

**NEWS**

**SECURITIES AND  
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**CURRENT DEVELOPMENTS IN DISCLOSURE POLICY**

REMARKS BY

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For forty-five years the Commission has administered a set of statutes based in large part upon the concept of full disclosure as a regulatory scheme for dealings in securities. Fundamentally, it is clear that no one could prudently purchase a security, which is only a piece of paper, unless information about the issuer was available. The certificate for a \$1.00 stock looks just like a certificate for a \$100.00 stock. Efficient allocation of capital is believed to be furthered if investors are able to make informed decisions in choosing between the numerous alternative investments available to them.

In view of the basic need for information, it will be provided in some way or another. But the Congress decided that simply allowing companies to disclose whatever they chose to disclose, and to not disclose whatever they preferred to sweep under the rug, subjected investors to undue risk, undermined investor confidence in the markets, and led to inefficient allocations of capital. Consequently, a government mandated disclosure system was thought to be needed in order to obtain more complete and balanced disclosure and to strengthen the integrity of the process.

Debate as to the soundness of this decision has waxed and waned across the years. It was very much on the agenda of the Advisory Committee on Corporate Disclosure. That eminent group concluded in its report to the Commission of November 3, 1977, that "the disclosure system established by Congress in the Securities Act of 1933 and

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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." 1/

This is a very nice endorsement. It is also one I believe most people, but certainly not all, would generally agree with. That conclusion, of course, does not mean that the existing system is perfect. Indeed, the Committee itself proposed significant changes. We live in a changing world and the disclosure system must respond to these developments. I recognize, however, that these changes also make your lives more difficult. Indeed, in response to a recent Commission release exploring the revision of an annual report form, the 10-K, one commentator weary with changing requirements, stated that what he thought was the best thing the Commission could do in that area was to announce that it would make no further changes at all for a period of at least five more years.

I wish we could afford to follow this appealing advice but I am afraid that we cannot. Consequently, the Commission and its staff have been working on new approaches to some areas of disclosure policy which will be of interest to you. There are several reasons for this activity. First, as I noted the Advisory Committee supports several significant changes in the Commission's rules, procedures, and

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1/ Report of the Advisory Committee on Corporate Disclosure to the Securities and Exchange Commission, House Committee on Interstate and Foreign Commerce, 15th Cong., 1st Sess, Committee Print 95-29, Nov. 3, 1977.

and approaches to disclosure matters. Secondly, in this age of regulatory reform, increasing attention has been placed upon the cost of governmental requirements, particularly as they affect small business, and this is an area we need to address. Finally, perhaps it is a national habit of mind to believe that almost anything can be improved if approached carefully and pragmatically.

Let me mention some of the approaches we have in mind.

### Separate Channels of Communication

In a recent speech 2/ Chairman Williams pointed out that currently there are two separate channels of corporate communications. The first is between the company and the SEC; the second is between a company and its shareholders. The channel to the SEC (10-K's and other formal filings) has the advantage of completeness and careful preparation in light of the liabilities and the review process involved. However, the style is a bit forbidding and, although apparently of use to financial analysts, it is not appealing reading for the public.

Communications to shareholders through press releases and annual and quarterly reports, on the other hand, are effective in reaching the general public. These documents, however, have been accused of painting too rosy a picture rather than giving a balanced set of disclosures.

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2/ Address of Harold W. Williams, Chairman, SEC, before the National Investor Relations Institute, March, 1979.

Ideally, the two streams could be merged into one, preserving, as has been said, the style of the annual report with the contents of the 10-K.

Last year the Commission issued a release calling for comments on the Advisory Committee's proposed Form 10-K, a proposal which in part was designed to address these issues. While there was a generally favorable response, there was no consensus on method. One thing was clear, and that was that companies would not welcome the idea of the SEC's imposing rigid requirements regarding the dialogue between companies and their shareholders in the annual report.

Perhaps there are methods of reconciling the two channels of communication short of mandatory requirements. For example, should the 10-K be made capable of a freer form of response, and if some information which is either immaterial or of relevance only to analysts could be either deleted or reduced to exhibits, many would believe a trend toward combining the 10-K and annual report would emerge. It is a concept we are exploring.

Another example is that of projections of forward-looking information. Here there has been active informal communication of projections to selected recipients. Virtually never have these projections been communicated to all investors in formal Commission filings. In part, this is attributable to past Commission attitudes which discouraged their inclusion.

As most of you know, the Commission has changed its view. Last November, the Commission issued a statement encouraging companies to disclose forward-looking information and adopted a set of very flexible guides for the disclosure of this information in Commission filings. At that time, the Commission also proposed for comment alternative versions of a safe-harbor rule for disclosure of forward-looking information, as recommended by the Advisory Committee. Owing in large part to the many thoughtful and detailed comment letters received, the final rule, which was issued just this week, reflects what we hope to be an effective accommodation of informational needs of investors with the potential burden faced by companies in communicating this information. The rule has been expanded from the proposed format to cover a wider variety of information than the customary "bottom line" numbers found in earnings projections. The rule now covers statements of plans and objectives and explanatory narrative statements in discussions and analyses of earnings statements. We hope that this will encourage those companies choosing to disclose forward-looking information to present a better discussion and explanation of anticipated performance.

In addition, the coverage of the safe-harbor rule has been linked to inclusion of statements in documents filed with the Commission or in annual reports to shareholders. This provision is intended to encourage the dissemination of this important information to all investors, rather than the selective disclosure that is often the current practice.

When the Commission undertook the task of encouraging the voluntary disclosure of forward-looking information, it recognized that this departure from past practice would entail some risk. The safe-harbor rule is a response to the concerns that have been expressed as a result of the earlier prohibitions and the specter of liability under the securities laws. We need your cooperation in our attempt to integrate forward-looking information into a more effective disclosure system and I encourage you to join us in our efforts.

#### Integration of the 1933 and 1934 Acts

Most of you are familiar with the discussions of recent years surrounding the integration of the continuous disclosure system provided under the 1934 Act with the requirements on securities offerings provided by the Securities Act of 1933. This was a focal point of the "Wheat Report" of the late sixties and is currently evidenced in the approach taken by the proposed American Law Institute Federal Securities Code.

This approach takes into account the fact that registrants are reporting publicly a great deal of information on a regular basis. In many cases, analysts are digesting this information in such a fashion that the market price of securities can well reflect such information. Therefore, less information need be provided in the context of distributions.

In its adoption of short form registration statements such as Forms S-7 and S-16, the Commission has taken steps in this direction. As you know, the Commission recently expanded the availability of Form S-16 to primary securities offerings directly to the public by certain issuers and their subsidiaries. One goal of this process is to shorten the time spent in registration with the SEC. This goal appears as if it is being met. A recent survey of about 50 S-16 filings shows that a majority of these filings were in registration with the SEC less than 10 days.

We are reviewing these filings and further considering the types of company that should be allowed to utilize the form. We are also studying some difficult questions associated with its usage, such as underwriter's liability for underlying documents and the liability of officers and directors for information disseminated in a system of continuous disclosure. We are seeking to refine and expand the concept of an integrated disclosure system.

#### Staff Review

I alluded earlier to the review process whereby the staff, and at times the Commission, considers the adequacy of disclosure documents. I should note that we regard that examination as an important safeguard.



At the same time, our resources at the Commission are being taxed to the fullest: our budget is not expanding to keep pace with the number of filings being made. There is a need to focus staff time on the more productive activities. Time would be best spent in the review of more novel and difficult areas, rather than on more routine filings.

As a consequence, the staff of the Division of Corporation Finance is actively working on reducing or even eliminating staff review of filings such as those on Form S-8. One approach might be to have post-effective amendments on that form to "go effective" automatically, reserving the possibility of stop order proceedings for egregious cases. Other techniques will be explored as well.

Another possible approach to achieving our goal of using staff time in the most efficient manner is industry specialization. The Division of Corporation Finance is considering a realignment of its reviewing staff by industry groups. It is anticipated that this would result in better and more efficient review by staff professionals who are attuned to the operations and trends of a particular type of registrant. As a result of branch specialization, familiarity with the types of disclosure most significant to a particular industry would improve the efficiency of the review system for the staff and registrants, and also result in more meaningful disclosure to investors. A correlative of industry specialization is the development of disclosure guidelines geared to particular

industries, such as those for electric and gas utility companies that were proposed for comment this week. As many of you are well aware, the requirements of some of the Commission's more general disclosure forms often call for information or presentations that may not be suitable for a company engaged in a particular industry. Specialized disclosure guidelines that can be used to satisfy some of these general requirements, such as business descriptions, should also result in easier compliance by registrants, more efficient review by the staff, and improved disclosure to investors.

### Special Situations

There are certain special situations in which the Commission finds it necessary to provide more explicit guidance. This may arise because of the special significance of an event to shareholders, difficulties encountered in the review process, or a situation where the interests of controlling persons may conflict with those of public shareholders. Going private transactions illustrate a situation in which all of these factors are present.

Because of the risk of overreaching to which unaffiliated security holders are exposed in these transactions, the Commission, in November, 1977, published for comment Rule 13e-3 and Schedule 13E-3. That Rule and Schedule would provide definitions, specific disclosure and dissemination requirements, particular antifraud provisions and would require that the transaction be fair to unaffiliated security holders.

The proposed fairness requirement was vigorously attacked by the commentators on the ground that the Commission does not have the authority to adopt such a requirement. It was also argued that the Commission should, as a matter of policy, refrain from imposing a fairness standard because, in the commentators' view, substantive regulation of corporate affairs is a subject for state and not federal cognizance and because the staff is not equipped to make determinations of fairness.

The subject is very difficult but it is not dead, as some people may have hoped. By the end of July the Commission will consider the staff's recommendations for final rules with respect to going private transactions. I do not know what will come out, but I suspect that more emphasis may be placed upon particularized disclosure as well as antifraud provisions.

#### Small Business

The Commission has recently given special attention to the effects of its requirements on small business.

In March 1978, the Commission announced a broad scale re-examination of the impact of its regulation on small businesses with an eye toward easing the burden wherever possible consistent with the Commission's statutory responsibilities. A total of 21 days of hearings were held in cities across the country and 4500 pages of testimony were taken. Our re-examination of our regulations

has resulted in a number of rule amendments and proposals which we believe are responsive to concerns expressed at these hearings.

The Commission has amended Rule 144 to more than double the amount of restricted securities which may be sold thereunder and to permit sellers to deal directly with a bona fide market-maker without engaging a broker. In addition, the Commission adopted a further amendment to the Rule which would remove the volume restrictions entirely--after a certain holding period--for persons not in control of the issuer.

The Commission has also endeavored to make offerings under Regulation A and Rule 146 more useful for small businesses. Thus, Regulation A was amended to increase the amount of securities which may be sold thereunder within a 12-month period from \$500,000 to \$1,500,000. Early indications are that both the number and size of Regulation A offerings have increased significantly. The Commission has also recently approved a release which permits the use of pre-effective selling documents in Regulation A underwritings. In addition to raising the Regulation A ceiling, the Commission also amended Rule 146 to permit the use of Regulation A-type disclosure to satisfy the Rule's information requirement for offerings which do not exceed \$1,500,000.

The Commission has taken another significant step expressly designed to assist small business capital formation. We adopted

a new registration form, called S-18. Because of the limitations of Regulation A, there was a need for a simplified and less costly form for the registered offering of securities by small businesses. In order to bridge the gap between Regulation A and Form S-1, the Commission's most elaborate and costly registration form, the Commission adopted Form S-18 and corresponding amendments to annual report Form 10-K. The simplified registration and reporting procedures which Form S-18 reflects were strongly endorsed by the witnesses at the hearings.

Using Form S-18 and the amendments to Form 10-K, a small unseasoned issuer may sell up to \$5 million in equity securities to the public without immediately incurring the full range of disclosure and reporting requirements--and the resulting costs. In addition, to provide some liquidity to early investors and venture capitalists, the form also allows them to sell up to \$1.5 million of stock they own in the company. We anticipate use of this form will significantly reduce legal and accounting costs and may enable small issuers to keep their local accounting firms when going public for the first time.

The Commission is hopeful that Form S-18 and the other actions I have mentioned will be of substantial assistance to small business. We recognize, however, that the problems of small business under

the securities laws deserve further and long range attention. Because of the recurring and pervasive nature of many of these problems, the Commission has established the Office of Small Business Policy within the Division of Corporation Finance. Mary Beach, the staff director of the Advisory Committee and currently an Associate Director in the Division of Corporation Finance, heads up the new Office.

As its first priority, the Office of Small Business Policy is considering the development of a special exemptive rule for small businesses as an alternative to Rule 146. One possible alternative is suggested by the proposed Federal Securities Code. It would avoid the more restrictive provisions of Rule 146 and Section 4(2) by providing a "limited offering exemption" for sales to not more than 35 non-institutional buyers. Offers to an unlimited number of institutional buyers could also be made. By utilizing the Commission's broad authority under Section 3(b) of the Securities Act, I am hopeful that we can devise an imaginative exemptive approach which will provide more certainty for issuers engaging in limited offerings without unduly jeopardizing investor protection.

Another problem which the Office of Small Business Policy intends to tackle is Exchange Act reporting. The Report of the Advisory Committee cited a number of factors which suggest that easier reporting requirements may be warranted for small businesses. In order to reduce disclosure obligations for small businesses

consistently with the protection of investors and the public interest, the Commission would need to identify a class of small businesses entitled to such relief. But the Commission has never classified or differentiated issuers on the basis of their size. Accordingly, there is little empirical evidence available for us to support determinations as to impact and benefit or to provide a basis for appropriate classification.

In order to assist the Commission in selecting appropriate criteria for this purpose, the Office of Small Business Policy, in cooperation with the Commission's Office of Economic and Policy Research, will seek to develop an empirical data base for issuers by asset size, revenues, earnings, trading activity, market capitalization, and other appropriate standards. Also, to aid in a determination of what relief, if any, should be granted to small businesses, consideration is being given to a survey of the information needs of investors in smaller enterprises. The staff has informed me that it will make every effort to develop proposals in this area by the end of this year. I hope they can, and I believe that the whole effort is well worthwhile.

### Conclusion

I have attempted to provide you with a small Cook's tour of our new approaches to disclosure policy. I believe that our efforts at improving the disclosure system are grounded in a recognition that the information needs of investors and capital

raising needs of companies are not static and that the manner in which our disclosure requirements affect these needs warrants continuous attention and can be improved. We hope that you will be participants in this process through commenting on our proposals and through bringing your own areas of concern to our attention. We in turn have an obligation to remain flexible in our interpretations of the disclosure requirements, to monitor their operation and make appropriate changes to them and to make sure that our endeavors to keep the system finely tuned do not result in the development of more changes than registrants can reasonably be expected to digest and adapt to in the time available. With your cooperation, I am confident that the coming years will prove us able to make the Advisory Committee's endorsement of the corporate disclosure system a lasting one.