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THE USES OF DISCLOSURE

An Address By

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It is commonplace to observe that the philosophy and means of federal securities regulation as embodied in the Securities Act of 1933 and the Securities Exchange Act of 1934 were profoundly conservative. Despite the strong temptations of the times to assign the government a heavier, more substantive role, the Congress embraced the principles of full disclosure and fairness as both necessary and sufficient. Fully informed investors in an honest market not only do not need or deserve the paternalism inherent in a system where the government prescribes, on the merits, or in accordance with some economic or social plan, what securities may or may not be sold; such investors in such an environment will, overall, effect a wiser allocation of capital resources than direct government prescription could achieve.

In this familiar formulation of received truth, what is meant by fully informed? In the face of the practical impossibility of making available to investors, or to anyone, every conceivably relevant item of information about every possible investment, combined with the human limits on effective absorption and use, how should it be decided what must be disclosed in publicly-available form? And if an item of information meets the general standards of disclosability, what should be done about the case where public disclosure might do harm to the company and its present investors -- inasmuch as disclosure to investors is unavoidably also disclosure to competitors, creditors, customers, tax collectors, plaintiffs' lawyers, the Antitrust Division, foreign countries, including unfriendly countries -- in short, to all the world?

These questions are as old as the SEC and yet as fresh as this morning's newspapers. And recent developments have taken these questions out of the recondite deliberations of securities law specialists and put them on the front page. One need not have any interest in or knowledge of the securities markets to have a lively concern for current disclosure effects and controversies.

The founding fathers of our disclosure apparatus took what must be regarded as a rather pedestrian attitude by the many groups of latter-day zealots who have discovered the other possible uses of compulsory disclosure. The basic canon is found in Schedule A of the Securities Act, which specifics the items of information to be supplied in registration statements for public offerings, with broad discretion in the Commission to vary the requirements or to add or subtract items. In adopting Schedule A, Congress obviously posited as the typical prospective investor, a reasonable economic man whose needs and desires for information were basic, financial stuff: balance sheets and earnings statements, capital structure, rights of security holders, especially of the securities being offered, a description of the business, major customers and contracts, litigation that might be costly, etc.

For forty years, the Commission has adhered pretty closely to the letter and spirit of Schedule A, on the one hand embellishing and adding to certain items, especially in the financial reports, to meet changing needs and standards, and, on the other, permitting the omission of some items in short-form registration statements for certain classes of registrants and offerings, as the Act expressly contemplated.

The same approach has prevailed in the Commission's development of the continuous reporting system based upon the Exchange Act. The spirit of Schedule A, so to speak, dominates the Form 10-K as well as the 10-Q and the 8-K. The forms are intended to provide the investor with the hard economic data needed for investment decisions.

This was revolutionary only in the sense that corporate managers were not accustomed to revealing such data to investors and, thus, to the public generally, and they did not enjoy the experience when these requirements were first imposed upon them. But that is old stuff, today. Present managers of publicly-held companies mostly grew up with the system and seldom even dream of a world without it. With some notable exceptions, the quarrels today are essentially marginal. We argue about the cost-benefit characteristics of proposed changes, whether too much data confuses more than it informs, and whether compulsory disclosures can serve professional analysts and the average individual investor with equal effectiveness. We seldom argue fundamentals.

The spirit of Schedule A and of the Securities Act and the Exchange Act also assumes that disclosure, of the sort contemplated, is good -- almost, but not quite, an absolute good. In order to establish the system with any integrity, the law and the Commission had to be largely deaf to expressions of fear of ruin through harm from educating competitors or, in an early leading case, harm through educating customers of excessive mark-ups. Bowing to these fears would have sabotaged the whole system.

There were, however, some initial concessions to countervailing harm to the enterprise. In Schedule A, copies of material contracts are required to be filed "but no disclosure shall be required of any portion of any such contract if the Commission determines that disclosure of such portion would impair the value of the contract and would not be necessary for the protection of the investors." Conversely, disclosures of contract terms that "would impair the value of the contract" must be disclosed, despite the projected harm, if "necessary for the protection of the investors." Rule 25 of the Commission's Rules of Practice, provides a procedure for requesting confidential treatment of such information, although the efficacy of this procedure is now subject to some doubt because of the 1975 Amendments and the Freedom of Information Act. Rule 171 under the Securities Act provides for the omission of classified information upon the filing of a statement from the classifying agency.

So the disclosure requirements have never been unqualified absolutes, but the major ameliorating influence against excessive disclosure has been the abiding principle of materiality. Overall, except for certain detailed affirmative requirements, information must be furnished if material. Otherwise, not. But nothing in either Act gives us more than a general guide as to what is material.

As to some disclosure areas, particularly financial information, we have by regulation set out some rules of thumb on specific problems of materiality, but there is no regulatory guide with respect to the narrative disclosures.

In general, outside the specific requirements of particular reporting forms, the courts, including the Supreme Court in the Affiliated Ute case, at least when dealing with Rule 10b-5 cases, have adopted a standard of materiality couched in terms of effect on investors. That is to say, information is material if it might influence a reasonable investor in making an investment decision. This standard, adopted by the Supreme Court, naturally gives us pause. It leads to thoughts about our methodology in rule-making.

If materiality is a matter of "effect" on investment decisions, should we know more about prospective investor responses before adopting rules and guidelines? To my knowledge, the Commission has only rarely sought, or even accepted, any sort of survey, or nose-count, approach to the question. But if that which is likely to influence investor behavior is material, how are we supposed to determine materiality? Simply make our own guess, with the inherent bias toward assuming that most investors are like ourselves? Or seek some empirical data on the question? The latter method seems shocking, but the logical trend is there.

There is another strain to disclosure that tends to lead in another direction. It is one thing to provide disclosures to facilitate economic investment decisions. The emphasis is somewhat different when disclosures are provided to facilitate the stockholder's franchise. Arguably, the stockholder, in determining how to vote for the election of directors, is just as "economic" -- just as profit and yield oriented -- as when he decides to buy, sell or hold securities. Arguably so, but in this context it is somewhat easier to say that he is interested in other matters, too, generally subsumed under the question of the quality of management. And here the Exchange Act, which creates our jurisdiction over proxy solicitations, provides no guidance other than the public interest and the protection of investors.

What does all of this have to do with any problems that concern you today? There are at least two areas of development which threaten a change of focus in disclosure philosophy and objectives and which might have a fundamental and prolonged effect. One of these is the pressure for disclosure of socially-significant matters. The other is the development of the application of disclosure requirements to illegal or undesirable corporate behavior, having in mind the foreign, and also domestic, situations where corporate funds are used for bribes, kickbacks, illegal political contributions, etc.

In the socially-significant area, we have had with us for some time a rule-making petition of the Natural Resources Defense Council, Inc., requesting that we require the regular reporting of all details concerned with environmental and equal employment matters. In response to the petition, and like petitions, several years ago the Commission adopted guidelines and amended forms to require expressly disclosures of environmental and equal employment opportunity difficulties. including actual and threatened litigation, but only to the extent material. The Commission stopped short of requiring disclosure of all violations of such laws and problems thereunder on the implied ground that investors at large were only interested in whether compliance with such laws was going to have a significant effect on the company's assets or earnings. The Commission declined to adopt disclosure requirements either to satisfy the putative "ethical" investor -- the person who is concerned with whether the company is in a state of grace as to the environment and employment policies, regardless of financial consequences -- or to provide an ancillary means of enforcing such laws through disclosure.

The petitioners were not satisfied with this response and persuaded the District Court that at least they were entitled to more elaborate consideration by the Commission, whereupon we set down their proposals for public comment, inviting, in addition, comments by others on other socially-significant matters. The end of this week we are due to report to the court our preliminary conclusions from the comments received. We may be forced to conclude that something more is necessary, at least in the environmental area.

In adopting the National Environmental Policy Act, the Congress used extreme and unusual language. It declared that "to the fullest extent possible, the policies, regulations and public laws of the United States shall be interpreted and administered in accordance with the policies not set forth in [the Act]" by all agencies of the Federal Government. This is strong stuff. We may have to conclude that the Congress meant to include us and the federal securities laws, although that does not necessarily mean acceptance of the full proposals of the Council.

Why do I put it in these terms, that we may be forced to do something more to encourage compliance with NEPA? Does this mean that the Commission really likes pollution, or illegal employment policies, or any other socially-undesirable behavior? It must seem so to the true zealots, but it should be obvious to thinking persons that this is not true. The argument is not over the relative desirability of the conduct concerned. The argument, in our terms, is over the integrity of the disclosure process. We think this process performs a most important economic function in informing investors without causing the federal government to intrude itself into the merits of the financings or corporate conduct concerned.

A somewhat different, but related and dramatic, instance of our attitude occurred a year or so ago when a major bank holding company registered a very large offering of floating rate notes -- something new to our capital markets at the time. The prospect of the offering caused some alarm because of its possible harmful effect on thrift institutions, and we were urged by some persons to prevent, or at least postpone, the offering by denying acceleration of the registration statement. We resisted these urgings as perversions of the process. If we read the term "public interest" in our acts to include the asserted undesirability of a particular financing vehicle because of anticipated effects on the economy or some portions thereof, we would change drastically, if quietly and subtly, the whole philosophy of the disclosure process. So, too, would we be revolutionizing the process if we consciously set about to use disclosure as a means of enforcing these laws or social goals without reference to our traditional standards of materiality to investors.

But what has this to do with bribes, kickbacks, and illegal political contributions? Simply this. The cases we have brought to date, in our view, meet the traditional standards. In some cases, they have involved a calculated scheme to violate our laws regarding corporate political contributions, which seems to say something material about management. In most cases, they have involved significant departures from fundamental principles of financial accountability through false entries and the production of unaccounted-for cash in substantial amounts. In some cases, they have also involved incorrect descriptions of how business is actually conducted and undisclosed hazards in the production of revenues because they are in fact dependent upon bribes which may not be repeatable, or which, when disclosed, may lead to harmful consequences.

My concerns in this area, and their relevance to my general theme, is not to justify what we have done but to express concern about how our actions are being read and projected. There is a momentum to logic in these matters that sometimes

In this regard, I would like to quote a most perceptive column of some months ago by William Safire, who wrote:

> "I sat down to write an essay defending corporations against the politically inspired application of ex post facto morality. But a lust for philosophical consistency brings me out on the side of the goo-goos, bleeding hearts and frank Churchgoers who will be as uncomfortable with my support as I am to be in their ranks.
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> The question at issue is: Should the public policy of the United States be to export its ideas about what is right and wrong to the rest of the world? Put another way, do we have a mission to sell our ideals of freedom and virtue in the far corners of the earth?
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> The answer is yes.
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> . . . It is not possible to sally forth carrying the American message of freedom and virtue on political matters, and then suddently to adopt the business-is-business argument on the conduct of businessmen abroad.
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> . . . America, to be herself, must be a force for good. Ethics in business is a part of the American Dream, even if we have fallen short often enough; America stands for competition on the basis of quality, price and service, and not on payola. If, in the short run, this costs us jobs and money, that's the price we pay for setting standards.
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> Holier-than-thou? Sorry about that, but democracy and honest competition are holier than totalitarianism and bribery. American ways and ideals should travel arm-in-arm with American trade and power . . .

The problem for those corporate managers who have difficulties of this nature is how to straighten things out without getting hurt too badly in the process. I am not certain that they all can. But we are striving to develop some reasonable standards of materiality that will be true to the integrity of our disclosure process and provide some guidance. It would help if the business community would strive with us.