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(202) 272-2650

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AN EXPERIMENT IN DEREGULATION

Stephen J. Friedman, Commissioner

Deregulation has been much in vogue in recent years. It was a centerpiece of the Carter Administration's economic program. There has been real progress in dismantling much of the economic regulatory structure that became part of our national life in this century: the airline, railroad, trucking, communications and banking industries have all seen major reductions in the government's decision-making role.

In large part, the thrust for deregulation is simply a natural stage in the life cycle of an experiment in ordering our ecomomic life. Like a strawberry patch, a regulatory experiment takes root, bears fruit, and then starts to ramble over the landscape. It requires cutting back from time to time.

Who is to do the cutting, and how do we know where to cut? As time wears on, a regulatory system comes to shape the industry it oversees. The participants grow weak and lazy where the system provides protection, and their view of life becomes conditioned by the rules. Both the regulators and the regulated come to accept the status quo as the natural state of affairs. There is an unquestioned assumption that deregulation will bring back the same old abuses that produced the demand for regulation in the first place.

Plainly, human nature has not changed since the 1930's, and if deregulation in the financial markets depends upon human evolution having produced a lower quantum of greed, bad judgment or willingness to take unreasonable risks with other people's money, it is not worth the attempt.

But while human nature does not change, market conditions and market structures do change, and we must find ways to test our ability to cope with those changes and with their impact on the tried and true ways of doing things.

Recently, I suggested that the time has come for the Commission to begin reviewing some of the basic assumptions underlying our complex system of mandatory public disclosure. It would be useful to gain some insight into the level and quality of public disclosure that would result from the natural operation of market forces on some of our largest, soundest companies. The Commission has historically taken the position that disclosure is a matter which requires the discipline of detailed regulation. We have left as little as possible to chance and market forces, and have promulgated detailed disclosure recipes to be followed in annual, quarterly and specialized reports, as well as in Securities Act registration statements.

There are significant benefits in a system of detailed rules. They can extract straight answers from companies that

might be inclined to shave the truth if the questions were less explicit. Another benefit is the comparability of alternative investments: all public companies provide the investing public with substantially the same minimum levels of disclosure. This approach places equivalent doses of information in the hands of the public so choices may be made based on intelligent comparison.

The disclosure system, as a whole, has brought great benefits to our securities markets. It has increased their efficiency and fairness and, by increasing the confidence of public investors, it has increased their depth and liquidity. I am not suggesting that we do away with the system. I am suggesting that, as responsible regulators, we have a continuing duty to assess that system, to test the relevance of its current form and to experiment with new approaches.

The largest companies in America are not necessarily the healthiest. But the markets are clearly at their most efficient in obtaining and appraising information about those companies. Moreover, there is substantial evidence that the mandatory disclosure system is not a significant route for the transmission of information to the marketplace for the largest companies. Press releases, reports to shareholders and the work of an army of analysts are far more important. The filing of formal documents by those companies seldom has an important impact on the price of their securities. If that is the case, we have to ask ourselves seriously what purpose the mandatory disclosure system serves.

The Experiment -- Disclosure in Response to Market Forces

It would be interesting to see the level of disclosure which the marketplace itself would require, absent direct interference from the Commission. I propose that a limited number of the largest and most closely followed companies be permitted to opt out of the mandatory disclosure system. For these electing companies, no Form 10-K's, 10-Q's or 8-K's would be required to be filed with the Commission. The sole required disclosure document would be an annual report to the shareholders, containing certified financial statements complying with Regulation S-X, and a management commentary on the financials. Other, less structured disclosure would be prompted by a simple, straightforward rule requiring the current public disclosure of "material" corporate developments. Similar requirements would replace the current registration statement and prospectus forms for the sale by participating companies of their securities to the public. The registration statement would be required to contain financials, management commentary and all other "material" facts, perhaps incorporated by reference.

Potential Problems

An experiment of this kind raises a host of questions, and I would like to explore a few of them with you briefly:

-- would the store of information represented by the Commission's files be lost?

-- does the absence of detailed disclosure guidelines constitute a trap for the unwary?

-- how would such an experiment relate to the Commission's enforcement program?

-- how would such a change affect the responsibility and liability of underwriters?

Store of Information

Although the Exchange Act filings are not a major route for the transmission of information to the markets, the large number of subscribers to these filings suggest that they are an important repository of information about companies. Moreover, the existence of a central repository for information is important to the Commission's enforcement program. Accordingly, annual and other reports to shareholders and press releases should be furnished to the Commission.

Trap for the Unwary

This open-ended disclosure approach could be criticized as replacing a known problem with its unknown cousin -- a liability with serious consequences and uncertain standards of compliance. I do not view that as a serious problem for several reasons. First, the experiment would be optional, and those without the stomach for freedom could remain within the haven of the mandatory disclosure system. Second, companies and their lawyers would have the mandatory disclosure system as a guide. But they will have acquired the freedom to decide that certain otherwise mandatory disclosures are, in fact, not material.

Third, you will quickly recognize that such a rule is not an enormous change in practical effect. It has always been clear that satisfying the minimum specified disclosure requirements does not bring a company within a safe harbor. Rules 12b-20 and 14a-9 under the Exchange Act, as well as Rule 408 under the Securities Act are similarly open-ended, although

perhaps not as broad. Each requires, as a supplement to the specified disclosure in reports, proxy statements and registration statements, further "material" facts.

Relationship to the Enforcement Program

In one of the real regulatory anomalies of our time, there is no set of legal rules under the Federal securities laws that specifies when companies must make current disclosure to the marketplace (as opposed to formal filings with the SEC). In general, companies have nevertheless been prompt and careful in providing the markets with current information, motivated by an admixture of Rule 10b-5, stock exchange rules, and informal practice. In crafting a current disclosure rule, the Commission would have to face up explicitly to such difficult questions as the degree to which corporate needs for confidentiality might justify a limited period of nondisclosure. As is the case today, there is no good reason to let the requirements of public disclosure jeopardize delicate merger negotiations or similar developments which flourish best in a limited period of darkness away from the relentless glare of public disclosure. Such an exception could not be permitted, however, in cases where unusual market activity or price movements give evidence that such information has not successfully been limited to those inside the corporation.

There is also a procedural problem which would arise in the absence of the Exchange Act filings. Presently, under Sections 13 and 15 of the Exchange Act, the Commission has the power to compel, without proof of scienter, the correction or amplification of mandatory disclosure documents in an efficient administrative forum. Other disclosure failings, however, can ordinarily be addressed only under the antifraud rules, which are often subject to the need to prove scienter and the traditional equitable requirements for an injunction.

Firms electing not to file reports under the Exchange Act would be free of both Section 13(a) and the Commission's ability to proceed in an administrative forum. Thus, if selected larger public companies are freed from mandatory disclosure, we might unintentionally forfeit effective power to regulate the disclosure that does result from market forces. This would be a serious mistake. To the extent that our primary concern is the flow of information to the marketplace, we ought to question whether it serves the public interest to require findings such as scienter and likelihood of repetition before the Commission can act. In order to maintain the Commission's essential minimum powers in this area, it should have the power to proceed in an administrative forum for failure to disclose material facts to the market.

This new administrative power should be freely available to require disclosure in any case in which there has been a finding that disclosure is materially defective. State of mind, likelihood of repetition and other such limitations should not apply. There is little connection between such limiting concepts, drawn, as they are, from the procedures governing private lawsuits, and the Commission's mandate to ensure adequate disclosure to the public securities markets. If there is information undisclosed which investors would find material, that should end the inquiry. What is the logic of having to show, in addition, that the information was "willfully" or "intentionally" withheld or withheld with "*scienter*"? Or that there is a likelihood that it will happen again?

Role of Underwriters

It is clear that the kind of experiment I am proposing would have important implications for the role and responsibility of underwriters. We have recently taken steps to integrate the disclosure documents under the Securities Exchange Act and the prospectus disclosure requirements under the Securities Act. That step has raised questions about the role of underwriters in the disclosure process. The responsibility of underwriters to investigate, perceived as so critical under the Securities Act, is wholly absent under the Exchange Act.

Moreover, if Exchange Act filings (other than financial statements and management commentary) are eliminated, what will be incorporated by reference? Will the result be to re-elevate the importance of the Securities Act prospectus? That does not make a lot of sense if we believe that investors in the secondary trading markets are as much in need of adequate disclosure as those who purchase newly-issued securities. On the other hand, if there is no full Securities Act prospectus and the reports to shareholders and the markets are incorporated by reference, will the result be to dilute even further the role of underwriters? And, if so, is that healthy?

Projected Experimental Results

What results might one expect from an experiment of this kind? Most important, I think, is a fresh perspective on the direction in which our disclosure system has been moving. We also can learn something of the natural baseline of disclosure which would be elicited by market forces. That will be a combination of information deemed material by the company and facts sought by analysts and others who follow that company. The very process of thinking through whether the Commission should seek to compel additional disclosures will inform our

understanding of what is material to investors. Information about what the market wants should be useful in shaping the minimum required disclosures for all companies, for it serves no purpose to force-feed the investor community with information it does not want.

I would be particularly interested in seeing the market's perception of particular disclosure items, such as management compensation. In that area, for example, a highly complex set of rules has been developed, and I am not sure the result is worth the effort. In addition, some commentators have argued that soft information -- projections and the like -- is the most important kind of information for most investment decisions. Similarly, for companies in basic industries, information about the direction of the general economy may be highly relevant. It would be gratifying if this experiment were to create a climate in which major companies felt free to share this type of data with the market participants.

Next, we are clearly moving toward an increasingly internationalized economy, in which the equity securities of companies will trade on an around-the-clock basis in markets throughout the world. We will be faced with the necessity of establishing a uniform set of disclosure standards appropriate for all markets. That will not be an easy task, and it will require that we examine our disclosure standards with clear eyes. An experiment of this character, which is addressed to precisely the slice of corporate America that is likely to fall into this "world class" securities group, could be very valuable.

On the other hand, it is possible that we may conclude that an environment of this kind is only feasible for a limited number of large companies, and that it should not be expanded. We would still have accomplished something if we reduce the level of regulation on a significant sector of the economy. It is also possible that analysts may find that the consistency and detail of disclosure that is provided by the mandatory system is of such benefit that their coverage is less efficient for the companies opting out of the system. Analysts have not been as active in commenting on SEC disclosure policy as we would like and an experiment of this character would require them to carefully evaluate current arrangements.

Of course, genuinely negative results are always a possibility. I strongly believe, however, that the threat of failure should not deter us unless the downside risk is so great it outweighs the potential benefits to be gained. It seems to me that the possible negative results fall into only two categories: failure of a sufficient number of companies to elect to participate and, more serious, the potential for fraud arising out of our decreased control. The first to me

seems not a problem at all, since the result would be no change from the status quo.

The second problem is obviously more serious in theory, but not, I believe, in practice. By limiting the experiment to the largest, most closely watched companies, we create a situation where a company stands to lose much from a small deception (both in reputation and liability). The scrutiny of the public markets, moreover, would tend to detect more ambitious fraudulent efforts. And the increased administrative powers of the Commission would provide a quick, sure remedy, if that proves necessary.

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The Commission's relationship to the disclosure process is analogous in many ways to that of a man riding a whale. Getting on top of the beast and not falling off were impressive achievements, but the real question is whether we are in control. It is time to step back and try to understand what we are doing in the larger sense. Only then can we make intelligent and informed moves towards additional deregulation.