



U. S. Securities and Exchange Commission  
Washington, D. C. 20549 (202) 272-2650

News  
Release

Address to the

Eleventh Annual Southern Securities Institute

(Edited and Annotated)

Tampa, Florida  
March 1, 1991

THE INTERSECTION OF BUSINESS NEEDS  
AND DISCLOSURE REQUIREMENTS:  
MD&A

Edward H. Fleischman  
Commissioner  
Securities and Exchange Commission  
Washington, DC 20549

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The views expressed herein are those of Commissioner Fleischman and do not represent those of the Commission, other Commissioners, or the staff.

My subject this noontime, flowing directly out of several of the panel presentations at this Conference, is the SEC-mandated disclosure affecting what I conceive to be the intersection between internal and external information -- the process whereby the monthly or bimonthly or quarterly review presented by the Chief Financial Officer of each of your business clients to his or her Board of Directors becomes the foundation for the multitude of individual buy or sell decisions that create the bid and offer prices for that company's stock and public debentures every day of the year. That process, in my view, both creates and reflects the requirements of Item 303 of the SEC's Regulation S-K: Management Discussion and Analysis (MD&A), 1/ and the importance of that process to our entire present-day disclosure scheme underlies the ever-growing role of MD&A that Carl Schneider has described with "only slight hyperbole":

[T]he MD&A requirement is tending to eclipse many of the other carefully balanced line item disclosure requirements, in much the same way that rule 10b-5 once threatened to supersede all of the carefully prescribed and balanced liability requirements. It would be only slight hyperbole to state that the MD&A is currently interpreted by the SEC as if it read as follows...."Disclose on a quarterly basis all material information, historical or prospective, that has impacted or might foreseeably impact on the financial affairs of the registrant." 2/

Back in the spring of 1974 I had the opportunity to

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1/ 17 C.F.R. 229.303 (1990) ("Item 303").

2/ Schneider, "MD&A Disclosure", 22 The Review of Securities & Commodities Regulation 149, 150 (1989).

participate in a forum on corporate disclosure. 3/ My subject then was the legitimacy of the public reporting company's withholding of information when that course of dangerous conduct was justified by "a proper corporate purpose". Even then, the "proper corporate purpose" justification had been considered and approved (in theory at least) by the Second and Tenth Circuits in their Texas Gulf 4/ and Financial Industrial Fund 5/ opinions and by federal district courts 6/ in opinions on sympathetic facts. My working tool 17 years ago was a hypothetical situation derived (as many such situations are) from a real-life problem I had faced a few years earlier -- and I'll take that same hypothetical as my working tool today.

My hypothetical company was a sizeable multi-line corporation, and my time frame was 1973-74 -- carrying substantially the same financial overtones (volatile interest rates, tight credit, selective public reception for equity offerings, and so on) as those implicit in 1990-91.

Sales and earnings are rising; the inferences drawn in the marketplace are favorable. It

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3/ See Bialkin, The 10b Series of Rules, Practising Law Institute Corporate Practice Transcript Series No. 21 (1975), comprised of the edited transcripts of the presentations at that forum ("PLI").

4/ SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 850 n.12 (2d Cir. 1968) ("valuable corporate purpose").

5/ Financial Industrial Fund, Inc. v. McDonnell Douglas Corp., 474 F.2d 514, 518-19 (10th Cir. 1973) ("valid corporate purpose").

6/ See, particularly, Segal v. Coburn Credit Co., [1973 Decisions] Fed. Sec. L. Rep. (CCH) ¶ 94,002 (E.D.N.Y. 1973).

has been recognized by the corporate management that one of its lines of products is threatened by a new generation of products, which have historically been directed to a different market but which must be expected to be adapted for sale in the market in which the corporation's line of products is sold. In other words, management has prerecognized the obsolescence of [a principal] product line. The corporation has a revised product line on the drawing boards, not yet manufactured, and management is facing the alternative decisions of refinancing and retooling and reselling or of phasing out the line. The corporation is a normal large corporation, with some long-term debt containing usual covenants: normal ratios, limits on annual interest charges, limits on other funded debt and limits on the amount of short-term debt that can be incurred. 7/

On those hypothetical facts I suggested, 17 years ago, that there was a justification for, and there were proper corporate purposes available to support, withholding of disclosure by my hypothetical company, citing the potentially deleterious effect of an immediate announcement on the company's current sales of its current product, on current employees selling the current product, on credit extended by current suppliers, on the interest of potential lenders who will be called on to help the company refinance, on the availability of potential investors, and on prospective sales of the new product actually on the drawing boards. But then, after discussing the relevant legal considerations, I concluded on a careful lawyer's note, with a reference to a little-cited rule of the SEC:

Perhaps most important, because of the

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7/ PLI, n.3 supra, at 94.

inexorability of the calendar, is rule 12b-20 under the Exchange Act, which covers the 10-Q's and 10-K's of reporting companies. Even if, in the exercise of good faith and proper business judgment, there has been a justification for nondisclosure prior to the 10-Q or 10-K filing date, the reporting of summarized profit-and-loss information and information as to stockholders' equity is required, by the rule (and by General Instruction H(g) to form 10-Q), to include "such further material information . . . as may be necessary to make the required statements . . . not misleading." My hypothetical case goes to both those categories of information. It seems to me, therefore, that the failure to make a very careful statement of all the problems involved in my hypothetical case might very well be violative of the requirements of the Rule. It must be remembered that the Second Circuit in Texas Gulf confined its deference to business judgment, even as to the timing of disclosure, "within the affirmative disclosure requirements promulgated by the exchanges and by the SEC." 8/

Today I'd like to revisit, with you, my hypothetical company and those same hypothetical facts, bearing in mind that Rule 12b-20 still exists, and focusing on the impact of the SEC's quarterly requirement for management discussion and analysis, the SEC staff's interpretations of that requirement, and the developing law relating to continued accuracy of once-disclosed information.

I don't have to remind you that MD&A elicits a quarterly discussion of what the SEC subtitled liquidity, capital resources and results of operations, within the general purview of "information that the [company] believes to be necessary to an

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8/ Id., at 103-4.

-understanding of its financial condition, changes in condition and results of operations." 9/ But I do want to pause on what have, now for almost a decade, been the key instructions to this disclosure rule:

With respect to liquidity, disclosure is required of "any known trends or any known demands, commitments, events or uncertainties that . . . are reasonably likely to result in" material changes. 10/ (the emphasis is mine)

- With respect to capital resources, disclosure is required of "any known material trends, favorable or unfavorable", and is related to changes in the mix and cost of capital resources. 11/ (the emphasis is mine)
- With respect to sales, revenue and income, disclosure is required of "any known trends or uncertainties that the [company] reasonably expects will have a material favorable or unfavorable impact", 12/ and is related to changes in the relationship between costs and revenues (such as known future increases in costs of labor or materials or price increases or inventory adjustments). (the emphasis is mine)
- With respect to all three analyses, by virtue of the general instruction putting each analysis in a larger focus, disclosure is required of "material events and uncertainties known to management that would cause reported financial information not to be necessarily indicative of future operating results or of future financial condition."13/ (the emphasis is mine)

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9/ Item 303, at ¶ (a), 2d sentence.

10/ Id., at ¶ (a)(1).

11/ Id., at ¶ (1)(2)(ii).

12/ Id., at ¶ (a)(3)(ii).

13/ Id., at ¶ (a), Instr. 3.

Now, "trends and uncertainties" -- doesn't that phrase neatly epitomize what the CFO of each of your client companies looks for each month when the first unadjusted set of weekly gross sales figures hits his or her in-box, or when the Vice President-Production comes in with the initial reports on start-up of the company's newest marketing, service or manufacturing facility? And doesn't that phrase exactly define the subject matter of the CFO's conference with the financial analysts from the company's commercial or investment bankers, when they have lost themselves in arrays of figures and are looking to the CFO for some interpretive key? And, finally, doesn't that phrase precisely describe what the CFO tries to convey to the company's directors when, at the Board meeting or perhaps the night before, you and they are all analyzing the company's present position in its industry, are all assessing "actual" against "budget" for the year to date, and are all trying to decide what the future holds? In that light, are you surprised that the SEC has prescribed the very same criteria as the basis for public disclosure?

I've sought (above) to emphasize that MD&A requires the disclosure only of known trends and uncertainties. The SEC encourages disclosure concerning the what-if's of the future; in fact, the SEC does have a safe harbor (Rule 175, 14/ cited in footnote 22 of the SEC's 1989 MD&A interpretation 15/) both for

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14/ 17 C.F.R. 230.175 (1990).

15/ Securities Act Release No. 6835, 43 SEC Docket (CCH) 1230 (1989) ("1989 Release").

required disclosure regarding the future impact of presently known trends and uncertainties and also for optional disclosure of anticipations of future occurrences or trends, extending to anticipations of the less predictable results of known trends (what I would categorize as "ruminations" on possible future events), and the SEC's 1989 MD&A interpretation carefully delineates the applicability of that safe harbor to both required and optional future-directed analysis.

Please notice that phrase: "future-directed analysis". The trend-centered, uncertainty-oriented disclosure elicited by MD&A, as well as the disclosure of anticipations and ruminations, is future-directed -- or, if you prefer me to use a slightly longer phrase, it is disclosure having "a forward intent and connotation." That slightly longer phrase, of course, is the qualifier that the First Circuit set down, in its en banc majority opinion in Backman v. Polaroid, 16/ as necessary to the imposition of a duty to update. 17/ Put another way, MD&A disclosure of the effects of known trends and uncertainties -- perhaps the disclosure that requires the greatest insight and professionalism on the part of company management and company lawyers, and therefore perhaps the disclosure that evokes the greatest disquiet as to its current accuracy on the part of those involved in its presentation -- is the disclosure par excellence

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16/ Backman v. Polaroid Corp., 910 F.2d 10, 17 (1st Cir. 1990).

17/ See, generally, Schneider, "Duty to Update: Does a Snapshot Disclosure Require the Commencement of a Motion Picture?", 2 Insights 3 (1989).



that must be watched between quarterly reports for material change in the very type of expected-to-be-relied-on and still-relevant information to which a duty to update is appropriately addressed.

Of course, the disclosure of known trends and uncertainties is the product of two levels of inquiry -- recognition (in the sense of both perception and understanding), followed by analysis. As to recognition, sometimes the line between the known and the knowable does get blurred -- partly because to outsiders (like the SEC's staff) benefitted by hindsight the knowable appears so clear, but largely because to insiders surrounded by budgets and projections the normal human self-image of competence and control tends to keep the knowable-but-disagreeable one notch below the threshold of recognition. Just as it's hard for a CFO to imagine himself or herself blindsided by surprises in the business of a company he or she knows so well, so it's hard for the SEC, the media, the shareholders and (in extreme cases) the shareholders' lawyers to believe that the substance of the newspaper headline that reads:

"CFO's Company Takes Huge Writeoff, Expects  
Largest Quarterly Loss in 5 Years"

was as much of a surprise to that CFO as it was to the public, particularly when the public was still relying on the upbeat quarterly report the CFO's company had published only a month earlier for its quarter recently ended.

Recognition is a problem, but the disclosure implications of recognition are always less important than the business

implications anyway: management must recognize the trends and the uncertainties in order to continue managing the company's business effectively. From both a disclosure and a business perspective, therefore, the important task is to create a pathway by which symptoms of trends and uncertainties will be quickly reported to the CFO, so that those symptoms can be subjected to appropriate analysis and response.

Once recognized, the second level of inquiry precedent to disclosure of trends and uncertainties is analysis, and the SEC's 1989 Release includes a lengthy articulation of its views on how that analysis is to be performed for disclosure purposes. Let's get the (rather surprising) analytical foundation in place before we start: the standard for "materiality" generally applicable for federal securities law purposes -- the Basic v. Levinson probability/magnitude standard for materiality of contingent information 18/ -- is not applicable to trend and uncertainty analyses (see footnote 27 of the 1989 Release); it is superseded by a specifically-designed "not reasonably likely" standard, applied as follows:

- First, management of your client company must decide whether it can conclude that the trend or uncertainty is not reasonably likely to come to fruition. If management can reach that negative conclusion, no disclosure is required.

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18/ Basic, Inc. v. Levinson, 485 U.S. 224, 108 S. Ct. Rep. 978, 987 (1988).

- But if management can't -- if its conclusion is positive or if it just can't tell -- then, management must assume that the trend or uncertainty will come to fruition, must objectively evaluate the consequences of that fruition if it happens, and must decide whether management can conclude that a "material effect" 19/ on the company's financial condition or results of operation is not reasonably likely to occur. If management can reach that negative conclusion, again no disclosure is required.
- Otherwise, the CFO and you must tell it "like it is" -- and, by virtue of Rule 12b-20, 20/ you must tell it completely, fully and accurately (no half-truths, no pulled punches, no subtly misleading statements), exactly "like it is".

Both of the first two steps of this analysis require consideration of whether management can conclude that a given result is "not reasonably likely". Where do you find guidance on the meaning of "reasonably likely"? That question is hard to answer. I can tell you that the meaning of "reasonably possible"

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19/ It is my understanding that, since fruition is assumed for this purpose, the phrase "material effect" appearing in fn. 27 of the 1989 Release and its accompanying text, uses the word "material in the Northway sense: an effect the disclosure of which "would [be] viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 449 (1976) (footnote omitted).

20/ 17 C.F.R. 240.12b-20 (1990).

in SFAS No. 5 (i.e., anything that is more than "remote" although less than "probable") 21/ was specifically not intended to be imported into the MD&A interpretation, although I can't point to any text or footnote that actually says that. I can also tell you that "reasonably likely" does not require that a given result be "more likely than not" (although it clearly includes any situation in which the result is "more likely than not"). All the rest is quite subjective: to me, a 5-to-1, 4-to-1 or even 3-to-1 shot is not "reasonably likely", so, in my own understanding, "reasonably likely" for purposes of this analysis is somewhere in the range of the 40% probability level -- if probability levels can be estimated and described with any degree of precision. In any event, in determining what is or is not "reasonably likely", you must again remember the effect of hindsight in coloring the integrity of the conclusion you and the company's management reach, as well as the personal penalties (cease-and-desist orders, disgorgement, and fines and officer-and-director bars in judicial proceedings) to which you and they will be exposed under the 1990 enforcement amendments 22/ if the SEC fails to believe that you made an honest determination. 23/

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21/ Financial Accounting Standards Board, Statement of Financial Accounting Standards No. 5, ¶ 3 (1975).

22/ Securities Enforcement Remedies and Penny Stock Reform Act of 1990, Pub. L. No. 101-429, 104 Stat. 931 (1990).

23/ See "New Law Adds Teeth to Disclosure Rules", Corporate Financing Week, vol. 16, no. 47 (Nov. 26, 1990), at 1: "[U]nder the recently passed Securities Enforcement Remedies and Penny Stock Reform Act, the SEC has sweeping authority to impose fines for any securities violation, including a

When I say that you must "tell it 'like it is'", there is one exception: the SEC staff is concerned that people may just take it at its own word -- that the uncertainty most likely to have an effect on liquidity, financial resources and results of operations (all three) is an acquisition by another company or a merger with another company of similar or greater size, with the result that most M&A negotiations would have to be

- squeezed artificially into the period between 10-Qs,
- decently buried when 10-Q time comes, without any arrangements for the inevitable exhumation and revivification, or
- disclosed when 10-Q time comes even though there's no firm deal.

That's not an acceptable result, and the SEC staff knows it -- so a specific exception has been made for M&A negotiations, subject to two conditions: (1) there must be no other requirement of public disclosure, and (2) the company must make a decision that disclosure would jeopardize the deal, which carries with it the requirement that there be no other public disclosure from any company source or from any outside source. 24/ (The Columbia

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lack of disclosure. 'Disclosure was definitely a strong aim from the very inception,' said David Mahaffey, assistant general counsel in the SEC's Office of the General Counsel. 'In cases where an officer or director is pondering whether to disclose or not to disclose, this is likely to tilt the situations toward the open,' Mahaffey said.... Officers and directors themselves are likely to be the ones forced to pay the fines in disclosure actions, Mahaffey said....".

24/ 1989 Release, at 1244.

Pictures case 25/ that Dick Leisner described yesterday is an example of denial from a source outside the company; had the Sony officials confirmed the existence of acquisition discussions, that disclosure could have deprived the company of the benefit of this exception.)

Now let me repeat my hypothetical: a sizeable multi-line corporation, in what I'll now specify to be the time frame of 1990-91.

Sales and earnings are rising; the inferences drawn in the marketplace are favorable. It has been recognized by the corporate management that one of its lines of products is threatened by a new generation of products, which have historically been directed to a different market but which must be expected to be adapted for sale in the market in which the corporation's line of products is sold. In other words, management has prerecognized the obsolescence of [a principal] product line. The corporation has a revised product line on the drawing boards, not yet manufactured, and management is facing the alternative decisions of refinancing and retooling and reselling or of phasing out the line. The corporation is a normal large corporation, with some long-term debt containing usual covenants: normal ratios, limits on annual interest charges, limits on other funded debt and limits on the amount of short-term debt that can be incurred.

Management clearly knows of uncertainties with the potential to have a material unfavorable effect on revenues and income as a result of obsolescence of a principal product line. And management clearly knows of uncertainties with the potential to

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25/ In re Columbia Securities Litigation; Murray v. Sony Corporation, Fed. Sec. L. Rep. (CCH) ¶ 95,604 (1990).

result in substantial redirection of liquid assets in retooling and remarketing, and the potential to change the mix and cost of capital resources via debt financing, for a replacement product line. The knowledge of those uncertainties points toward disclosure in the next 10-Q -- but disclosure, for all its virtues, can also be self-fulfilling. Nothing shakes up bank creditors more quickly (witness Campeau Corporation in late 1989) than a statement that the company may not be able to pay its debts, and in my hypothetical case nothing would tend to stop orders more quickly, or to transfer negotiating strength more effectively from a licensee manufacturer to its licensor -- all to the disadvantage of the company and the advantage of its competitors -- than a statement that a principal product line is being phased out before the company can also state that the replacement product line is ready. Let's therefore perform the MD&A analysis, together, carefully.

Management can't reach a conclusion that the uncertainty is not reasonably likely to come to fruition -- it is reasonably likely to do so.

So, on to the second determination: whether the consequences of that uncertainty (obsolescence due to a competitor's new generation of products), assuming fruition, are or are not reasonably likely to have a material effect on the company's financial condition or results of operations?

- When will the fruition take place? How far along is the company's replacement product line? What is the company's prior history of manufacturing and marketing new products?

- May the company assume that its new product line will fill the void? (I think this is the wrong question; let me try again.) If the company has reasonable grounds to believe that its new product line will fill the void, does the company have an obligation to overlook those grounds and take only the bleakest view?
- Is "a [clearly] proper corporate purpose" (i.e., are obligations, outside the federal securities laws' mandates of disclosure, to conduct the company's business) allowed to affect the interpretation of disclosure obligations? Does it make a difference if the "not reasonably likely" analyses result in grey-area (as contrasted with black-and-white) determinations under MD&A?

These questions have no yes or no answers. They are put, by an SEC Commissioner, because of concern in favor of disclosure -- and because of concern that overly rigid emphasis on nothing but disclosure, divorced from the required analysis, disserves the cause it seeks to vindicate.

The Supreme Court has twice now, in defining materiality for general use under the federal securities laws (i.e., general use outside MD&A) laid down a definition indicating that the threshold of mandated disclosure is not to be lowered to the point where it gives no effective limit to what an investor or prospective investor may claim to be relevant to investment decisionmaking. 26/ Bearing that in mind (and whether working within or outside the MD&A context), I think it fair to conclude that good faith in recognizing the ultimate facts and performing

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26/ TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438 (1976); Basic, Inc. v. Levinson, 485 U.S. 224 (1988).



the required analysis, and present accuracy of information, remain the touchstones for proper disclosure.

I think, similarly, that good faith in recognizing the ultimate facts and performing the required analysis, and present accuracy of information, also remain the touchstones for resisting assertions of liability made on the basis of hindsight and with the clarity born of subsequent developments. When the presumption that an MD&A analysis was accurate-when-disclosed turns out to be false, then good faith leads inexorably to a duty to correct a statement that explicitly or implicitly is predictive and has "a forward intent and connotation", but, when inaccuracy develops out of subsequently-arising facts, neither good faith nor accuracy has yet led to an ubiquitous and ever-present duty to update -- or rather, taking a cue from Dick Phillips' comments yesterday, has yet led to an ubiquitous duty to update immediately. The en banc Backman decision confirms me in that conclusion.<sup>27/</sup>

Whether as an initial or corrective matter, of course, disclosure is always the safest route, but I persist in believing that disclosure should not be a knee-jerk reaction. From one for-the-time-being SEC Commissioner's point of view,

- Disclosure that plunges a company into a business quagmire may be effective as disclosure but is hardly contagious as an example to others.
- Disclosure made to comply with requirements that prod the company and its management to

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<sup>27/</sup> Backman v. Polaroid Corp., 910 F.2d 10 (1st Cir. 1990).

reexamine their capability for predictive business conduct is disclosure at a higher level of effectiveness.

- And disclosure that is congruent with the company's business needs is the best disclosure of all.

The objective of the SEC, in promulgating and interpreting MD&A requirements, and in applying Rule 12b-20, has been and should be to keep the pressure on reporting companies to recognize trends and uncertainties earlier, to make reasonable likelihood determinations with less fear as to likelihood, to alert present shareholders (and debentureholders) and those considering investment alike, at less threatening junctures, of what is seen to be lying just over the time horizon. In that fashion, with a bit of flexibility for peculiar circumstances (like the context of merger negotiations), the SEC will not only be encouraging compliance with the disclosure mandates of the 1933 and 1934 Acts but will be encouraging as well the management insight and capability of, and the deepening of public confidence in, that section of our economy whence comes the highest portion of America's technological innovation and of America's international competitiveness -- namely, the large group of for-the-most-part smaller, still-evolving, honest, intent-on-being-law-abiding, private-sector businesses like those represented by the lawyers attending this Institute today.