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Remarks of

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THE EVOLUTION OF DISCLOSURE REGULATION

BY THE SECURITIES AND EXCHANGE COMMISSION

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I. A Balanced Full Disclosure Philosophy

Disclosure regulation philosophy in the United States may well be traced to the famous remark of Louis Brandeis that "Sunlight is said to be the best of disinfectants; electric light the most efficient policeman." 1/ Instead of utilizing a system of merit regulation based on state law models, the Securities Act of 1933 ("the 1933 Act") was drafted as a "Truth in Securities" Act emphasizing public disclosure of material information as the primary mechanism for federal regulation of the securities markets.

A second aspect of disclosure regulation policy was addressed by President Franklin Roosevelt in 1933 when he stated in his message to Congress that "the purpose of the legislation ... is to protect the public with the least possible interference to honest business." 2/ Today, nearly fifty-five years later, a balanced full disclosure philosophy still serves as a touchstone for the Commission's continuing regulation of disclosures regarding publicly-traded securities.

The informational requirements imposed by the registration provisions of the Securities Act of 1933 were followed by the registration and periodic reporting provisions of the

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1/ L. Brandeis, Other People's Money (1914) p. 92.

2/ S. Rep. No. 47 at 6-7 and H.R. Rep. No. 85 at 1-2, 73d Cong., 1st Sess. (1933).

Securities Exchange Act of 1934 ("the 1934 Act") and together these Acts furnish the securities market with a vast body of information critical to daily investment judgments. As the Supreme Court noted on Monday of this week, "In drafting [the 1934] Act, Congress expressly relied on the premise that securities markets are affected by information, and enacted legislation to facilitate an investor's reliance on the integrity of those markets." 3/ Directly or indirectly, millions of financial professionals, institutional investors, and small investors depend on the quality, timeliness, and reliability of the disclosure mandated by the Federal securities laws. Much of the strength of the United States equity markets derives from access to information which serves as guidance for investment decisions.

II. Balancing Disclosure Needs and Costs

We must all recognize, however, that the character of the capital markets has changed and that 1988 is not 1933. Today, securities are distributed and traded publicly through constantly changing techniques that were unknown in the thirties. Because of new technologies, trading takes place in volumes and at speeds unimaginable in 1933. Additionally, the markets are presenting investors with an increasingly complex stream of innovative investment securities.

3/ Basic Incorporated v. Levinson, No. 86-279, slip op. at 20 (S. Ct. March 7, 1988).

Against this background of change, the Commission today must identify the informational needs of the public, assess market changes realistically, and implement our mandatory disclosure system pragmatically so that it will not create unnecessary impediments to the conduct of honest business.

In order to ensure adequate disclosure without impeding market efficiency, the Commission seeks to understand the practical workings of the markets. With knowledge of the markets in mind, the Commission can make reasonable assessments as to the public benefits resulting from the disclosure system. Where the public benefits from mandatory disclosure do not justify the attendant cost of compliance, the Commission should modify or eliminate the disclosure requirement.

III. Changes Stemming From the 1963 Special Study

As I have indicated, our disclosure system has changed dramatically since 1933. More important, going back to 1963 - only 25 years ago - we see a system of federal disclosure regulation distinctly different from the system of today, even though arising from statutes that remain essentially unchanged.

In 1963, over-the-counter stocks for the most part were publicly traded without adequate available public information. In contrast, in registered offerings of securities, the prospectus of the most seasoned issuer on the New York Stock

Exchange was required to be as complete as that of a company making its first public offering. Although periodic reporting requirements existed under the 1934 Act, transactional disclosure under the 1933 Act operated in virtual isolation from 1934 Act reports. The 1934 Act reports themselves were poorly disseminated. With regard to the private offering exemption, great uncertainty existed concerning the ability to sell securities without registration. Unregistered resales of privately-acquired and control securities was governed as much by lore as by law. Other recognizable differences are also apparent to those of us who have been involved in the securities field for the last quarter century.

In 1962, following a market break, Congress directed the Commission to study the adequacy of investor protection in the securities markets. The resulting Special Study of the Securities Markets 4/ made recommendations for improvement of the disclosure system. It acknowledged that information in 1934 Act reports was then inadequately disseminated and underused, and concluded that the "continuous reporting requirements . . . can and should be made to . . . provide a reservoir of reliable, reasonably current data about an issuer." 5/ The Special Study recommended "closer integration

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4/ Securities and Exchange Commission, Report of Special Study of Securities Markets, H.R. Doc. No. 95, 88th Cong., 1st Sess. (1963).

5/ *Id.* at 594.

of [1934 Act reports] . . . with [1933 Act] registration requirements," 6/ including incorporation by reference of periodic reports in lieu of prospectus disclosure, a radical suggestion in the regulatory environment of 1963. Milton Cohen, the director of the Special Study, stated the need most succinctly and forcefully in his influential 1966 article, "Truth in Securities" Revisited: "[I]t is my plea that there now be created a new coordinated disclosure system having as its basis the continuous disclosure system of the 1934 Act and treating '1933 Act' disclosure needs on this foundation." 7/

The Special Study's recognition that filings under Sections 13, 14 and 16 of the 1934 Act could provide a unitary base of public disclosure, serving both primary and secondary securities markets, was remarkable in its foresight. In 1963, this reservoir of information was largely untapped. Today, it is a vital resource for the public markets. As supplemented by the timely disclosure requirements in Form 8-K and in exchange and NASD rules, and by the general fraud prohibitions of Rule 10b-5, periodic reports provide easily accessible, timely, and comprehensive information. Integration of 1933 Act and 1934 Act disclosure systems now underlies the Commission's regulatory scheme, and should continue to do so. Today 1934 Act disclosure is the core of 1933 Act filings, resulting in a simplified and integrated disclosure system.

6/ Id.

7/ Cohen, "Truth in Securities" Revisited, 79 Harv. L.R. 1340, 1341 (1966).

The concept of integrated disclosure goes beyond rationalization of the statutory system of public disclosure. Incorporation by reference provides an important aspect of modern disclosure policy. Significantly, the Commission has permitted 1934 Act reports about issuers to be incorporated by reference into Forms S-2 and S-3 and, in parallel circumstances, Form S-4 and merger proxies. These abbreviated transactional forms recognize that when an issuer has a sufficient reporting history, an informed public market will utilize information contained in 1934 Act filings when making assessments and will reflect that information in the market price of the issuer's securities. This important acknowledgment of the market's efficiency furnishes the regulatory justification for disclosure through incorporation by reference rather than through physical presentation. For the most closely followed issuers, Form S-3 permits primary offerings of securities by means of a prospectus only a few pages long. The Commission's adoption of this procedure reflects its understanding that purchasers in such offerings buy on the presumption of a market consensus that takes public information into account.

The Commission's understanding of current informational needs may also be seen in other regulatory reforms. The 1933 Act recognizes that non-public offerings should not require registration. 8/ Commenting on the private offering exemption,

8/ 1933 Act, Section 4(2).

James Landis wrote in 1933 that "[t]he sale of an issue of securities to insurance companies or to a limited group of experienced investors, was certainly not a matter of concern to the federal government. That bureaucracy could hardly equal these investors for sophistication, provided only it was their own money that they were spending." 9/ Despite the logic of the position that sophisticated investors do not need the protection of 1933 Act registration, the refinement of statutory terms such as "not involving any public offering" 10/ and "underwriter" 11/ has at times led to interpretative questions of almost metaphysical dimensions. In the absence of Commission interpretative rulemaking, the legal uncertainties contained in the 1933 Act may have the effect of restricting sources of capital and liquidity, particularly for small business.

The regulatory response of the Commission to this problem has been impressive and it continues today. Following the 1969 recommendations of the Wheat Report, 12/ the Commission in the early 'seventies adopted the 140 series of 1933 Act rules.

9/ Landis, The Legislative History of the Securities Act of 1933, 28 Geo. Wash. L.R. 29, 37 (1959). Landis participated in drafting the statute and served as the Commission's second Chairman.

10/ 1933 Act, Section 4(2).

11/ 1933 Act, Section 2(11).

12/ Securities and Exchange Commission, Disclosure to Investors, A Reappraisal of Administrative Policies under the '33 and '34 Securities Acts (1969).

Two of these safe-harbor rules, Rule 146 (now succeeded by Rule 506 in Regulation D) and Rule 144, have evolved into a mature and predictable body of law under the Section 4 exemptions. Additionally, the accredited investor concept added to the statute by the Small Business Incentive Act of 1980, 13/ and expanded in Regulation D, 14/ clarified the definition of sophisticated investor by substituting verifiable objective standards for the uncertain subjective standards existing under prior law.

Developments in resales under Rule 144 15/ illustrate the Commission's pragmatic acceptance of the need to match disclosure protections with needs to raise capital. After initially requiring persons selling restricted securities purchased in non-public offerings to comply with the provisions of Rule 144 16/ regarding: 1) current public information; 17/ 2) amounts of securities to be sold; 18/ 3) the manner of

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13/ Pub. L. No. 96-477. The law added the definition of "accredited investor" in new Section 2(15) of the 1933 Act and provided an exemption from registration for offers and sales to such investors in Section 4(6).

14/ 17 C.F.R. 230.501-506. The statute's definition of "accredited investor" is expanded in Rule 501(a).

15/ 17 CFR 230.144.

16/ *See* Release No. 33-5223 (January 11, 1972).

17/ Rule 144(c).

18/ Rule 144(e).

sale; 19/ and 4) notice of proposed sales, 20/ the Commission has removed all of these restrictions for non-affiliates 21/ who have held such securities for at least three years. 22/ This remarkable relaxation of restrictions recognizes that there are circumstances where those who do not control an issuer should be allowed to resell securities obtained in private offerings even if the availability of public information is not assured. Here the Commission has balanced the need to encourage small business financing with the needs for disclosure. The latter needs are met, albeit not perfectly, by securities law anti-fraud prohibitions against misrepresentations 23/ and insider trading. 24/

IV. Recent Applications of the Balancing Philosophy

Although the Commission's recent efforts in the disclosure area have been guided by a philosophy sometimes characterized as "deregulatory," I would label that guiding principle as an effort to achieve appropriate balance rather than a drive

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19/ Rule 144(f).

20/ Rule 144(h).

21/ *See* Rule 144(a)(1).

22/ Rule 144(k) as amended in Release No. 33-6488 (September 23, 1983).

23/ 1933 Act Sections 12(2) and 17(a). 1934 Act Section 10(b) and Rule 10b-5.

24/ Rule 10b-5.

toward deregulation. Today, as former Chairman Shad told a Senate Committee in 1981:

> [T]he Commission is strongly in favor of efforts to eliminate unnecessary regulation so long as there is not undue erosion of investor protections. 25/

Application of this balancing philosophy toward disclosure has resulted in removal of unnecessary regulatory impediments. Several recent rule changes illustrate the philosophy.

In November, 1986, the Commission adopted amendments to its proxy rules to apply the integrated disclosure system to proxy disclosure. 26/ The amended rules allow "company-specific information required in connection with mergers and acquisitions 27/ to be incorporated by reference under a system similar to that in Form S-4, the registration form for business combinations. Where securities are being authorized, issued or exchanged, 28/ the principles of integrated disclosure have been adapted in order to bring the benefits of the system to these transactions without unintentionally increasing the information required.

25/ Statement of John S.R. Shad, Chairman of the Securities and Exchange Commission, before the Senate Committee on Banking, Housing, and Urban Affairs, regarding S.1720 and S.1721 (October 30, 1981) (commenting on proposed Glass-Steagall revisions).

26/ Rel. No. 34-23789 (November 10, 1986). See also, Rel. No. 34-24515 (May 27, 1987).

27/ Item 14 of Schedule 14A.

28/ Items 11, 12 and 13 of Schedule 14A.

In 1987, the balancing philosophy guided the Commission in rule changes eliminating the need to file pricing amendments before going to market. 29/ In that instance the Commission recognized that pricing information could be provided to investors, without the formality of a pricing amendment, while maintaining 1933 Act liability.

Recently adopted amendments to Rule 174 30/ will reduce the prospectus delivery period to 25 days in initial public offerings of securities that either are listed on an exchange or authorized for quotation on NASDAQ. The rule change is premised on exchange and NASDAQ requirements, and the market processes themselves, which provide investor protection adequate to permit relaxation of prospectus delivery requirements.

Only last week, the Commission adopted amendments to Regulation D broadening the definition of accredited investor in circumstances where it is plain that risk-bearing ability and bargaining power will allow the investor to obtain necessary information without the compulsion of federal law. 31/ At the same time, the Commission has suggested that some failures

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29/ Rule 430A, Rel. No. 33-6714 (May 27, 1987).

30/ Adopted on November 24, 1987, but still awaiting final Commission approval of text.

31/ Release No. 33-6758 (March 3, 1988). Amended Rule 501 effectively "expand[s] the definition [of accredited investors] to include virtually all classes of institutional investors." At 3.

of compliance under Regulation D should not destroy the claim of exemption and expose the issuer to liability for violation of Section 5. This recognition is embodied in a rule proposal, now awaiting public comment, that would afford a defense to a charge of Section 5 violations. The "innocent and immaterial" defense of proposed new Rule 508 would provide that minor and isolated deviations from the conditions of Regulation D will not necessarily cause a loss of the exemption for the entire offering. 32/

Another illustration of the Commission's cost balancing approach is its recognition that costs and benefits in the disclosure area affect the Commission administratively just as they do issuers. The Commission achieves efficiencies in its processing of 1933 and 1934 Act filings by its selective review procedures. 33/ Under selective review, the staff reviews the most critical transactional and continuous disclosure documents. Other documents are selected for review on an audit basis or through a selection process designed to assure review of issuers whose filings have not been reviewed for a lengthy period of time. Selective review has permitted the Corporation Finance staff to respond promptly to the changing financial environment, particularly to the heavy increase in novel securities and other complex structured offerings.

32/ Rel. No. 33-6759 (March 3, 1988).

33/ These procedures are designed to improve specific disclosure documents where deficiencies can be remedied by correction. Where evidence of willful violation or substantial injury to investors is found in the review process, correction and enforcement sanctions are used.

Criteria for selective review change with the market developments and the nature of the workload in the Division. Last year, indemnification law changes caused all proxy statements with such provisions to be reviewed. Disagreements with accountants have recently been added to selection criteria.

V. Current Commission Disclosure Concerns

As our securities markets and securities products develop at a rapid pace, the Commission is constantly being confronted with new disclosure problems. As it seeks to regulate the securities markets in the real world, the Commission continually is striving to adapt the disclosure mechanism to the current environment.

The Commission's continuing drive towards establishment of an operational Electronic Data Gathering, Analysis and Retrieval ("EDGAR") system typifies this effort. When it becomes operational, EDGAR will increase the efficiency and fairness of the markets for the benefit of investors, issuers and other market participants by reducing from days and weeks to minutes and hours the public dissemination of time sensitive corporate information. The utility and feasibility of EDGAR has been demonstrated by the success of the EDGAR pilot, now in its fourth year of operation. The EDGAR pilot has successfully logged over 30,000 electronic filings. 34/ Over 1,200 companies now are submitting some or all of their filings electronically.

Another important initiative is continuing to be developed by the staff in its "Rule 144A" project. To date, institutional holders wishing to resell securities privately have relied upon lawyers' opinions that sales and resales to institutional investors do not constitute distributions and are therefore exempt from registration. A new Rule 144A would provide a safe harbor for the resale of unregistered securities between institutional purchasers. Such a clear exemption for institutional resales could contribute to the market's liquidity and efficiency. The staff is developing the scope of the rule, with respect to the securities it would cover (perhaps distinguishing issuers on the basis of their reporting status) and the range of permissible institutional purchasers. As with other recent rule proposals, the staff may recommend proposal of alternative versions of the rule.

In a related matter, the Commission is now considering a rule proposal submitted by the American Stock Exchange to establish a marketplace, known as SITUS (System for Institutional Trading of Unregistered Securities), for the secondary trading of foreign securities by and among Exchange members

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34/ This total includes filings made under the 1933 and 1934 Acts, the Public Utility Holding Company Act of 1935, the Trust Indenture Act of 1939, and the Investment Company of 1940.

and institutional investors. It has been reported that the National Association of Securities Dealers is considering a similar proposal.

Another major area now of concern at the Commission involves the accelerating development of new instruments and financing techniques. No longer do companies merely issue common stock, debentures, or notes. New instruments include complicated new securities called names such as CATS, SPINS, TIGRS, CARS, or Zero Coupon Notes. Asset-backed securities offerings are burgeoning. Structured financings and leveraged buyouts give rise to extremely complex debt instruments. Developing credit enhancement techniques add further complexity to the picture.

The Commission's problem is to see that the disclosure concerning these new products and financing strategies adequately enables investors to evaluate their risks. In today's world of financial sophistication, innovation and novelty, increased attention must be given to the transaction terms of securities.

Not only are there difficulties in describing the new securities, and their risks to the buyer, but their effects on issuers must be described. These concerns have led the Commission to suggest to the FASB that it begin a project in disclosure regarding new financial instruments. 35/

35/ See Financial Accounting Standards Board Exposure Draft, Proposed Statement of Financial Accounting Standards, Disclosure about Financial Instruments (November 30, 1987).

VI. Accounting Matters

Competition, the complexity and novelty of transactions, and the desire to structure transactions to achieve certain accounting results all contribute to pressures on auditors regarding appropriate accounting presentation. There is an overriding accounting principle that must prevail - fair presentation of the substance of a transaction - so that the issuer's operating results and financial condition are fairly presented. This result is imperative. As I recently indicated in a speech to the American Institute of Certified Public Accountants national conference, "accurate and complete financial information enables investors to evaluate past performance and to form reasonable judgments about future performance." 36/

The Commission's shared concern over the reliability of financial reporting is clearly evidenced in three continuing rulemaking projects. 37/ First, as I am sure you are aware,

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36/ Remarks of David S. Ruder, Chairman, Securities and Exchange Commission, at the Fifth Annual AICPA National Conference (January 5, 1988).

37/ The Commission shares many of the concerns expressed by the Treadway Commission. Recognizing the magnitude of injury that can result from fraudulent financial reporting, that body recommended comprehensive changes in the system to guard against public harm caused by false financial statements. The Treadway recommendations look to all participants in the process, understanding that effective assurance against false financial reporting requires the efforts of all, including management, independent auditors and the accounting profession as a whole, in addition to the Commission. Report of the National Commission on Fraudulent Financial Reporting (October, 1987).

opinion shopping among auditors can be used to conceal unfavorable financial results, and it diminishes public confidence in the reliability of reported information. In June, 1987, the Commission proposed for comment rules that would require broader disclosure of circumstances surrounding changes in accountants. 38/

A second initiative seeks to strengthen professional standards in accounting by requiring independent public accountants to undergo periodic peer review of their practices. 39/

A third Commission concern for maintenance of high professional standards is reflected in its consideration of amendments to Rule 2(e), the Commission's authority to discipline persons appearing before it. One alternative under consideration is to make Rule 2(e) proceedings presumptively public as a deterrent to inappropriate professional practices. 40/

VII. International Disclosure Problems

As a final matter, you should be aware that some of the most challenging disclosure issues are those arising as a consequence of the growing internationalization of the securities markets. Ongoing initiatives, like the 144A

38/ Rel. No. 33-6719 (June 18, 1987).

39/ Rel. No. 33-6695 (April 1, 1987).

40/ Rel. No. 33-6662 (September 29, 1986).

project, will play a significant role in the development of those markets. Internationalization brings with it a myriad of issues, brought into focus by the blurring of national boundaries in the capital formation process.

One important question is the manner and extent of disclosure required in multinational offerings. Under one approach, called the "common prospectus" approach, participating jurisdictions would agree upon common disclosure standards and would accept a single document that would be used in each of the participating countries. Under another approach, called the "reciprocal" approach, the prospectus required in the issuer's home country would be accepted in each of the participating jurisdictions. 41/ The Commission is in the process of developing a proposal for reciprocal disclosure for the registration of specified securities, on an experimental basis with a small number of nations. Reciprocal registration would be introduced first for world class issuers of investment grade debt, which trades in large part based upon yields and ratings. The concept also would allow limited rights offerings and exchange offers to be made by reciprocal registration.

Reciprocal registration raises the issue of mutual acceptability of accounting and auditing standards. Since accounting principles and auditing standards are critical to the integrity and credibility of our disclosure system, it

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41/ *See* Rel. No. 33-6568 (February 28, 1985).

is essential that any cooperative approach emphasize the importance of these well-established standard-setting systems in financial statements. The Commission is actively involved in initiatives to reduce differences in these areas internationally.

Historically, flexibility in light of changing circumstances has played a central role in the formulation of disclosure requirements. This flexibility is evident in the Commission's efforts in the international area.

VIII. Conclusions

Ultimately, recognition of the world trading environment and notions concerning the role of this nation's markets in the overall scheme of the global marketplace may lead to changes in disclosure concepts. I am convinced, however, that the decision to rely upon full disclosure as the center point of our regulatory philosophy is the correct decision in 1988 as it was in 1933. That decision and our balanced and pragmatic regulatory approach will serve us well in both domestic and international markets.