REMARKS OF RICHARD B. SMITH, COMMISSIONER,
UNITED STATES SECURITIES AND EXCHANGE COMMISSION,
BEFORE THE 23rd NATIONAL CONFERENCE OF THE AMERICAN
SOCIETY OF CORPORATE SECRETARIES, INC.,
SAN FRANCISCO, CALIFORNIA, JUNE 17, 1969

Administrative Disclosure Reform at the SEC

I first want to thank you for having invited me to join you at your national conference this year.

My wife unfortunately is unable to be here with me. She had been particularly interested in accompanying me. She wasn't at first sure, when I told her about it, what kind of secretaries' convention this was going to be ... and in San Francisco!

When corporate secretaries meet annually, it must be the annual meeting of annual meetings -- and one I suspect you find considerably more enjoyable than the others for which you are responsible.

I particularly admire your willingness to let the SEC have something to do with this one -- I would have thought you probably feel we have too much to do with the others!

Knowing that we are, in effect, uninvited attenders at your corporate annual meetings, I must say it's an especially nice feeling to be an invited guest at your Society's annual gathering. And I thank you.

I've personally seen your role now from three, maybe four, vantage points -- for a number of years as a member of a law firm acting as outside company counsel, and at times as underwriter's counsel, for a period of a year or two as a full-time member of a corporate legal department, and for the past two years as a member of a regulatory agency. I applaud the contributions you make through this Society toward the improvement of corporate practices.

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I decided to talk a bit with you today about the current developments at the Commission that are most likely to have some effect on all of you: corporate disclosure improvements. I

should point out the customary: that I speak only for myself and not for any of my colleagues on the Commission or staff.

Some of you might be unhappy about certain of the suggested disclosure reforms -- for one thing they may mean more work. But in considering them, I hope that you will look to their objectives -- which lie in a more rational and cohesive disclosure system, a more relevant and administrable one, one that turns on more objective tests, an approach that seeks out the real needs of the markets and stockholders -- so as to make the corporate production of information less an exercise and more a function.

No doubt, the panoply of disclosure requirements that has grown up over the past 35 years, since the federal securities legislation was enacted, has made compliance an increasingly complicated matter. Let me read you two letters actually received by the Commission's Chicago Regional Office five or ten years ago from a lawyer in a small Kentucky town. His letters give you some idea of how the complexities struck him:

> Dear Sirs:
>
> Mr. John Smith, president of Pond City Auto Auctions, has handed me your letter of January 12 to which please refer.
>
> Now I set up the corporation for these fellows. They have bought themselves a lot and are aiming to put up a place where used cars are auctioned off.
>
> The boy's intentions were to sell stock only to used car dealers. I know this for a fact, because I set in on several of their meetings when they started the corporation last September. Of course, I suppose they could sell stock to the public if they took a mind to. There is nothing in their charter forbidding it.
>
> Now I frankly tell you that I am a country lawyer. There are a dozen lawyers in this town, and I would not give two cents for what all of us put together know about Federal law. The reason is that each one of the regulatory or administrative agencies of the govt. has got its own books of rules and regulations and if a lawyer here had them he would be needing a barn to put them in, and he

would be bankrupt from buying them. So, most of us gave up on Federal law long ago. All I've got is a $3 book on bankruptcy. If some poor fellow comes in with a Federal problem, I tell him to write his Congressman. There may be a copy of the Securities Act of 1933 in this town, but I don't know who would have it, and I sure don't.

So, if the Pond City Auto Auction boys are doing something you don't like, you let me know what it is and I will tell them to quit it.

I can't figure how you ever even heard of this outfit. I think their competitors must have written to you. Maybe you could also check on their competitors.

Yours,

Dear Sirs:

I thank you for your letter of January 29.

It <u>does</u> appear that the stock offering might not have been entirely intrastate, and that therefore registration is required. I have wended my way through all the material you sent me, and I think I fairly comprehend the substance of Release Nos. 4434, 4554, 4450, 4470, and the Securities Act of 1933. However, I must confess that the "General Rules and Regulations" is the most incomprehensible document that has ever come to my hand. When I graduated from law school, I got the highest grade on the state bar exam. I have an I.Q. of 137, and I still can't read this damn thing and make any sense out of it. Couldn't you just send me some blank forms to fill out? Then we could do business.

Yours,

As you see, country lawyers can be extremely effective.

Would that life for you and me (and for Mr. Haack and Mr. Phelan from whom you just heard) could be that simple. As

the nation's industrial system and its processes of capital formation have become larger and more complex, so disclosure requirements have become necessarily more sophisticated. In approaching disclosure we must be as careful about simplistic solutions or views as about needlessly convoluted and abstruse ones, such as may give our Kentucky lawyer reason to complain.

* * *

Every institution is called upon to renew or reform itself. Without that it becomes either irrelevant or an impediment. Constructive changes in an institution must come thoughtfully and deliberately and with awareness of consequences. The SEC as an institution is no different. I believe I can report to you today that some hopeful processes of disclosure reform are at work at the SEC.

The fulcrum of discussion there, on this subject, is now the report submitted a little more than two months ago entitled "Disclosure to Investors -- A Reappraisal of Administrative Policies Under the '33 and '34 Acts." It has become commonly known as the Wheat Report.

That's led to some confusion. Some thought it was something prepared by the Agriculture Department. Others, who recognized it had come out of the SEC, figured -- despairingly -- that now the SEC was intending to extend itself to commodities. Well, the disclosure study was really done by a small group drawn from the staff of the SEC, headed by my colleague, Commissioner Frank Wheat. The study was authorized by the Commission in November of 1967.

A little background may help to show why I am encouraged, and to show the admirable and fascinating interaction between constructive critics outside the agency and administrators within the agency. The latter I believe are showing the capacity for a "consciously critical attitude" (in then Dean Frankfurter's words) toward their own rules and forms.

After referring to the background, I'll discuss some of what I consider more relevant proposed changes for you to think about.

* * *

As good on the whole as the federal securities legislation has been, as the disclosure system took hold there developed some anomalies in its application that were generally recognized.

The first federal law, the Securities Act of 1933, was directed at offerings of new securities to public investors. When a company is reaching public investors for the first time, this was and is a valid point in time to require that the prospective investor be provided with full and meaningful information about the "intricate merchandise" he is being solicited to buy. And when a company already has public stockholders but there is no background of meaningful public information about it, as was the case generally speaking in 1933, the point of offering is again a valuable time to require a full and systematic collection of information and presentation of it to the prospective investor.

When the Securities Exchange Act of 1934 was passed, it concentrated not on new offerings but on the trading markets. It recognized the value of continuing reporting by companies whose securities were outstanding in the hands of the public, and so it required filing of periodic reports with the Commission and dissemination of certain information to the shareholders in connection with shareholders meetings. The requirements, however, were limited to companies that happened to have made offerings under the 1933 Act and companies whose securities were listed on the national securities exchanges, which were the focus of the 1934 Act.

The over-the-counter securities markets received more attention in the Maloney Act amendments of 1938, but that legislation concentrated on broker-dealer aspects and not on the over-the-counter securities themselves. That was not done until 1964 when the Congress passed amendments extending the 1934 Act reporting and proxy requirements to the larger over-the-counter companies.

In the meantime, over those 30 years, and particularly in the later post-war years, it became increasingly evident that something was getting out of phase. While the proxy material clearance process evolved over the years into a meaningful disclosure tool, the periodic reports -- required by statute only to be filed with the Commission and not required to be distributed to investors -- became little more than Commission enforcement aids.

The 1933 Act prospectus was the pre-eminent disclosure tool. Because of that the Commission took rigid positions on exemptions from the Act's registration requirements. Perhaps the most troublesome exemption was that for "transactions by issuers not involving any public offering." The Commission was faced with the question of how evasions or avoidances of disclosure could be prevented where issuers sold securities to a few individuals who then resold to the public? The Commission seized on the definition of an underwriter, a sale by whom would require registration. The statute defines an underwriter as "any person who has purchased from an issuer with a view to... the distribution of any security." The Commission developed tests for when a person became a statutory underwriter that hinged on the words "with a view to." Given that hinge, the tests became very subjective in character. What was the purchaser's "view"? What was the investor's intent? What was his state of mind?

The effect of this in turn was to put the bar and everyone else at some loss to predict with any confidence when the Commission would feel that registration was required. And that led them to seek the guidance of the Commission staff who developed the now well-known technique of issuing or denying "no action" letters. The beneficial end result was to control, to a large extent, the distribution of unregistered securities. Little distinction, however, was made among kinds or sizes of distributions (at least not on any theoretically consistent basis), or between companies reporting under the 1934 Act, with securities already in the hands of the public and about which there was substantial current information, and non-reporting companies.

The body of intricate law and lore that was accumulating around the event of "offering," public and non-public, somehow seemed to be missing the main arena. Somehow the extensive time and cost in the preparation and processing of a 1933 Act registration for a company whose securities were already being continuously evaluated and traded in the market seemed disproportionate to the economic realities. It became especially noticeable where distributions in a particular security were small in relation to the outstanding.

That's for one security. In the aggregate of all securities, the disproportion in emphasis is even more striking.

The dollar volume of transactions in outstanding equity securities has vastly outpaced offerings of new securities. On the New York Stock Exchange alone, from the $10 to $20 billion annual volume plateau that existed in the eight immediate post-war years, the annual dollar volume has steadily increased over the next dozen years, getting to almost $100 billion in 1966, and last year aggregating $145 billion. At the same time, the dollar volume of new equity offerings by issuers for cash stayed between roughly $1 and $3 billion during all these post-war years. As a result, the proportion to trading volume necessarily decreased. Over the last three years the total new offerings of equity securities, which include both over-the-counter and those to be listed on the exchanges, were less than two percent of the New York Stock Exchange trading volume alone.

Thus, when you look at the total universe of securities transactions and the efficacy and pertinence of disclosure requirements, you can see that the trading markets are overwhelmingly important compared to new issues. It is just for this reason that a number of informed people have been suggesting that the Commission's historic emphasis on the sporadic and fulsome disclosures in connection with new offerings is out of phase with the importance of upgrading continuous disclosure requirements about outstanding securities.

And in some ways (certainly not all), Rule 10b-5 developments in the courts can be seen as judicial attempts to remedy this dislocation or gap in systematic disclosure policy. The gap also lent more credence than was otherwise deserved to those who began questioning the whole concept of corporate disclosure that is so basic to our system of, if you will, people's capitalism.

Constructive critique was growing outside the Commission. One such critic, Louis Loss, now a professor of law at Harvard, had commented for years in his treatise on Securities Regulation and elsewhere, about the need for integration of the two statutory philosophies.

The immediately galvanizing comment was probably Milton Cohen's article in the May 1966 issue of the Harvard Law Review. Mr. Cohen, a private practitioner in Chicago, had been director of the Commission's Special Study. His was a vigorous argument for a coordinated disclosure system. Mr. Cohen put it this way:

> The crucial question, obviously, is the appropriate application of the '1933 Act" concepts to issuers that are already '1934 Act' continuous registrants. Rightly viewed, it is not a question of weakening the protections of the 1933 Act but rather of strengthening those of the 1934 Act's continuous disclosure system -- the basic system -- and then eliminating 1933 Act burdens that are essentially superflous.

Mr. Cohen's article was followed six months later by a conference of securities lawyers in Chicago under the auspices of the American Bar Association's Section on Corporation, Banking and Business Law. At that conference, Professor Loss proposed the concept of legislative codification of the federal securities laws. Many of you here may be familiar with the proceedings of that interesting conference which were published in the April 1967 Business Lawyer. That was followed in May by an article of Carl Schneider in the University of Pennsylvania Law Review advocating administrative revision of the disclosure requirements.

Meanwhile, back at the Commission, matters were not entirely standing still. They were being at least pushed along by two general developments, and perhaps one specific. They helped coalesce with the outside comment into the decision that a broad re-examination of disclosure policy should be undertaken.

One harsh development was the bind in which the Commission found itself by reason of budgetary cuts and reduction in personnel levels. This occurred in the face of a vastly increased workload resulting from the burgeoning financing and acquisition activities and trading volume. The demands on the reduced staff were enormous in processing of an ever increasing number of 1933 Act registration statements (and '34 proxy statements swollen by the '64 amendments), and the comparably increasing volume of no-action letter requests. This was, at the same time, both a strong pressure for re-examination and an inhibiting factor because people had little time within the Commission to spend on broad policy re-examination. It's hard to see land when you barely can keep your head above water.

Another development was the new technology being brought to the attention of the Commission for the storage, reproduction and dissemination of information filed with the Commission. The potentialities of data processing and information distribution systems for meaningful 1934 Act disclosure could not be ignored.

Then in the summer of 1967 a request for a no-action letter came before the Commission. It involved the application of Rule 133 to an acquisition of a closely-held corporation in exchange for listed shares. While I do not have time in this talk to enter into a discussion of Rule 133, suffice it to say that the Commission reversed a previous position and denied the issuance of a no-action letter. The case is referred to in the Wheat Report. For me at least, it led to a revisiting of the persistent interpretative difficulties under Rule 133, and crystallized for me the mandate for change.

In these various ways the need for rationalizing, or coordinating, or integrating, disclosure theory and practice at the Commission was accentuated, and in November 1967 the Commission formed its internal study group to examine the operation of the disclosure provisions under both the 1933 and 1934 Acts and to recommend what could be done administratively.

Also that fall, the Commission took its first slight step toward integration of the 1933 and 1934 Acts in adopting Form S-7. That, as you know, is a registration statement that can be used by companies of a certain size requiring somewhat less information than the S-1. The Commission required, as a part of the standards for use of the S-7, timely compliance by the issuer over a period of years with 1934 Act reporting and proxy requirements. In my view, were the 1934 Act reports of better quality and better distributed, such reporting and proxy compliance should be about the only requirement for use of an even more abbreviated S-7.

Since those beginning steps at administrative reform the idea of a legislative codification program has also gained momentum. The American Law Institute has decided to sponsor a codification effort, subject to obtaining the funding, and Professor Loss will be its reporter. I know how comprehensive an effort this must be (it would not relate only to disclosure). I also have some sense of how long it takes for legislation to be drafted and enacted. And I recognize that any rule-making efforts on the part of the Commission are limited by the frame-

work of existing statutes. For those reasons I see nothing inconsistent between the ALI's codification program and the Commission's administrative program. They are complementary. Where the courts have decided, and where the statutory patchwork has left or created anomalies and disjunctions in treatment, improvement by legislation will be necessary. Yet, what the Commission created by rule and interpretation is certainly within its power to improve if it can. Moreover, practice under revised rules can provide valuable experience to the codifiers.

A review of the background would not be complete without recognizing the role that former Chairman Manuel Cohen played in instituting the disclosure study. It is a tribute to him that despite his expressed fondness for the "decorative curlicues" and "imaginative interpretations" which he had so much to do in creating and which helped make the securities legislation work so well for so long, he nevertheless was willing to recognize that we cannot, in his words, "assume that methods which were entirely proper, even praiseworthy, at an earlier time are necessarily beneficial in a changed environment."

Recognition should also be given to the role of Chairman Hamer Budge in authorizing the immediate release of the Wheat Report. It could have been bottled up in staff and Commission review for months. Its immediate release has served to preserve the momentum of reform.

Finally, tribute is due to Commissioner Wheat for having carried an arduous task through to conclusion. The report, given the complexity and technical difficulty of the subject, is remarkably lucid and free of the customary "interested in, affected by and concerned with" tautologies of bureaucratese. It flows readily from policy to application and in total is a well constructed document. I am sure those of you who have read it will agree, whether or not you concur in all its conclusions.

* * *

Now what is the reform about?

Well, I hope that my description of the background has served to indicate the apparent direction of reform. I should make it clear that in describing so briefly my view of the background,

I do not mean to underweigh the great achievements of the Commission and its staff over those years in forging a workable disclosure system unparalleled in the world. We are here talking only about likely areas of improvement, not renunciation. And really, until the statutory amendments of 1964 were enacted, it is questionable whether the changes we are now considering were practicable.

The cornerstone change is the upgrading of the content, format and dissemination of the periodic reports filed by all domestic companies whose securities are registered under Section 12 of the 1934 Act or who are required to file such reports by reason of having registered an offering under the '33 Act. Time permits me today to discuss only this one set of proposed changes. They are the changes that probably would most directly affect you.

The basic registration form under the '34 Act, Form 10, would become something closer to a 1933 Act prospectus in coverage. It would contain a brief description of the business, particularly of developments over the last five years, a five year summary of earnings, brief descriptions of properties, control relationships, and numbers of shareholders, management and its remuneration and transactions with the registrant, a description of the registered securities and recent issuances of securities, pending legal proceedings, a current balance sheet, and a statement of the sources and application of funds (this latter would be a new financial statement requirement, which many companies are already providing voluntarily).

The Form 10, once filed in its expanded form, would be updated annually by means of the familiar Form 10-K. However, the items of that form would become essentially carry forwards of the basic Form 10, reflecting material development within the past year. The Form 10-K would be required to be filed within 90 days of fiscal year-end rather than 120 as at present, or within five days of publication of the annual shareholders report if earlier. Accountants tell us this would be no problem, particularly if some of the financial schedules are simplified. That would be considered and practicable adjustments made in order to achieve better timeliness of the body of the 10-K. For instance, the schedule for supplementary profit and loss information could be filed 120 days after year-end.

You'll be glad to hear that, while considered, virtually no recommendation was made for change either in the status of

a company's annual report to shareholders as a non-filed document, or in the annual proxy statement. The only suggestion for the annual report was, by rule, to seek to prohibit misleading condensations or comparisons of financial information in any part of the report. For the proxy statement, there was one lightening recommendation, which if adopted would also have to be carried over to Form 10 and prospectuses, and that is to increase the $30,000 limitation on reporting directors' and officers' remunerations to $40,000. (Since you here are all over that anyway, it will not impress you, I guess!) Also, there would be no duplication of information between the 10-K and the annual proxy statement. If it is reported in one place, as for instance, management compensation in the proxy statement, it need not be reported again in the other. That theme runs through all of the disclosure study recommendations--avoidance of duplicative reporting.

Thus you can see the outline of a rational, systematic, continuing disclosure procedure that would make the Commission's '34 Act files usable. However, annual updating is not enough. At the present time the 9-K semi-annual and 8-K event-that-month reports are supposed to serve as interim sources of information. I say supposed; they're almost never used. They should be discarded and that is what the Disclosure Study recommends. In their place it recommended a regular quarterly report, to be filed on a new form 10-Q within 45 days after the end of the quarter.

The 10-Q would have two parts. The first part would report on significant corporate events occurring during the quarter. In other words, it would contain the substance of the present 8-K report, but would be filed on a regular quarterly basis rather than monthly on an event-occurrence basis. There is one exception. The Study Group recommended that whenever a significant acquisition or disposition of assets occurs, a 10-Q covering that event would have to be filed within ten days after execution of the written agreement. Financial statements of the business acquired would also be called for when an acquisition is reported on 10-Q. It is recommended that the test of a significant acquisition or disposition be changed from 15 percent to 10 percent of either net book value or gross revenues.

Now it is proposed that the first part I have just described of Form 10-Q be subject to the liability provisions of Section 18 of the '34 Act -- in this respect the same as for Form 8-K at present.

Part two of 10-Q would contain unaudited summarized profit and loss information, including earnings per share for the quarter and a summary statement of capitalization and shareholders' equity at the end of the quarter. That information would not be subject to the liability provisions of Section 18. In this respect it is like the 9-K.

You see that this SEC system would remain one of periodic reporting. It is not a timely reporting system. That, I have said before and the Wheat Report takes the same position, should remain administered by the self-regulatory agencies. The major exchanges have, generally speaking, excellent standards and procedures for prompt communication to shareholders and the markets of news concerning material developments. And, as you probably know, they are policed and enforced. I don't think the Commission with its necessarily more rigid legal framework can do as good a job in this area. It is troublesome that there is no comparable structure for requiring timely disclosures on over-the-counter securities. It is possible that a more meaningful SEC periodic reporting system will help to improve timely reporting procedures for over-the-counter companies generally.

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The Disclosure Study goes into two other aspects of 1934 Act reporting which I shall not have time to develop here but will mention only briefly.

One is the question of how those reports are disseminated. Little good is done by having reports filed with the SEC and stored away in dusty corners where they are difficult to extract, expensive to reproduce, and not available in any case until too long after the event. We have already, at the Commission, taken some steps to improve that aspect, with the introduction of a microfiche system. I am sure you have some familiarity with the microfiche concept, which duplicates and reduces the size of written pages and places a number of them on a small transparency card. Microfiche are now mailed to subscribers within five days after the material is filed, on a twice-weekly basis. I am hopeful that the dissemination time can be shortened considerably, to between 24 and 48 hours after filing. I also hope the pages of a report will become a standard 8 1/2" by 11" size; this would at least facilitate microfiche reproduction. One of the Wheat Report recommendations is to require everything practicable to

be filed on that size paper, so it can be readily reproduced and made usable by the financial community. More attention, in my view, has to be paid to getting information filed in computer-readable form. It seems envitable that more and more the financial community will be using financial information in that form, and I believe we should adjust to that. There is some discussion of the technology in this interesting area in the report.

A second aspect of '34 Act reporting to which attention is given in the report is the enforcement of the reporting requirements. Because of the timing necessities in public offerings, the attention of a very limited size staff is necessarily focused on '33 Act registration statements. Consequently, '34 Act reports receive second-drawer treatment. To make this proposed system work, there would have to be prompt and more thorough staff review of periodic reports. That is a factor, probably budgetary, that will have to be related to these recommendations. The Study concluded that the formal and informal enforcement tools presently available to the Commission, if vigorously used, would effectively encourage compliance with the reporting requirements. There are EDP potentialities for kicking out delinquencies and deficiencies in the reports that are filed. The information, again, might be put in a form for filing that would be machine readable to some extent. In any case, the presently somewhat lenient attitude toward late filings would have to be changed. To be effective, filing dates would have to be maintained.

A number of the Report's other recommendations depend on the improved '34 Act periodic reporting system. Most important, I feel, is the shift from subjective to more objective standards in the area of secondary sales of privately placed securities. The new series of rules drafted by the Study in this area distinguish between companies filing periodic '34 Act reports and those which are not reporting. Stockholders of reporting companies would generally be permitted limited sales of their privately placed securities after a one-year holding period. On the other hand, stockholders of non-reporting companies will be required to hold all their privately placed securities for an extended period. This dichotomy, I feel, gives proper consideration to the fact that the marketplace will have generally adequate information about the reporting company, sufficient to provide disclosure protections to prospective purchasers in the market of limited amounts of those securities. The effort here

is the development of objective standards so that shareholders, issuers and counsel can tell with some precision whether a stock can be sold or not.

In the area of business combinations, the Study would propose to eliminate the theoretically and practically difficult Rule 133 exemption. The Study would treat as sales of securities all statutory consolidations and mergers and those sales of assets that are followed by dissolution of the acquired company, and where the acquired company is publicly held, make them subject to some form of '33 Act registration. The objective of the Study here was to reduce the possibility that management will choose one form of business combination over another on the basis of whether or not an exemption from registration is available under the federal securities laws. That objective, it seems to me, is eminently sound. Recommendations are also made for a two part proxy statement and exchange offer prospectus, which have become incredibly prolix and difficult to read. The first part would be a readable summary and the second part would have the detailed matter necessary for analysts at least.

Attention is given to gun jumping questions, seeking to introduce more clarity in that area. Recommendations are made with respect to Regulation A--the standards for use of it are proposed to be loosened. And then there are some limited recommendations in the area of the disclosure content of prospectuses and on the vexing question of when prospectuses must be delivered. Consistent with improvement in '34 Act reporting, one of the Study's recommendations is to make Form S-7 available to a wider range of companies. The Study also suggests the use of a short form prospectus for secondary offerings on exchanges, for issuance of stock of reporting companies on exercise of warrants, and conversion of publicly held securities of an affiliate.

* * *

What's the status of the matter now?

The Commission has not acted at this point on any of the recommendations. At the present time our staff is engaged in considering and preparing specific rules and forms and will submit their recommendations to the Commission on which to publish for public comment. As is the Commission's practice, any new proposed rules and forms will be published for public comment

and revised, if advisable, in light of that comment before being adopted by the Commission. I would expect that the '34 Act reporting rules and forms may be the first out, because others would necessarily flow from that, although I hope some of the others may accompany them. I do hope that I've given you some sense of the importance of the '34 Act reporting system, in the shift of emphasis from the '33 to '34 Act that it implies. I also hope that, while it may mean some more work for most of you in the room, you will respond constructively to specific rule or form proposals. Our common objective here is to benefit ultimately both the business community and the investing public.

Well, I thank you very much. I also want to express our thanks to the Society for the help and assistance I know your committee gave the study group in working on this. I hope that we can continue to expect and anticipate the same kind of constructive criticism and cooperation as we had then in achieving our mutual goals. I believe the way in which this study proceeded, with extensive discussion with and soliciting of viewpoints from organizations such as yours, is the most constructive way to go about any real reforms in this area.