likely to be correlated with other (competitive) signals (e.g., dividend announcements). Hence, for the reasons cited above, the three stages of the analysis are repeated relative to the date of annual earnings

announcement identified specifically for each firm in the experimental and the control samples.

G. Sample and Data Sources

A list of 81 companies disclosing sensitive foreign payments up to a cut-off date of May 31, 1976, was provided by the staff to the SEC Advisory Committee on Corporate Disclosure. Of the 81 companies, 7 were excluded from the analysis either because weekly price and volume data for the required period was unavailable or because no specific date of payment disclosure could be identified from public records. A review of various public documents indicated that a total of 91 firms had made disclosures on or before May 31, 1976. In other words, the experimental sample reflects approximately 80% of the population which had identified itself on or before the cut-off date.[14/] Further information about the sample may be obtained from the author.

A control sample of 65 firms was selected. First, a

14/ The self-selected nature of the sample raises additional economic considerations, potentially relevant for the analysis. On the one hand, firms that disclosed immaterial amounts and thus may have had little to lose may have done so to signal their high ethical standards of business practice. On the other hand, firms with practices that, in their judgment, were corrupt may have come forward voluntarily to avoid the high costs of legal proceedings that otherwise may have been incurred. Apart from the size-of-payment factor, it was not possible to determine fully other aspects of this self-selection phenomenon.

portfolio of firms was identified for each of the 34 four-digit Standard Industrial Classification (SIC) Codes represented in the experimental sample from the Annual Industrial Compustat tape. Second, total assets as of the fiscal year-end 1974 and an estimate of relative risk were obtained for each firm in the experimental sample as well as for all firms that potentially could enter the control sample. Third, control sample portfolios by industry were established by matching first the relative risk and second the size characteristics of each firm in the 34 SIC Code industry groups. The control and the experimental portfolios, matched on a firm-by-firm basis, were generally of equal number. Smaller numbers of firms were used in those control portfolios heavily dominated by sensitive payment disclosing firms (e.g., the pharmaceutical and aerospace industries). In one case (General Refractories), a match could not be made since there was no other firm in its four-digit industry group. Also, 13 firms in the control sample disclosed sensitive foreign payments after the May 31, 1976, cut-off date. However, this was not unexpected in view of the aforementioned industry effects associated with early disclosure. Post-cut-off date effects are discussed briefly in the Results section.

Weekly percentage changes in stock prices (R_{it}) and in average weekly transactions volume (V_{it}) for the period January 11, 1971, to September 3, 1976, were obtained from the

Interactive Data Corporation. The size of firm data (total assets) was extracted from the Annual Industrial Compustat tape (data item #6) and preliminary estimates of relative risk were obtained from the Value Line Investment Survey.[15/] The computation date for relative risk was that closest to 3 months prior to a firm's most recent year-end in the study period. (The earliest and latest fiscal year-ends were June 30, 1975, and April 30, 1976.) As a proxy for aggregate market expectations of earnings, a forecast of earnings-per-share was obtained from the same Value Line publication. This was subtracted from actual earnings-per-share (obtained from several sources including Moody's, Standard and Poor's and Wall Street Journal publications) to obtain a measure of unexpected earnings-per-share. If this variable was positive (negative), earnings performance was considered to be favorable (unfavorable) relative to investors' expectations.

The Wall Street Journal Index, copies of firms' Form 8-K and 10-K reports (provided by the staff to the SEC Advisory Committee on Corporate Disclosure) and various other public documents (e.g., The New York Times, Newsweek and letters to shareholders) constituted the sources of data for obtaining exact dates of disclosure for each

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15/ The Value Line risk estimates were preliminary in that the subsequent analysis used relative risk calculated from the linear regression equation specified in footnote 10. No biases should result from this two-step procedure.

experimental group firm, dollar amounts reported, and the number of years over which the payments had been made. The date of disclosure for a control group firm was the same calendar week in which the paired treatment firm disclosed sensitive foreign payments. Other details such as whether the disclosure was voluntarily made and if the amount was indicated to be insignificant by the firm's management were also noted. Multiple sensitive payment disclosures were made by only 15 firms in the experimental sample. These may have related to the same or different payments episodes.[16/]

Linear regressions (the models are specified in footnotes 10 and 13) to compute the regression "residuals" were estimated using a nonreport period of 140 weeks. For each firm, week number 140 was either 9 weeks prior to the week of the first sensitive foreign payment disclosure or 9 weeks prior to the annual earnings announcement, whichever came first. In order to exclude past annual earnings effects, 17 weeks surrounding the week of the 1971-1975 annual earnings announcements were deleted, giving 35 weekly observations each year

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16/ The empirical analysis was carried out including and excluding the additional disclosures as separate data points. No insights were provided by this distinction. Since they should not be viewed as "independent" observations, the report deals only with a firm's first public announcement.

or 140 observations for the 4-year nonreport period. The report period comprised either the 17 weeks surrounding the week of the sensitive payment disclosure or the annual earnings announcement during the April, 1975, to May, 1976, study period.

H. Results

The empirical results embodied in Tables 1-7 are based on a 74-firm experimental sample (KTYPE = 1) and a 65-firm control sample (KTYPE = 2). Earnings performance for the combined sample is classified in terms of whether the unexpected earnings-per-share performance was favorable (ITYPE =1) or unfavorable (ITYPE = 2). Two further partitions were made for the experimental group only. These were (1) firms disclosing sensitive foreign payments before February 4, 1976 (IDATE = 1), and after February 4, 1976 (IDATE = 2), and (2) firms disclosing sensitive foreign payments amounting to $300,000 or more regardless of the size of firm, its earnings and the number of years over which the payments may have been made (IMAT = 1) and firms disclosing payments amounting to less than $300,000 (IMAT = 2). Clearly, the criteria for the IDATE and the IMAT partitions are arbitrary. The February 4, 1976, criterion date was influenced by a desire to reduce substantially the potentially confounding nature of annual earnings announcements which tended to cluster in the months which followed. Although

the most visible of dollar amounts, the absolute dollar amount ranking for IMAT is an approximation to the issue of materiality. Interestingly, Chairman Sommer (of the SEC Advisory Committee on Corporate Disclosure) agreed, in a private conversation, that the IMAT cutoff was most reasonable under the circumstances. One should bear in mind, however, that more sophisticated measures would have restricted the applicability of the IMAT criterion to all experimental sample firms (due to lack of information on number of years during which payments were made). Further, it is not clear that individuals have been applying traditional net income-based materiality criteria to the sensitive payments issue. At least the SEC guidelines appear to reflect a broader interpretation extending potentially to violations of law in overseas countries and immoral business conduct with foreign government officials.

The control group companies were matched with the experimental sample by industry and then primarily by relative risk and secondarily by size (total assets). Analysis of variance tests indicated that, as one would expect from the research design, differences in relative risk (recalculated using the linear regression technique described in footnote 10) were statistically insignificant.[16/] Not

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16/ Two classical experimental analysis of variance designs were used to examine the differential effects of KTYPE,

only were KTYPE and ITYPE differences insignificant, but also for the experimental sample there was no difference in mean relative risk across the IDATE, ITYPE and IMAT partitions.[17/] The selection procedure, however, provides no direct assurance that the effect of variables other than those used for matching will be similar for both samples. Thus the financial profiles of the two samples are described utilizing four dimensions (size,

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16/ (con't.)

ITYPE, IDATE and IMAT on relative risk. The first was a fixed effects model with 2 factors, KTYPE and ITYPE, applied to the 139-firm sample. The second was a fixed effects 3-factor model with factors ITYPE, IDATE and IMAT applied to the 74-firm experimental sample only. The residuals from each model were assumed to be independently distributed $N(0,\sigma^2)$ variables. The usual restrictions on the main effects and the interaction effects parameters applied. Note, for the fixed effects model, lack of normality (which is not extreme) is not an important matter. Variance heterogeneity has little effect on the F statistics, provided the sample partitions are of approximately equal size (Neter and Wasserman (1974)).

17/ For example, cross-sectional statistics for $\hat{\beta}_i$ were as follows:

Partition		Mean	Standard Deviation	Decile .10	.50	.90
KTYPE=1	74	0.9973	0.2386	0.7362	0.9814	1.2849
=2	65	0.9918	0.2747	0.6271	1.0159	1.2766
ITYPE=1	67	0.9955	0.2353	0.6408	0.9996	1.2766
=2	72	0.9940	0.2739	0.6864	0.9814	1.2849

Other cross-sectional statistics were calculated. The mean $\hat{\alpha}_i$ was -0.0003 and -0.0004 for the KTYPE=1, 2 partitions, respectively. The mean R^2 was 29.26% and 24.73% for KTYPE=1 and 2, respectively.

profitability, liquidity and financial risk) found typically in merger and failure predictability studies plus foreign markets exposure expressed as the ratio of foreign sales to total sales. Intuitively, the likelihood of foreign payments activity, whether disclosed or not, ought to be greater for firms whose markets are outside as opposed to inside the United States. All financial data is fiscal year ended 1974, taken from the Annual Industrial Compustat tape except for foreign sales data which was obtained from company annual reports and SEC filings. 18/

Table 1 reports the means and standard deviations for each variable and tests for significance of difference between the experimental and the control sample. All variables except foreign sales/total sales (%) are insignificant at the 0.05 probability level regardless of whether the 5/31/76 disclosure status (the original cut-off date) or the 12/31/76 disclosure status (a "reclassified" cut-off date) was used to partition the full sample of firms. 19/

18/ David Hughes and Joan Karlin (Stanford University) assisted in developing and analyzing the financial profile data.

19/ The finding that the experimental and control firms differ in their foreign markets exposure raises a related issue of residual price change/volume differences due to foreign currency translation adjustments. Although the Financial Accounting Standards Board's Discussion Memorandum first appeared in March, 1975, to some degree the study-period overlaps with the period of exposure and adoption of the FASB's Statement on this problem. The translation controversy is, however, a bookkeeping issue only insofar

Such similarity is, of course, exactly what was intended, since, to examine the securities market impact of disclosure, it was necessary to have the two samples as indistinguishable as possible on all grounds other than disclosure. What is most striking is the high degree of comparability that results by matching primarily on the basis of relative risk--a variable which apparently captures a wealth of financial information.[20/]

I. Earnings: Price Change and Volume Tests

Table 2 details the residual volume surrounding the week of annual earnings announcement identified for each firm in the experimental and the control samples. The mean residual volume response is presented in both an unstandardized

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19/ (con't.) as no evidence has surfaced to suggest that management's operating-investment and financing decisions (hence future cash flows) have been significantly altered as a consequence of the change in accounting policy.

20/ As an additional check on the homogeneity of the firms, linear discriminant analysis was conducted in an attempt to distinguish statistically between the two samples. Three combinations of discriminating variables were investigated using the original control and the experimental groupings. One of these combinations was repeated utilizing the "reclassified" sample groupings. The models included various combinations of indicators of size, profitability and risk. All included foreign markets exposure. None of the attempts possessed discriminatory power at level of significance = 0.05. It should be noted, however, that there still remains some uncertainty about the status of the control group. Are they "not-bribing" firms (the discriminant model is deficient) or merely "bribers" who have not yet disclosed?

(raw) and standardized form. The standard deviation of the nonreport period residuals, $\hat{\sigma}(\hat{\gamma}_{3it})$, was used to standardize the report period residuals. An abnormally higher transactions volume occurs at week 0 (earnings announcement date). This finding is consistent with the proposition that annual earnings announcements convey information relevant to the optimal holdings of securities by market participants.[21/] A classical, fixed effects 2-way ANOVA procedure was used to examine differences in the volume activity due to whether the firm was in the experimental or control sample (KTYPE) and reported favorable or unfavorable earnings information (ITYPE).[22/] Only in week 0

21/ This result is consistent but not as dramatic as that reported by Beaver (1968) due to his more restrictive selection criteria that (1) no dividends were announced in week 0 and (2) less than 20 news announcements per year appeared in the Wall Street Journal Index.

22/ Two factors (KTYPE and ITYPE) with an interaction effect were used to analyze the cross-sectional distribution of standardized residual volume for each of the 5 weeks surrounding the week of announcement. No serious violations were evident in that the standardized residual volume was symmetrically distributed, the volume residuals were heterogeneity-adjusted by way of their standardization, and the extraction of market-wide effects and synchronization of different chronological dates served to reduce substantially the presence of cross-sectional dependence. It should be noted, however, that one assumption of the ANOVA procedure is that the experimental and control samples should be independent. The pairwise matching procedure introduces a dependency between the two groups especially where the same chronological date is used to match the treatment firm's "disclosure." Although the sample means are unaffected, the sampling variability of the means may well be altered.

did the ANOVA test indicate any statistically significant effects. The probability values associated with not rejecting the absence of effects due to KTYPE and ITYPE, when in fact the effects are present, were 0.044 and 0.065, respectively. Also, when applied to the experimental sample only, a separate 3-way ANOVA test[23/] indicated that there was a significant interaction between the timing of the sensitive payment (IDATE) and its dollar significance (IMAT). Associated with the IDATE-IMAT interaction were probability values of 0.092, 0.033 and 0.096 in weeks -2, -1 and 0, respectively. A complementarity relationship of the kind mentioned earlier would seem to be reflected in the data in that firms that disclosed material (as operationally defined) payments early in the study period experienced significantly higher transactions volume during the weeks surrounding their annual earnings announcement. Moreover, transaction volume appeared to be greater for the experimental group than for the control group. This result also suggests the existence of complementarity between the sensitive payment disclosures and earnings announcements. Indeed, the use by some firms of their Form 10-K to report under the voluntary program is one reason why this might occur.

23/ Three factors (ITYPE, IDATE and IMAT) with three 2-way and one 3-way interaction effects were used in the ANOVA applied for each of the weeks 2, -1, 0, 1, 2.

Table 3 reports the residual percentage price change variability and the cumulative residual percentage price change that occurs in the weeks surrounding the announcement of annual earnings. First, it is apparent from Table 3 that the mean cumulative residual differs according to whether favorable or unfavorable earnings are reported (ITYPE). A 2-way ANOVA test, using the cumulative residuals as the dependent variable, indicated that the strongest effects occurred (as expected) during week 0 (with level of significance $p = 0.061$) and week 1 ($p = 0.078$). Notwithstanding earnings effects, the cumulative price response to the announcement of annual earnings did not differ between the experimental and the control sample. Nor did the cumulative response within the experimental sample differ between the timing (IDATE) and the significance of dollar amount (IMAT) partitions when the 3-way ANOVA test was applied. In short, the systematic or cumulative price response that occurred during the weeks surrounding the announcement of annual earnings was largely unaffected by knowledge of a firm's involvement in foreign payment activities.

Measures of the variability of the residual percentage price changes in the weeks surrounding the announcement of annual earnings are also shown in Table 3. The mean absolute value of the unstandardized residual price change and the mean square of the standardized residual price change are reported.

Relative to the weeks shown, there appears to be no striking increase in price change variability during week 0. Consequently, the results are not as dramatic as some earlier studies have shown.[24/] They are, however, still most consistent with the proposition that the securities market response is greater than what is considered normal (based on past activity) for the firm. For example, the mean squared residual price change was 30.47%, 28.75% and 22.15% higher than the average for the nonreport period during weeks -1, 0, and 1, respectively. Recall that, although the nonreport period excludes the effects of past annual earnings announcements, past first, second and third quarterly earnings announcements are included in what is considered normal price change activity.

The variance of the residual percentage price change is significantly greater for the experimental sample than for the control sample during week 0. Using the variance of the standardized residual as the dependent variable, the 2-way ANOVA indicated a probability level of 0.019 associated with the KTYPE factor during week 0. No other effects were significant at the 0.05 level during any of the weeks -2, ..., 2. Consistent with the higher transaction volume that was observed at week 0, a complementarity relationship appears

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24/ Beaver (1968) reports a standardized mean square value for week 0 of 1.67 for 143 noncalendar-year firms. On the other hand, Patell (1976) reports, for 336 firms, a similar standardized mean square value for week 0 of 1.172.

to be reflected by this data also. In short, the sensitive payment disclosure appears to lack unambiguous implications for the firm when viewed jointly with information concerning earnings performance.[25/]

J. Sensitive Foreign Payment Tests

During the week of disclosure of the sensitive foreign payment, no apparent increase in transactions volume took place in either of the samples. The mean residual volume statistics are shown in Table 4 (unstandardized and standardized variables are reported). The tests of differences in the mean standardized residual volume using the ANOVA procedure indicated that the experimental sample was not statistically different from the control sample during weeks -2,...,2. Note, the smallest level of significance was the probability value p = 0.253 associated with week 0. Nevertheless, the transactions volume for the experimental sample did exceed (but not significantly, as anticipated) the control sample transactions volume for weeks -7,...,6 and -7,...,7 for the standardized and the unstandardized variables, respectively.

25/ Due to the nature of the propositions which emphasize market response at the time of public disclosure, only the critical weeks -2,...,2 are incorporated in the significance testing procedures in this and the succeeding section. Weeks -8,...,-3 and 3,...8 were always scanned for potentially interesting findings. But in moving away from week 0, in either direction, it is likely that one runs a greater risk of rejecting the null hypothesis (due to sampling variability effects only) when it is true in fact that there are no information effects.

The mean standardized transactions volume was 0.4079, 0.1874 and 0.5014 of one standard deviation higher than the mean nonreport period transactions volume (constructed to have zero mean and variance equal to one) for weeks -1, 0 and 1, respectively.

Further insights into transactions volume activity surrounding the week of the disclosure of the sensitive payment are evident from an examination of Table 5. Table 5, which reports the probability values associated with F statistics for all sources of variation, indicates significant earnings effects ($p = 0.044$) reflecting that, for some firms, the annual earnings announcement and the sensitive foreign payment disclosure may have been contemporaneous. Of more interest, however, is that firms disclosing material dollar amounts experienced dramatically higher transactions volume in weeks -2,...,2 and that this effect differed across firms disclosing early and late within the study period with the early firms experiencing higher transactions volume. Note that the level of significance for the IDATE-IMAT interaction is 0.026 for week 0. The probability values for the materiality factor alone are 0.056, 0.207 and 0.067 for weeks -1, 0 and 1, respectively.

Tables 6 and 7 analyze the residual percentage price change variability and the cumulative residual percentage price change surrounding the sensitive payment disclosure.

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An unstandardized mean absolute residual and a standardized mean square residual are presented for the variability measures. The evidence suggests that the residual price change variability surrounding the sensitive payment disclosure was greater for the experimental sample in that probability values of 0.195 and 0.060 are associated with weeks 0 and 1, respectively (refer to Table 7).[26/] Within the experimental sample, week 1 seems especially affected by the timing (IDATE) and the dollar significance (IMAT) partitions as well as the earnings performance (ITYPE). The greater level at price variability of firms with early disclosures appears to differ significantly from firms with late disclosures ($p = 0.001$). As well, firms with early disclosures of significant dollar amounts experienced greater price variability than those with early disclosures of insignificant dollar amounts. That i , Table 7 indicates that the IDATE-IMAT interaction effect is significant for $p = 0.002$.

It is also of interest to contrast the price change variability analysis with the volume analysis surrounding the disclosure of the sensitive payment. Both variables

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26/ On the basis of frequency of the sign of the difference in standardized mean square over the 17-week period, however, the reverse is true. But it is highly implausible that differences in weeks 5,...,8 are due to anything but sampling effects.

tend to be significantly higher for those firms in the experimental sample with material dollar payments during either weeks 0 or 1. Note that the residual volume activity (including the significant interaction effects) tends to lead the price activity. This result is not inconsistent with the existence of trading by skilled individuals who have acquired and processed information relevant to their optimal holdings of securities earlier than those who may be less skilled in the acquisition and processing of timely information.

Tables 6 and 7 also present evidence on the systematic impact of the sensitive payment disclosure on the value of a firm. Both standardized (accumulated from week -4) and unstandardized (accumulated from week -2) measures of the cumulative residual price change are presented. Residuals accumulated from week -8 and other weeks prior to week 0 were also computed with similar results. From Table 6, it is apparent that a systematic negative effect occurred during weeks -2,...,1. For all versions of the cumulative response, the experimental sample residuals were below those for the control group. However, the systematic drop in price was reversed in week 2 and succeeding weeks indicating that the overall response by securities market agents was temporary. That is, within two to three weeks subsequent to the disclosure, the data indicate that firms' percentage price changes reverted back to normal. As predicted, the

control group reflects a similar trend in the mean residuals due to industry effects. If held from the beginning of week -2 to week 1, a portfolio of firms that had disclosed sensitive payments would have decreased in value by .0275% for this period. This should be contrasted with the decrease in value of the control sample of .00842% for this same period. The ANOVA tests performed detailed in Table 7, did not detect any statistically significant difference in the cumulative percentage price change between the two samples in these weeks.[27/]

K. Concluding Remarks

Two important consequences concerning the disclosure of sensitive foreign payments are that (1) individuals, in aggregate, alter their probability beliefs of the future cash flows associated with their investment portfolios, and (2) individuals alter the holdings of securities in their optimal portfolios. The evidence presented in this report indicates that the disclosure of sensitive foreign payments has had nontrivial measurable economic consequences of the above kind. The specific findings are summarized below.

27/ Not unexpectedly, the initial fears held by some corporate officials that curtailment of "payoffs" would mean lost business seem to have been unjustified in an *ex post* sense. *A Wall Street Journal* survey of 25 corporations who had disclosed making large payments abroad indicates, that while all firms had forbidden their employees to engage any further in "payoffs," not one of the 25 firms reported losing a significant portion of its foreign business (Pappas (1977)).

1. The transactions volume for firms during the weeks surrounding the disclosure of their sensitive foreign payments was generally greater than the transactions volume for firms that were similar in their relative risk and industry characteristics but had not disclosed foreign transactions. Firms that disclosed significant dollar payments experienced a higher transactions volume than those that did not, as did firms that disclosed significant dollar payments early in the study period. The transactions volume effect was very slight when viewed relative to the abnormal increase that occurred during the week of annual earnings announcement.

2. The sensitive payment disclosure and the announcement of annual earnings appeared to exhibit a complementarity relationship. That is, there was a significant interaction at the time of the annual earnings announcement between firms with significant dollar disclosures that also disclosed foreign payments at the same time. Not only did the configurations of information held by participants in the securities market appear to change in response to earnings announcements, but also the extent of this change seemed to differ according to whether or not the firm disclosed foreign transactions.

3. In the week following the week of sensitive foreign payment announcement, the variability of residual price changes was statistically greater for firms that disclosed

foreign transactions than those that did not. Firms that disclosed significant dollar transactions appeared to be more affected than firms whose payments were small or immaterial. Firms that disclosed early in the study period seemed more affected than those that disclosed at a later point in time.

4. When synchronized to the date of the annual earnings announcement, the variance of the residual percentage price change was significantly greater for firms that disclosed foreign payments than those that did not. Consistent with the second of the above findings, the response to annual earnings appeared to differ according to whether foreign payments were disclosed.

5. Firms disclosing sensitive foreign payments appeared to experience a small decline in the value of their common shares. The effect was temporary and, within two to three weeks after the week of disclosure, a firm's security price reverted back to normal levels. As predicted, the control group reflected a similar trend in the mean residual percentage price change due to industry effects. Nevertheless, the tests performed did not detect any statistical difference in the cumulative residual percentage price change between the two samples. Hence, systematic revisions in price by securities market agents would appear to be practically imperceptible to analysts, a firm's management and the financial community in general.

This study has been concerned with the consequences of a specific disclosure policy: namely, the disclosure of a firm's sensitive foreign payments. It is an attempt to apply an empirical yet scientific tradition to questions of disclosure as they affect the beliefs of securities market participants and ultimately the value of the firm. The findings appear relevant to the question of investor materiality in that agents seemed to respond differentially to the dollar amount of the payment disclosed. However, this is not to say that other "noneconomic" disclosure criteria, such as violation of U.S. or foreign laws, falsification of accounting records and involvement of foreign government officials, are no less necessary to ensure that the particular SEC filing is not misleading.

Lastly, the findings suggest that the degree of concern by those in governement as indicated by legislative activity and the involvement of several agencies (SEC, Internal Revenue Service and the Justice Department) does not appear entirely commensurate with the small temporary impact of the disclosure on the value of the corporation. Clearly, the issues are complex, but what is perceived to be an apparent difference between the reaction by market participants and regulatory agencies themselves would seem to suggest that further investigation is desirable. For example, both phenomena may be endogenous in that the nature of the regulatory activity may have been induced by individuals'

market reactions and vice versa. There are, of course, many social implications to justify the concern of legislators and regulatory agencies that price change and volume activity would never detect, that should, nonetheless, be incorporated in a complete analysis.

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Table 1

FINANCIAL PROFILE OF EXPERIMENTAL AND CONTROL SAMPLE
CLASSIFIED BY DISCLOSURE STATUS

Dimension	Financial Variable	Disclosure Status as of 5/31/76					Disclosure Status as of 12/31/76				
		Mean		Standard Deviation		T-Statistic**	Mean		Standard Deviation		T-Statistic**
		Experimental	Control	Experimental	Control		Experimental	Control	Experimental	Control	
1. Profitability	EBIT*/ Total Assets(%)	13.64	13.65	6.81	6.56	-0.01	13.84	13.31	6.58	6.91	0.43
2. Profitability	Pre-Tax Margin (%)	9.78	9.74	6.31	6.65	0.03	10.06	9.24	6.13	6.99	0.65
3. Size	Sales ($mill)	3481.7	2465.8	6415.9	5693.9	0.97	3249.58	2641.38	6090.47	6116.90	0.57
4. Size	Aggregate Market Value($mill)	1779.1	1063.4	4115.6	2123.4	1.25	1686.84	1082.07	3889.62	2283.83	1.14
5. Liquidity	Current Ratio	2.13	2.33	0.75	0.83	-1.45	2.20	2.25	0.77	0.82	-0.37
6. Financial Risk	EBIT*/ Interest	8.25	11.28	9.81	15.07	-1.35	8.75	11.02	9.94	15.87	-0.98
7. Financial Risk	Total Debt/ Net worth	1.49	1.70	2.26	0.94	0.95	1.41	1.27	2.14	0.99	0.43
8. Financial Risk	Dividend Payout(%)	37.23	38.84	18.93	21.46	-0.44	36.04	40.11	18.20	22.73	-0.91
9. Foreign Exposure	Foreign Sales/ Sales(%)	35.97	28.33	16.93	15.29	2.48	35.13	28.13	16.21	16.57	2.18

*Earnings before interest and taxes
**Pooled variance estimate

Table 2

RESIDUAL VOLUME FOR ANNUAL EARNINGS ANNOUNCEMENTS
(EXPERIMENTAL AND CONTROL SAMPLE COMBINED)

Week Relative to Announcement Date of Annual Earnings	Unstandardized Mean $[\hat{v}^*_{it} \times 10^3]$	Standardized Mean $[\hat{v}_{it*}/\hat{\sigma}(\hat{Y}_{3it})]$	Standardized Decile .4	.5	.6
-8	-.1110	.0340	-.2368	-.0934	.1427
-7	.0020	.2188	-.2717	-.0501	.1556
-6	.0220	.1617	-.2311	-.1305	.1296
-5	-.0860	.1002	-.3106	-.1211	.1477
-4	.1140	.2932	-.3873	-.2125	-.0660
-3	-.0370	.2573	-.4376	-.1534	.1674
-2	-.0570	.4619	-.2827	.1421	.3955
-1	-.1040	.3654	-.3477	-.0190	.4992
0	.1620	.7334	-.0383	.2857	.6295
1	.0140	.4428	-.1274	.2436	.7111
2	-.1160	.3370	-.2521	-.0225	.3738
3	.0510	.4210	-.3401	.0116	.3408
4	.0690	.4530	-.2783	-.0195	.4808
5	.0920	.4106	-.3708	-.1123	.1313
6	.0060	.2654	-.3725	-.1651	.0852
7	.0050	.3650	-.3455	-.2005	.2296
8	.0990	.4747	-.2727	-.1372	.1163

Table 3

RESIDUAL PERCENTAGE PRICE CHANGE FOR ANNUAL EARNINGS ANNOUNCEMENTS

Week Relative to Announcement Date of Annual Earnings	Residual Percentage Price Change Variability: Unstandardized Mean Absolute Value $\times 10^2$ All firms	Standardized Mean Square: All firms	ITYPE = 1	ITYPE = 2	Cumulative Residual Percentage Price Change: Standardized Mean, ITYPE = 1: $t_1 = -8$	$t_1 = -4$	ITYPE = 2: $t_1 = -8$	$t_1 = -4$
-8	3.2850	0.8272	0.9596	0.7039	.0911		-.0512	
-7	4.2427	1.2944	1.5148	1.0893	.2478		.0327	
-6	3.4927	0.9191	0.9714	0.8704	.4512		.2501	
-5	2.8360	0.5485	0.4363	0.6529	.5255		.2376	
-4	3.7424	1.0898	0.9235	1.2445	.7989	.2753	.3130	.0754
-3	3.7946	1.1832	1.1145	1.2470	.8822	.3536	.3065	.0689
-2	4.2335	1.2864	1.0359	1.5196	.9814	.4558	.4061	.1685
-1	4.1221	1.3047	1.4402	1.1786	1.2517	.7262	.3751	.1374
0	3.9907	1.2875	1.2625	1.3107	1.5466	1.0211	.5144	.2767
1	3.8641	1.2215	1.5365	0.9284	1.6977	1.1722	.6717	.4341
2	3.3785	0.9464	1.1461	0.7605	1.6886	1.1631	.6159	.3783
3	3.5618	1.0174	1.1750	0.8707	1.7807	1.2552	.5609	.3233
4	4.0757	1.3833	1.6601	1.1257	1.9067	1.3812	.3980	.1604
5	3.4538	0.8078	0.6631	0.9425	1.9623	1.4368	.3741	.1365
6	3.1579	0.8087	0.6121	0.9917	1.9927	1.4672	.4773	.2397
7	2.8412	0.6064	0.6429	0.5763	2.1007	1.5752	.4957	.2581
8	3.1432	0.7032	0.5316	0.8628	1.9982	1.4727	.6844	.4468

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Table 4

RESIDUAL VOLUME FOR SENSITIVE FOREIGN PAYMENT DISCLOSURES

Week Relative to Disclosure of Sensitive Payment	All Firms		Experimental Group		Control Group	
	Unstandardized $[\hat{\upsilon}_{it*} \times 10^3]$	Standardized $[\hat{\upsilon}_{it*}/(\hat{\sigma}_{3it})]$	Unstandardized	Standardized	Unstandardized	Standardized
-8	.0220	.2088	-.0550	.1347	.1090	.2932
-7	-.0520	.3697	-.0860	.4057	.0140	.3286
-6	.0680	.3075	.2960	.5197	-.1910	.0658
-5	-.0540	.2773	.1460	.3577	-.2810	-.0420
-4	-.0270	.3252	.1170	.4778	-.1900	.1514
-3	-.0630	.3240	.1140	.5391	-.2650	.0792
-2	-.1170	.2290	-.0350	.2611	-.2110	.1924
-1	.0350	.4024	.1040	.4079	-.0440	.3961
0	-.1280	.0859	-.0200	.1874	-.2520	-.0296
1	.0820	.4490	.2260	.5014	-.0810	.3893
2	.0350	.3186	.0790	.3289	-.0150	.3070
3	-.0430	.2582	.1870	.5215	-.3050	-.0414
4	.0390	.4084	.3620	.6798	-.3280	.0995
5	.0960	.4256	.3650	.6913	-.2100	.1231
6	-.0400	.1299	.0690	.1939	-.1640	.0571
7	-.0760	.1665	-.1120	-.0297	-.0350	.3898
8	-.0820	.2240	-.0080	.1651	-.1660	.2910

Table 5

ANALYSIS OF VARIANCE OF STANDARDIZED RESIDUAL VOLUME:
PROBABILITY VALUES ASSOCIATED WITH F STATISTICS
(EXPERIMENTAL SAMPLE ONLY)

Source of Variation	Week Relative to Disclosure of Sensitive Payment				
	-2	-1	0	1	2
Main Effects	0.999	0.086	0.152	0.188	0.186
IDATE	0.999	0.999	0.999	0.999	0.999
ITYPE	0.999	0.138	0.044	0.188	0.999
IMAT	0.999	0.056	0.207	0.067	0.055
2-Way Interactions	0.156	0.120	0.021	0.999	0.999
IDATE ITYPE	0.999	0.999	0.165	0.145	0.233
IDATE IMAT	0.999	0.198	0.026	0.999	0.999
ITYPE IMAT	0.028	0.030	0.059	0.999	0.999
3-Way Interactions	0.999	0.999	0.207	0.098	0.999
IDATE ITYPE IMAT	0.999	0.999	0.207	0.098	0.999
Explained	0.394	0.091	0.025	0.207	0.342
(Multiple R)	(0.147)	(0.294)	(0.255)	(0.254)	(0.258)

Table 6

RESIDUAL PERCENTAGE PRICE CHANGE FOR SENSITIVE FOREIGN PAYMENT DISCLOSURES

	Residual Percentage Price Change Variability				Cumulative Residual Percentage Price Change			
	Experimental Group		Control Group		Experimental Group		Control Group	
Week Relative to Disclosure of Sensitive Payment	Unstandardized Mean Absolute Residual x 10^2	Standardized Mean Square	Unstandardized Mean Absolute Residual x 10^2	Standardized Mean Square	Unstandardized Mean x 10^2 t = -2	Standardized Mean t = -4	Unstandardized Mean x 10^2 t = -2	Standardized Mean t = -4
-8	3.5747	1.3017	4.9974	1.8424				
-7	3.9552	1.4972	3.0659	0.7486				
-6	4.1574	1.3000	3.7963	1.0818				
-5	3.7753	1.2860	3.9796	1.1137				
-4	4.2167	1.5880	3.7212	0.8783		0.0211		0.0345
-3	3.4038	1.0430	3.8294	1.1586		0.1567		0.1645
-2	3.4697	1.0898	3.2837	0.7779	-1.0537	-0.0834	0.3600	0.2208
-1	3.2074	0.9807	4.1942	1.1173	-1.3808	-0.1447	-0.0980	0.1152
0	3.5827	1.0650	3.2133	0.6998	-1.8933	-0.3002	-0.5768	0.0246
1	4.7877	2.0871	3.6187	1.1051	-2.7500	-0.4302	-0.8420	-0.1203
2	3.9923	1.0839	3.5557	0.8850	-1.9006	-0.2903	1.0236	0.2595
3	2.9639	0.7980	3.3228	1.0061	-1.6438	-0.2331	0.8221	0.3231
4	3.7473	1.2115	2.8376	0.7198	-1.0269	-0.0567	0.5523	0.2662
5	2.5770	0.5783	3.5863	1.0564	0.2715	0.1133	0.8278	0.3044
6	2.8852	0.7989	3.6254	0.8075	-0.2786	0.1744	1.4962	0.4303
7	2.8165	0.6808	3.4407	0.8355	-1.1602	-0.0332	1.1294	0.2561
8	2.4715	0.5054	3.1488	0.8976	-1.0883	-0.0348	1.9677	0.5028

Table 7

ANALYSIS OF VARIANCE OF RESIDUAL PERCENTAGE PRICE CHANGE:
PROBABILITY VALUES ASSOCIATED WITH F STATISTICS

Source of Variation	Standardized Residual Percentage Price Change Variability					Standardized Cumulative Residual Percentage Price Change*				
	Week Relative to Disclosure of Sensitive Payment					Week Relative to Disclosure of Sensitive Payment				
	-2	-1	0	1	2	-2	-1	0	1	2
Experimental Sample										
Main Effects	0.999	0.999	0.999	0.001	0.238	0.999	0.999	0.999	0.999	0.999
IDATE	0.999	0.999	0.999	0.001	0.055	0.999	0.999	0.999	0.999	0.999
ITYPE	0.224	0.999	0.318	0.010	0.959	0.999	0.999	0.999	0.999	0.999
IMAT	0.999	0.999	0.999	0.114	0.999	0.999	0.999	0.999	0.999	0.999
2-Way Interactions	0.999	0.311	0.999	0.003	0.999	0.999	0.999	0.999	0.288	0.147
IDATE ITYPE	0.999	0.999	0.999	0.024	0.999	0.999	0.999	0.999	0.999	0.999
IDATE IMAT	0.268	0.104	0.999	0.002	0.999	0.271	0.999	0.999	0.999	0.999
ITYPE IMAT	0.999	0.999	0.999	0.256	0.224	0.999	0.999	0.999	0.124	0.029
3-Way Interactions	0.999	0.999	0.999	0.056	0.013	0.036	0.174	0.999	0.999	0.999
IDATE ITYPE IMAT	0.999	0.999	0.999	0.056	0.013	0.036	0.174	0.999	0.999	0.999
Explained	0.999	0.999	0.999	0.001	0.091	0.433	0.999	0.999	0.999	0.999
(Multiple R)	(0.147)	(0.129)	(0.127)	(0.423)	(0.234)	(0.108)	(0.106)	(0.149)	(0.064)	(0.083)
Experimental & Control Sample										
Main Effects	0.999	0.999	0.325	0.098	0.999	0.999	0.999	0.999	0.999	0.999
KTYPE	0.999	0.999	0.195	0.060	0.999	0.999	0.999	0.999	0.999	0.283
ITYPE	0.999	0.999	0.999	0.153	0.999	0.999	0.999	0.999	0.999	0.999
2-Way Interactions	0.101	0.999	0.201	0.085	0.265	0.999	0.999	0.999	0.298	0.224
KTYPE ITYPE	0.101	0.999	0.201	0.085	0.265	0.999	0.999	0.999	0.298	0.224
Explained	0.284	0.999	0.276	0.058	0.999	0.999	0.999	0.999	0.999	0.330
(Multiple R)	(0.092)	(0.045)	(0.128)	(0.181)	(0.056)	(0.102)	(0.091)	(0.094)	(0.094)	(0.120)

* $\Sigma_{t=-4}^{T}[\hat{\epsilon}_{it*}/\hat{\sigma}(\hat{\omega}_{it})]$