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FINANCIAL COMMUNICATIONS AND FULL DISCLOSURE

Remarks of

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It is a pleasure to come home to Los Angeles and to talk about financial communications or financial disclosure. 1/ I have been in that business ever since I got out of law school, moved to this city and went into the practice of law, primarily in the financial and corporate field.

I would like to start at the root of the matter. Public ownership and public dealing in securities are impossible without disclosure and financial communications. A security is simply a piece of paper which represents an interest in, or an obligation of, the issuer. Without knowing something about that issuer, it is impossible to distinguish between a worthless piece of wallpaper and an investment worth thousands of dollars or tens of thousands of dollars. Consequently, the private enterprise system as we know it in this country cannot exist without some form of financial communications and disclosure.

There has thus always been some disclosure wherever securities are bought or sold, but some types of disclosure are worse than no disclosure at all, such as outright lies or figments of some promoter's imagination. When, back in the 1930's, it was determined by the Congress that the Federal Government would have to enter the field of securities regulation, there was some controversy as to whether the emphasis should be on disclosure or on substantive determinations by the Government as to the merits of securities such as had existed in a number of the states, including California. The Congress chose, I believe wisely, that the Federal effort should focus primarily on disclosure, and the Securities and Exchange Commission was created to administer this scheme. The

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Commission thus shares with the financial community and with business and industry the responsibility for attempting to see to it that disclosure and financial communications are adequate and accurate.

We have in this country two types of disclosure and financial communications, which for convenience I will refer to as official disclosure and unofficial disclosure. I was tempted to use the terms "required" and "voluntary disclosure" but unfortunately, although rather more descriptive and understandable, these terms are not quite accurate. A good deal of corporate disclosure, although not required by law, is required by rules and policies of the stock exchanges as to companies which are listed there. Further, under some circumstances, what would normally be voluntary disclosure may become, in effect, mandatory, as where a corporation is purchasing shares of its own stock at a time when there are material, undisclosed facts about its business. This is an aspect of the insider-trading question which I intend to touch upon in more detail later. Official disclosure comprises the scheme of business and financial reporting and disclosure which is required of substantially all publicly owned corporations under the Securities Act of 1933 and the Securities Exchange Act of 1934, together with such disclosure as may be required by state law. Essentially, the Federal scheme contemplates that whenever a corporation offers its securities to the public, the investor shall be provided with a comprehensive description of the company and of the relevant and material facts with respect to its business and finance. This was supplemented under the Securities Exchange Act of 1934 by a scheme of registration, periodic reports and proxy statements which provide disclosures at specified times or upon the occurrence of specified events.

While the official scheme of disclosure provides an indispensable reservoir of business and financial information presented under statutory sanction, it is supplemented by an immense and invaluable flow of corporate and financial information contained in annual and quarterly reports to stockholders, letters to stockholders, press releases and other sources, all of which, in combination, are utilized and analyzed, not only by individual investors, but, more importantly, by professionals in the securities and investment field.

The combination of official and unofficial, or mandatory and voluntary, disclosure, which prevails in this country is undoubtedly the best in the world. Certain other countries have well-developed systems of required disclosure--indeed, much of the inspiration for the Securities Act of 1933 was drawn from British legislation going back as far as 1844 when prospectus requirements were introduced by the Companies Act of that year. On the other hand, there has, I think, been considerably less willingness on the part of companies in most other countries to provide the extensive and valuable unofficial disclosure which has become customary in this country. In that connection, I read with interest an article in the current issue of Fortune Magazine which discussed economic conditions in West Germany and pointed out that notwithstanding the well-known "economic miracle," as the postwar recovery of West Germany has been described, there is some danger that this progress may not be sustained because the capital markets are weak and the public is not disposed to commit its savings to equity securities. It is no coincidence that West Germany is endeavoring to improve its system of corporate disclosure, nor, I think, is it a coincidence that the securities markets in the United States are the strongest in the world, a far larger proportion of the American people own stocks than is true anywhere else, and we have the most advanced scheme of financial communications and disclosure.

While we all of us may well be proud of what has been accomplished in this field, there is no occasion for complacency. American business and industry are becoming more complex, particularly with the rise of conglomerate corporations, and there is a need to improve our disclosure and communications, both official and unofficial. Earlier this month, the Commission announced the completion of a report to it by a small group, headed by a distinguished Californian, Commissioner Francis M. Wheat, which for about a year and a half has been engaged in a comprehensive reappraisal of the Commission's rules and procedures with respect to disclosure under the Securities Act of 1933 and the Securities Exchange Act of 1934. This report is so recent that the Commission has not yet had an opportunity to completely review it, and I should emphasize that it has not been approved or adopted by the Commission. Nevertheless, I commend it to your attention. In my personal opinion, it is a masterly piece of work and holds a potential for a major clarification and coordination of disclosure procedures under the two securities acts. Unfortunately, the Commission did not have the money to print it up and distribute it widely, but fortunately private enterprise--as it often does--filled the gap which the Government could not meet and various private organizations and financial printers either have printed it for wide distribution or are in the process of doing so. Disclosure is not the easiest thing in the world to write about, particularly in a clear, let alone an entertaining, way, but it is nevertheless important and the report of the Commission's study group is well worth reading by anyone having an interest in the field, and this, I believe, definitely includes corporate management. There is another area of official disclosure which is a source of concern to us currently and that is the provision of adequate, understandable and timely disclosure with respect to corporate takeovers. Congress addressed itself to this problem last year and passed Public Law 90-439, effective July 29, 1968, which provides as presently pertinent that anyone who purchases more than 10 per cent of any class of equity securities registered under the Securities Act or who makes a tender offer for 10 per cent, or more, of any such class, must provide certain disclosures about himself, his sources of financing, and his intentions. Solicitations in favor of and against tender offers are subject to regulation, and manipulative and deceptive practices in connection with these are prohibited. This legislation filled a significant gap. Previously it was possible for some broker or banker to announce that he was making a tender offer on behalf of an undisclosed principal, at a specified price, and let it go at that. This contrasted with the situation where securities rather than cash are offered in exchange for securities of the so-called target company, where registration and full disclosure have been required under the Securities Act since 1933.

Notwithstanding the requirements of registration, disclosure in this latter area presents a problem. Where a large conglomerate corporation is offering its securities in an exchange offer, the prospectus becomes an extremely complex document, not because we want it that way but because the situation is inherently complicated, particularly where the proposed acquiring corporation offers, in exchange for each share of the target company, a complicated package consisting, for example, of three quarters of a share of a newly created subordinated convertible preferred stock and one eighth of a share of its own common stock and a warrant to purchase one fifth of a share of its own common stock. Security analysts apparently believe that they can put a price tag on this kind of a combination, but I notice that different analysts often come up with different figures. If, as is often the case, the tender offer is contested by the management, or one or two additional suitors enter the field, the situation becomes even more difficult and it is even harder to prevent investors from becoming misled.

I believe there is also a need to improve accounting practices as they relate to conglomerate corporations and to mergers. The Commission has been working on this, particularly in the area of so-called divisional reporting; that is, requiring conglomerates to disclose the results of operations of each major unit. Unless this is accomplished, a takeover by a conglomerate will result in a decrease in the amount of available financial information. The results of operations of what was an independent company will simply disappear into the consolidated financial statements of the conglomerate. Meanwhile, the accounting profession is doing a great deal of work in an effort to arrive at a better and more uniform method of accounting for corporate combinations. Under the present scheme of things, it seems that, at least in some instances, an acquiring corporation is able to select whatever method of accounting will produce the greatest apparent increase in earnings per share. This difficulty is compounded when the acquiring company is a glamor company whose shares sell for a high multiple of earnings, while the acquired company is viewed more conservatively in the market place. In such a situation, the acquiring company can often increase its reported earnings per share by the simple device of making an acquisition, although the actual operations of both companies are no more profitable than they were before the combination.

These, then, are the principal areas of concern and change with respect to official, or required, disclosure. The area of unofficial, or voluntary, disclosure is also not without developments. The stock exchanges, particularly the New York Stock Exchange, have recently revised and refined their procedures for requiring timely and adequate disclosure of material developments in their affairs. At the same time the subject of so-called insider trading has attracted increasing attention. Indeed, from reading press accounts, one might suspect that the principle that corporate insiders who trade on the basis of material, undisclosed information violate the fraud provisions of the securities laws is an idea that the Commission and the courts first thought of in 1968. This is definitely not the case. The principle has its roots in the common law and was applied by the Supreme Court of the United States as long ago as 1909. The Commission and the courts have been following it under the securities laws since at least 1943. In 1951, Chief Judge Leahy of the United States District Court for the District of Delaware put the matter briefly and bluntly as follows:

> "The rule is clear. It is unlawful for an insider, such as a majority stockholder, to purchase the stock of minority stockholders without disclosing material facts affecting the value of the stock, known to the majority stockholder by virtue of his inside position but not known to the selling minority stockholders, which information would have affected the judgment of the sellers." 2/

Application of this established principle in specific cases, however, continues to present interesting and difficult questions. These include such things as who is an "insider," what information is "material," and when is information deemed to be "disclosed" so that insiders may trade?

It was clear from the outset that corporate officers, directors and controlling stockholders, as well as the corporation itself when buying its own stock, are "insiders." This list, however, is not exclusive. In 1961, the Commission in the Cady Roberts case, 3/ held, in effect, that any person who had a relationship with a corporation giving access directly or indirectly to information intended to be available only for a corporate purpose and not for the personal benefit of anyone, could not trade on the basis of such information if it was material, and applied this rule to a brokerage firm which had a representative on the board of directors of a corporation. This formulation was accepted by

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2/ Speed v. Transamerica Corp., 99 F. Supp. 808, 829.

3/ 40 S.E.C. 907 (1961).

the Court of Appeals for the Second Circuit in the well-known Texas Gulf Sulphur case.[4/] The same basic principle was applied by the Commission to a prospective underwriter who received material information in that capacity in the Merrill Lynch case.[5/]

The question of what information is material is more difficult. Various abstract formulations have been attempted by the courts and by the Commission, generally in terms of information which would be important to reasonable investors in making investment decisions, and in terms of information which may reasonably be expected to have an impact on the markets. We recognize that general standards, such as those, are more difficult to apply in concrete situations. It should be noted, however, that in the cases which have recently been decided, the information was not only important but rather strikingly so. These cases involved such matters as a substantial cut in the dividend in Cady Roberts, the extraordinary mineral discovery in Texas Gulf Sulphur, the sharp and unexpected decline in the company's earnings in the Merrill Lynch case, and others. While general definitions do not always answer concrete cases, it is usually possible to identify material information by the application of good business judgment to all of the facts in a specific situation. In this connection, there are two approaches which may be somewhat helpful. If the company itself regards the information as a corporate secret which must be carefully guarded, this is at least a red flag. Further, if the insider attempts to put

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4/ S.E.C. v. Texas Gulf Sulphur Co., 401 F.2d 833 (1968).

5/ In the Matter of Merrill Lynch, Pierce, Fenner & Smith, Inc., Exchange Act Release No. 8459 (November 25, 1968).

himself in the shoes of an ordinary investor and considers whether such an investor might not feel that he was being unfairly dealt with if he was asked to buy or sell his stock without having this information, this is again a red flag. This problem of what information is material has been likened to the situation described by Mr. Justice Stewart in one of the obscenity cases in the Supreme Court. He there stated that he was not attempting to define "hard-core pornography" and then continued by saying, "Perhaps I could never succeed in intelligibly doing so. But I know it when I see it, ..."[6/]

The question of when information is "disclosed" for the purpose of the insider-trader decision was considered in the Texas Gulf Sulphur case. The Court of Appeals held that before insiders may act upon material information, such information must have been effectively disclosed in a manner sufficient to ensure its availability to the investing public. The court said that at a minimum this did not occur until the news could reasonably have been expected to appear over the medium of widest circulation, the Dow-Jones broad tape. This particular ruling is the subject of a petition for certiorari now pending in the United States Supreme Court.

The Texas Gulf Sulphur case also involved the important question of whether or not an insider, who himself cannot trade because he has material undisclosed inside information, can pass the information on to others in order that they may make use of it. The court held that the giving of such "tips" was likewise a violation of the Act and Rule 10b-5.

6/ Jacobellis v. Ohio, 378 U.S. 188, 197.

The Merrill Lynch case presented a similar problem in that certain of the respondents there stipulated to a finding that they had passed on material undisclosed inside information to certain large institutional customers. The Commission held, in accordance with the decision in the Texas Gulf case, that this also was a violation of the rule. The Merrill Lynch case also presented the question, which was referred to in the Texas Gulf Sulphur case, but not there presented or decided, as to whether a person who receives such a tip violates the rule if he acts on it while the information is still undisclosed. That phase of the Merrill Lynch case is now pending before a Commission hearing officer and may be expected, in due course, to come before the Commission, and consequently it would not be appropriate for me to discuss it here.

The fact which I earlier referred to, that, largely by coincidence, several important cases involving insider trading have been decided by the courts and the Commission within recent months has given rise to some concern in the financial community that corporate officials can no longer disclose information to interested financial analysts, stockholders and others unless they make it the subject of a public release, and that a desirable flow of corporate information will thereby be restricted. In my view this concern is unwarranted. Although it appears that for a while last summer and fall, certain corporate officials and their counsel reacted and, in my view, overreacted in this direction, I believe it is now coming to be recognized that the principles announced in the Texas Gulf Sulphur and other cases will not unduly restrict the flow of corporate information; on the contrary, they should increase and expedite that flow. If insiders were in a position to trade upon material undisclosed information, they would have an incentive to delay or manipulate disclosure in order to take advantage of the information. Since, however, recent cases have determined that they are not entitled to trade on this information, they have an incentive to disclose it promptly so that any transaction which they may wish thereafter to have will not raise a question as to a possible violation of Rule 10b-5. Moreover, as various members of the Commission and its staff have made clear in recent public discussions of the question, the principles announced in these cases do not prevent corporations from discussing their affairs with shareholders or security analysts, provided that any material undisclosed information is disseminated publicly to all investors rather than being communicated to a few.

Thus, I believe that the principle which has been developed by the Commission and the courts over the years with respect to the use and abuse of material inside information will not only improve the quantity and quality of disclosures in our security markets but will also contribute significantly to the maintenance of fair and honest markets and to the preservation of investor confidence in those markets. After all, if the ordinary investor is to get the impression that insiders and professionals can deal with him on the basis of important information not available to him, he might well conclude that the securities markets were a safe place only for insiders and professionals. Such a conclusion would of course inflict grave harm upon our markets and the economy, and the Commission will continue to do its best to make sure that such conditions do not prevail.

Another area in which there have been significant developments with respect to unofficial disclosure involves misleading corporate press releases. This question was presented to the court in the _Texas Gulf_ case, where the company had put out a release concerning its mineral discovery which the Commission alleged was misleading. Section 10 of the Securities Exchange Act and Rule 10b-5 thereunder apply to transactions only if they occur "in connection with the purchase or sale of a security." The district court in the _Texas Gulf_ case held that since neither Texas Gulf itself nor its officers and directors were buying and selling at the time the release was issued, the release was not issued in connection with the purchase or sale of a security. The court of appeals thought otherwise, holding that the phrase "in connection with the purchase or sale of any security" intended only that the device employed, whatever it might be, be of a sort that would cause reasonable investors to rely thereon and in connection therewith, so relying, cause them to purchase or sell the company's securities. This sounds like a technical legal distinction, and so in a sense it is. It is, however, extremely important. If the statute and rule were construed as the district court did, it would mean that a company and its management, if they were not themselves buying or selling securities, could put out any statement they pleased, no matter how false or misleading, free of any restraint under the Federal securities laws. In view of the volume of press releases that companies issue nowadays, investors could, I think, view that situation with some alarm. The Court of Appeals for the Second Circuit has recently reaffirmed its _Texas Gulf_ position in two other cases, and in both of them the defendants are seeking review in the United States Supreme Court, so that we may have this question before the high court in the near future. Although the court of appeals gave the "in connection" phrase a broad reading, it was otherwise quite cautious in dealing with the press-release issue, recognizing, as we do, that this can be a two-edged sword. If corporations are liable in damages for a well-intentioned but poorly executed press release, this could inhibit the flow of corporate information. On the other hand, it is important to our securities markets and the investing public that those who report corporate developments do so carefully and, in so far as reasonably practical, accurately. The court declined to determine whether the press release in question would mislead the average reasonable investor and remanded this question to the district court for further consideration. It went on to hold that even if the release was misleading in this sense, there was still no violation unless its issuance resulted from a lack of due diligence on the part of those responsible for it, either in ascertaining the facts or in describing them. Judge Friendly, in a concurring opinion, strongly hinted that there could be no liability for damages in this type of case, even if there was negligence, in the absence of recklessness or willful fraud. He did agree, however, that the Commission might obtain an injunction against a misleading press release which was negligently issued.

In that connection, I recently noted with interest that in the course of pretrial proceedings in the private actions for damages arising out of the _Texas Gulf_ press release, the court stated that the parties conceded that the plaintiffs would have the burden of showing that the release was prepared with a "reckless disregard for the consequences . . . or an outright, wilful misrepresentation because of fraudulent motives." This would seem to be a substantial burden and if the law develops in this direction, the specter which has been raised of huge damage awards resulting from press releases which are innocently but negligently prepared, should be laid to rest.

I have detained you long enough from the interesting panel discussion which is to follow. In closing, I would merely reiterate that accurate and adequate financial communications are essential to the functioning of the securities markets and thus to our economic system. We have an excellent system based not only on state and Federal law but in large measure on the enlightened self-interest of the business community and that like apparently everything else in our society, it is changing. Unlike some of the other changes which we witness about us, I see in this area lively prospects for considerable improvement and progress.