NEWS
SECURITIES AND EXCHANGE COMMISSION
Washington, D. C. 20549
(202) 755-4846

FOR NOON RELEASE, THURSDAY, NOVEMBER 8, 1973

DISCLOSURE IN THE CONTEXT OF A CHANGING REGULATORY SYSTEM

Address by

Hugh F. Owens
Commissioner
Securities and Exchange Commission
Washington, D. C.

The Kansas Bar Association's
Securities Institute
Wichita, Kansas
November 8, 1973

It is a pleasure for me to be here to discuss a subject that I know is of importance to many of you. It is an area on which students spend semesters, the American Law Institute has spent years and you as practitioners have spent lifetimes. I am referring specifically to disclosure under the federal securities laws or, put another away, the production and the dissemination of information about issuers of securities.

When we speak of disclosure, we are talking primarily about two fundamental concepts, concepts that are as simple as they are elusive. The first of these, embodied in the Securities Act of 1933, is that it is not in the public interest for investors to purchase stock from an issuer or underwriter unless certain information is available. The second, embodied in the Securities Exchange Act of 1934 as amended in 1964, is that it is not in the public interest for investors to buy and sell securities in the market place unless certain information is available.

The Commission has, over the last several years, been carrying out a program designed to merge or integrate these two concepts. The objective of this program is to create a system of continuous disclosure so that any investor at any given time has access to the most recent information about a corporation. In the Commission's view, the person making an investment decision does not care whether the securities are coming directly from the corporation as part of a public offering or are coming from another stockholder through the trading markets. The investor in either case should have access to the same information and the Commission is trying to assure that he does.

The disclosure system to which I have just alluded is just that -- a system made up of a carefully worked out, interrelated series of statutory provisions, rules, disclosure forms, guidelines and interpretive releases. It is

the function and the duty of the Commission to review constantly and refine the component parts of the system and reassess their effectiveness. It must be receptive to the need to make the system more meaningful and useful when that need arises.

Today, I would like to focus on several specific steps which the Commission has recently taken which are designed both to improve the actual disclosure called for by this system and to expand the dissemination of the information being disclosed. I will also touch briefly on the status of several recently adopted rules and rule proposals having an impact on the availability of certain exemptions from the 1933 Act. These rules, commonly referred to as the "140 series," although not calling directly for disclosure of specific information, play an important role in the Commission's attempt to implement a continuous disclosure system. They are designed to further the fundamental purposes of the federal securities laws in protecting investors and in assuring the maintenance of fair and informed securities markets.

A major aspect of the Commission's program to improve the content of the disclosure system it administers is centered around its efforts to make the prospectuses filed under the Securities Act and the reports filed under the Exchange Act more readable, more understandable and more informative.

The Commission has been concerned for some time with the clarity or lack thereof of the prospectus filed under the Securities Act. That document is statutory sales literature and to function properly it must communicate properly. Unfortunately, it would appear that the presentation of the complex material contained in the prospectus is often just that -- complex, involved and difficult for the average investor to comprehend.

In response to the need for more effective communication in the prospectus, the Commission has recently adopted new registration guides and amended several existing ones which will provide for more summarizing, highlighting and indexing of significant information. For example, new Guide 59 calls for a summary, immediately following the cover page of S-1 and S-2, of the content of the prospectus, emphasizing the salient features of the offering with appropriate cross references to the more detailed disclosure of these features elsewhere in the prospectus. Other guides have been amended to provide for a graphic presentation of such factors as the dilution of a new investor's equity investment, the difference in the price paid by public investors and by promoters, the amount of equity purchased by the new investor's dollar as compared with that of the insider and the net use of proceeds. It is hoped that this type of description of these elements will convey to the average investor a better picture of the economic realities involved in investing in the securities of a particular issuer, particularly high-risk, new issues.

Along this same line, the Commission has also been very concerned with the descriptive language used in filings under the 1933 and 1934 Acts. Too often in such filings companies resort to what is termed "legalese" or "boiler plate" to describe their operations and their prospects instead of the kind of concise and specific language that many companies use in their annual reports. It is doubtful, for example, that prospective investors ever learned much about the outlook of a new product or about a company's competition in stock phrases such as "there can be no assurance that the registrant will succeed in developing a commercial market for its product" or "a substantial number of companies that are engaged in the same business as the registrant have greater financial

resources, experience and are better known to the public than the registrant." By the same token, it is very difficult to see how anybody learns about how the offering price of a new security was determined by reading statements such as "the initial public offering price has been determined through negotiations between the underwriter and the company."

I think most of us would agree that an investor should be told about the status of product development; that the principal bases of competition such as price, product performance and other factors should be identified and the competitive position of the company explained; and that the factors that were considered in determining the offering price for the securities should be spelled out. In recognition of this, the Commission, in June of this year, adopted amendments to several of its registration and reporting forms which reflected the preference for more informative disclosure. In addition to expanding the descriptive portion of the filings relating to product development, competition and stock price just alluded to above, these amendments call for more meaningful disclosure of the background and performance of the management of the issuer. In the case of certain registrants offering securities to the public for the first time, it is now required that there be disclosure of the issuer's plan of operation for a specified period following the date of the offering. The Commission believes that a description of such plans relating to new ventures is particularly necessary since, generally, there is an absence of historical information available to the public concerning such ventures in the form of reports filed with the Commission or published by financial services. Investing in this type of venture may also involve a greater risk of loss.

Reforms in the textual portion of prospectuses and periodic reports are, however, only one side of the Commission's push for improvements in the content of these filings. Anyone who has been a close observer of the activities of the Office of the Chief Accountant of the Commission knows that he, with the support of the Commission, is aggressively moving to require financial statements to contain more and more information that may be useful to investors. For instance, the Commission recently adopted revised proposals for disclosure in footnotes of information concerning the capitalized value of financing leases and the impact on income which would derive from such capitalization. The Commission recently has also republished for public comment revised proposals calling for increased disclosures of significant accounting policies and the impact of these policies on financial statements. I might note something that may have escaped your attention in the notice accompanying that proposed rule change. To the best of my knowledge, for the first time the Commission has recognized that some of the information mandated by it may be of utility only to professionals and skilled analysts, and might be beyond the ability of the ordinary investor to comprehend. Lest you think this represents a complete turn around, I should add that there is also pending a proposal calling for revisions to the Guides for Preparation and Filing of Registration Statements to require an introductory narrative explanation of the Summaries of Earnings and Operations whenever clarification is needed to enable investors to appraise the quality of earnings. The proposal calls for management's analysis of the material changes in the amount and source of revenues and expenses, as well as an analysis of changes in accounting principles whose application have a material effect on the comparability of net income. This is an effort to afford individual investors a better opportunity to understand the significance of what lies in the figures.

One final aspect of this ongoing Commission effort to make corporate disclosures more useful, which is worthy of some discussion, centers around the proper place for projections in filings with the Commission. As you know, the Commission held hearings last fall on the matter of forecasts, projections and estimates in hopes of developing a record that would serve as a basis for re-assessment of the Commission's long-standing position with regard to projections. More than 50 persons testified, representing public corporations, the securities industry, the self-regulatory organizations, the academic community, and the accounting and legal professions. As you would expect, the testimony represented every conceivable opinion. Many letters from companies were also received, almost all of them hostile to the idea of being forced to make public projections. The Commission evaluated the testimony received in the light of its own experience, and in February of this year issued a statement of its conclusions on the subject.

These conclusions, generally, were that no issuer be forced to make a public projection but that issuers who meet certain standards, such as a history of earnings, be allowed to include projections in filings with the Commission. Also of some significance was the conclusion that any time an issuer makes a projection public, whether through a press release, a talk with analysts or otherwise, such projection should be filed with the Commission. Once an issuer has filed a projection with the Commission, it is contemplated that it would have certain obligations to update the projection and, in its 10-K, to compare actual results with the projection made.

The staff of the Commission is now in the process of drafting rules and forms designed to implement these conclusions. One of these rules, which I am sure will be of particular interest to all of you, will attempt to indicate clearly that a carefully prepared and reviwed, reasonably based projection is not a guarantee

of future performance subject to liability under the securities laws if it does not ultimately prove accurate. In other words, it will be recognized that a reasonable projection is not a guarantee of results. Once the rules and forms are drafted and approved by the Commission, they will be published for comment. They will not be finally adopted until after an evaluation of the comments received.

The Commission recognizes, however, that all of the detailed information about which I have been talking today will be of little use if it is not readily available to investors. Disclosure implies not only the production of information, but also the dissemination of that information. One without the other is meaningless. In response to this situation, the Commission has taken several significant steps as part of its overall disclosure program to foster the adequate dissemination of material facts regarding issuers of securities.

For example, the Commission has increased its enforcement activity to compel timely filing of required reports, and, administratively, the staff generally will not process registration statements covering public financings if the required 1934 Act reports have not been filed. In addition, the Commission, together with the major stock exchanges, has taken the lead in encouraging prompt reporting of material corporate developments prior to the time periodic reports are required to be filed with the Commission. While it is recognized that the care and effort which go into the preparation of a statutory filing may preclude its being filed immediately after the basic information is available, it is felt that this should not prevent the prompt announcement of the information to stockholders, the press and any appropriate self-regulatory organization.

The SEC's efforts in the area of dissemination have also focused new attention on the annual report to shareholders, the most widely distributed and widely used source of information about a company. The Commission recognizes that potentially meaningful information contained in the various reports filed with it,

particularly the 10-K, may languish in the Commission's Public Reference Room available only to a limited number of people. Despite good intentions, it would appear that these reports, at this point in time, are not serving their disclosure purposes because, although they require information to be produced, they do not cause it to be adequately disseminated. These periodic reports cannot match the annual report in this respect. The Commission, thus, is seriously considering exploring the idea of integrating the production of information function of the statutory reports with the dissemination function of the annual reports.

In order to provide a basis for considering such an integration, former Chairman Casey appointed in 1972 an Advisory Committee for Industrial Issuers to make recommendations with regard to the disclosure pattern as it affected industrial issuers. The principal thrust of its report, I think it is fair to say, was the annual report and this Committee, composed of a number of lawyers and industrial leaders, as well as investment bankers and accountants, did make a series of suggestions with respect to the contents of the annual report.

As a basic underlying premise, they recommended that the Commission overcome its traditional reluctance and require the inclusion of certain information in the annual report itself. Specifically, the Advisory Committee called for the annual report to contain, in substance, the line of business disclosure and the five-year summary of operations from Form 10-K. In addition, the Committee recommended that the annual report include a brief description of the company's business, a suggestion that seems eminently reasonable. They called for identification of, and comment on significant changes in, management and, in the case of outside directors, a statement of their outside affiliation. In connection with the financial information, the Committee recommended that an explanatory comment on material changes in financial condition and results of operations in the past year, as well

as on material non-recurring items, be included. The Committee also recommended that, where not adequately covered in the footnotes to the financial statements, there be disclosure in the text of the report of principal accounting policies and changes in the policies.

A task force of the staff of the Commission is now in the process of evaluating the recommendations of the Industrial Issuers Advisory Committee. Although the Commission has not yet made any decisions on this matter, I think it can be said that there may well be some changes in the content of annual reports.

An effort will be made to have the annual report remain as much a province of management as is possible; the Commission's primary concern, however, is that certain kinds of material information reach the public. I do not believe that expanded Commission requirements about what must be in the annual reports ill necessarily preclude the reports from retaining their usual artistic splendor, heir literary style or their overall appeal to their readers. Clearly, these eports should and can do a better job of communicating with shareholders and the nvestment community.

As mentioned at the beginning of my talk, one final subject I would like o touch on today is the present status of the "140 series rules" which relate rimarily to the exemptions provided by Sections 3(a)(11), 4(1) and 4(2) of the curities Act. As I am sure most of you can attest, a body of "lore" has arisen ince the passage of the 1933 Act with respect to these sections which has provided substantial source of grist for the law review mill and ulcers for the practitioners. the past few years, the Commission and its staff have been involved in a concerted fort to clarify the requirements for the applicability of the key exemptions from

registration embodied in these sections. The result of these efforts has been the adoption of Rule 144 and the publication for comment of proposed Rules 146 and 147. The steps taken by the Commission in this area have been aimed at increasing investor protection by providing assistance to counsel, their clients, and members of the public in understanding the circumstances under which the exemptions are available. I would like to discuss briefly each of the rules with you and indicate generally what our experience in administering them has been.

The exemption from registration provided by Section 4(1) of the 1933 Act for transactions by any person other than an issuer, underwriter or dealer was intended by Congress to distinguish between distributions of securities and trading in securities. That section was intended to allow ordinary trading to take place without compliance with the registration requirements of the Act. Rule 144 provides that persons who sell unregistered securities of an issuer for their own account, or persons who sell unregistered securities for the account of a controlling person of an issuer, will not be deemed to be engaged in a distribution of the securities if the securities are sold in accordance with all the terms and conditions of the rule. The conditions to be met include a two-year holding period, a limitation on the amount of securities that can be sold in any six-month period, a requirement that the shares be sold in brokers' transactions, the availability of public information concerning the issuer, and the filing of a notice of sale with the Commission.

Based upon a year and a half of experience in administering Rule 144, I can report to you that the rule is working very satisfactorily. Issuers, brokers, transfer agents and selling stockholders have apparently worked out satisfactory procedures for handling sales of securities pursuant to the rule, although some

problems may still arise because these necessary parties to a Rule 144 transaction find themselves unable to work with each other. An indication of the extent to which Rule 144 is being utilized is given by the fact that 31,783 reports on Form 144 were filed with the Commission between April 15, 1972, the effective date of this rule, and October 1 of this year. Adoption of the rule has also decreased the number of no-action requests received by the Commission's staff and the number of requests for interpretation of the new rule is beginning to level off.

While the staff of the Commission has, through its staff interpretative procedures and the publication of Securities Act Release No. 5306, clarified many of the questions concerning the provisions of the rule, certain substantive questions continue to arise on a regular basis. One apparent source of concern to individuals relying on the rule is the requirement that persons agreeing to act in concert with respect to their resales of securities must aggregate such resales in determining the amount that can be sold under the rule. The reason that this question remains unclear is that whether certain persons are "acting in concert" depends upon the facts in each particular case and, accordingly, it has been necessary for the staff to take a case-by-case approach in responding to interpretative inquiries relating to this provision. While the staff will attempt to assist members of the public in considering this question, it would be helpful to keep in mind that the reason for including the "acting in concert" provision in the rule was to prevent planned distributions made in purported reliance on the Section 4(1) exemption which are not, in fact, casual trading transactions.

The Section 4(2) exemption provides that "the provisions of Section 5 shall not apply to . . . transactions by an issuer not involving any public offering." The phrase "transactions not involving any public offering" is not defined by the Act or, except in limited circumstances, in the existing rules under the Act.

The basic criteria to be considered in determining the availability of Section 4(2) were established by the Supreme Court in the Ralston Purina case. The main consideration is whether the offerees need the protection afforded by the Act as evidenced by whether the offerees have "access" to the same kind of information that registration would disclose and whether they are able to fend for themselves. The application of these criteria and other guidelines set forth from time to time by the Commission and the courts has resulted in uncertainty about the application of the exemption.

Proposed Rule 146, as revised on October 10, 1973, is designed to provide more objective standards in order to clarify the uncertainty about the exemption to the extent possible. In line with the Supreme Court's Ralston Purina decision, the Commission is of the view that the significant concepts to be considered in determining when transactions are deemed not to involve any public offering are access to the same kind of information that registration would disclose and the ability of offerees to fend for themselves so as not to need the protections afforded by registration. The proposed rule contains several conditions that are designed to implement these concepts.

In order to comply with the rule, the offeror must prove that he has satisfied all of the conditions of the rule. The conditions relate to:

(a) limitations on the manner of offering;

(b) the nature of the offerees;

(c) access to or furnishing information;

(d) number of purchasers;

(e) limitations on distribution; and

(f) report of sales.

The Commission has made certain revisions in proposed Rule 146 as a result of the public comments received in response to the proposed rule as initially published. For example, the proposed rule has been revised to provide for an "offeree representative" rather than an "investment representative." The term has been more precisely defined and certain requirements have been deleted or modified in order to make the proposed rule more workable. Closely tied to the concept of offeree representative is the concept of ability to bear the economic risk. The revised rule provides that either an offeree has to have the requisite knowledge and experience (in which case he should be able to "fend for himself" and be able to decide intelligently whether or not he wants to assume particular risks) or, if the offeree needs the aid of an offeree representative in order to meet the knowledge and experience test, he must be able to bear the economic risk of the investment.

The rule as originally proposed made no specific reference to business combinations. However, the revised rule contains several new elements that relate specifically to business combinations. Of particular importance are the provisions allowing an affiliate of a corporation to be acquired to act as a representative, in certain circumstances, of all the shareholders, and the waiver of the "economic risk" test where offerees are represented by an affiliate in a business combination.

With respect to "access to" and "furnishing of information," the proposed rule has been revised to make it clear that an offeree must either have <u>access</u> in the traditional sense (based on employment relationship or economic bargaining power) <u>or</u> he must actually be furnished with certain information. In either case, the offeree must also have available the opportunity to obtain additional information ecessary to verify the information received. The rule has also been revised to

specify the type of information required. For reporting companies, information contained in the most recent Form 10-K and subsequent reports should be provided, as well as a description of the securities, the proposed use of proceeds and any material adverse change in the affairs of the issuer; for non-reporting companies, the type of information required by Schedule A of the Act, with provision for unaudited financial statements, would have to be provided.

The requirements of the proposed rule dealing with the number of purchasers have been revised to pertain to sales by an issuer of the same class of securities, thereby avoiding the problem of integrating debt and equity securities. Also, the revised rule provides that certain types of persons, in addition to those purchasing for large amounts of cash, would not be included in the computation; for example, executive officers and directors, banks making loans, employees purchasing pursuant to employee plans, and purchasers in a business combination. In addition, the dollar amount required to be purchased in order not to be counted has been lowered from $250,000 to $150,000.

Finally, under the revised rule the Form 146 would not need to be filed if the aggregate price of the securities sold in reliance on the rule in the preceding 12-month period to persons other than those purchasing for $150,000, officers and directors, employees (up to 35) and banks (notes only) did not exceed $100,000. Thus, the issuer would not have to file a report of a bank loan, or exercise of stock options or issuance of stock to executive officers or directors.

Section 3(a)(11) of the Act exempts from certain provisions of the Act, including the registration requirements of Section 5, securities that are part of an issue offered and sold only to persons resident within a single state or territory if the issuer is a person resident and doing business within that state or territory. Congress apparently believed that a company whose operations are restricted to one

area should be able to raise money from investors in the immediate vicinity without having to register the securities with a federal agency. In theory, the investors would be protected both by their proximity to the issuer and by state regulation.

The Commission is aware that there are many public offerings of securities made in reliance on the exemption from registration provided by Section 3(a)(11). Some issuers, however, may not be familiar with the administrative and judicial interpretations of that section and, therefore, may be relying on it mistakenly. Moreover, the Commission believes that local businesses seeking financing solely from local sources should have objective standards to facilitate compliance with Section 3(a)(11) and the registration provisions of the Act. Accordingly, the Commission has proposed Rule 147 which would define certain terms in, and clarify certain conditions of, Section 3(a)(11). All of the conditions of the rule must be satisfied in order for the proposed rule to be available. These conditions are that the issuer be a resident of and doing business within the state or territory in which offers or sales are made, that no part of the issue be offered or sold to non-residents of such state or territory or reoffered or resold to non-residents for a period of time after distribution of the issue. The rule defines "part of an issue," "resident," and "doing business within."

In general, public comment on the proposed rule indicates that the commentators were favorably disposed toward the rule, except that serious objections have been raised as to the definition of "part of an issue" as being too inflexible, and to the limitation on reoffers and resales as making the rule unworkable. In general, the attempt to define "residence" was applauded but the efforts to define "integration" met with less enthusiasm. The Commission will soon be in a position to take action on the proposed rule and will consider these public comments in deciding how to proceed with it.

In closing, let me say again how pleased I am to be here. I hope that my remarks have provided some enlightenment regarding the SEC's actions in the areas I have discussed today. I realize that the changes the Commission has already effected and has proposed to effect will no doubt continue to bring various objections from different issuers and their counsel. I believe, however, that these efforts of the Commission will definitely prove, in the long run, to be most beneficial to issuers and the investing public alike.