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"Public Response to the Commission's Proposed Implementation of the Wheat Report"

Thank you, gentlemen, for giving me the opportunity to speak to you today. I had the pleasure, last year in San Francisco, of addressing the business world's most exemplary annual meeting - the National Conference of the American Society of Corporate Secretaries. I see some familiar faces here today from that enjoyable and constructive session. Earlier this year, in February, I was invited to talk to the New York Regional Group of your Society. So you see, I am probably old hat by now.

I should at this point make the customary statement - that the views I express are my own and not necessarily those of my fellow Commissioners or members of the Commission's staff.

As you may know, for some time concern has been expressed with the disparity between the disclosures required to be made in registration statements filed under the Securities Act of 1933 and the pattern of disclosure that presently exists under the Securities Exchange Act of 1934. Under that Act companies file periodic reports with the Commission--primarily the annual 10-K, semi-annual 9-K, and occasional 8-K which is designed to elicit disclosure of material events.

The disparity became increasingly evident after the 1964 amendments to the Exchange Act. Those amendments, among other things, broadened the periodic reporting requirements to encompass virtually every American company which has had a registered public offering or which otherwise has $1 million in gross assets and 500 shareholders. Few public companies of any significance--except for specially exempted businesses like regulated insurance companies and banks--are not now subject to the regimen of periodic reporting and proxy statement disclosure.

The result of this should be, and was doubtless intended by Congress to be, the creation of a valuable reservoir of continuing, relatively current public information about companies whose securities are publicly held and traded. The need for continuing disclosure to holders of outstanding securities and to persons contemplating purchase or sale of such securities in the trading markets is, I believe, apparent . . .although some may question the extensiveness of the information needed, just as some have questioned how valuable the reservoir is in its present condition.

Unfortunately perhaps, as you know, the quality and quantity of data furnished in periodic reports has, until now, never approached the thoroughgoing, rigorous disclosure standards employed in registration statement filings under the '33 Act. Historically, viewed in the light of consistent Congressional concerns about new offerings of securities to the public, this dichotomy in disclosure policy may have been justified.

There is also a practical reason for it. Intensive attention is brought to disclosure under the pressure of a new financing--by the issuer, and his counsel and accountants, wishing to raise money and by the underwriter, and his counsel, wishing to distribute the securities. Both are acutely aware of the need to obtain acceleration or avoid a stop order by the Commission in order to go, and, residually at least, of the liability exposure they have if the job of disclosure is not carefully done. The existence of a registrant requesting action by the Commission also serves to focus and discipline the attention of our staff on its processing job. The offering prospectus thus became the prime disclosure tool.

For a number of reasons, the periodic reports to be filed by the issuer after the distribution is completed became the neglected step-child of the disclosure system. For one thing, there was no procedure for their public dissemination although they were publicly filed documents. For another, their form, content and accuracy were less than adequate to be really useful to investors and their advisers. And not unimportantly, the highly motivated focus and discipline that the underwriting process brings to disclosure were not present, so the periodic reports have not been as carefully or timely prepared by the

issuer or reviewed by the Commission. The result was that they were filed in a rote way and gathered dust in the Commission's file drawers.

Well, the first difficulty I mentioned, dissemination of the periodic reports outside the Commission, has been substantially improved by the microfiche system inaugurated more than a year ago. Copies of any periodic report filed with the Commission are quickly available to any member of the public who chooses to pay for them. The second difficulty I mentioned was the inadequate form, content and timeliness of the periodic reports. The proposed improvement there is what I shall be talking about later. The third difficulty, how to bring to periodic reports something approaching the quality of attention that the prospectus receives, is a problem. That involves shaking of former ways of doing thing, and some cost--on the reporting company's part, and on the Commission's part to provide reasonably adequate and prompt review. While additional thought and planning must be given to this, my personal feeling is that the cost is clearly worth the candle.

Now as to the periodic reports themselves, and the problems their inadequacy creates. In an extraordinary exercise of self-evaluation and criticism which must surely be considered unique, and yet--I would like to think--characteristic of the SEC's sense of administrative responsibility, a disclosure study group under the direction of former Commissioner Wheat was formed in late 1967. Its efforts culminated in an in-depth analysis of the prevailing patterns of disclosure under the federal securities laws and concrete recommendations for administrative reform within the framework of existing statutes. The Wheat Report, as it is commonly known, was released last spring.

The Report proposed far reaching changes and additions in Commission rules and forms. They were designed to produce more meaningful, timely and accessible corporate disclosures and, for the first time, to relate proposed improvements in periodic reporting under the '34 Act to the functional necessity of direct dissemination of disclosure documents under the '33 Act. Stated very broadly, the thesis of the Wheat Report was that if the content and accessibility of periodic reports could be substantially improved, the Commission could with reasonable

safety permit both some simplification of the '33 Act prospectus requirements for reporting companies, and some relaxation of the requirement to register sales of relatively small amounts of restricted securities of reporting companies.

The Wheat Report itself generated considerable comment even though it was not an official Commission document. This past fall, the Commission promulgated for public comment, although in modified form, many of the Wheat Report proposals. The fact that some proposals have not been promulgated--such as those dealing with the broadening of Regulation A and revisions of Form S-1 and merger proxy forms--does not necessarily mean that these proposals have been rejected. Nor is it likely that the proposed changes which have been promulgated will be adopted without further changes. The Commission's staff has been analyzing the letters of comment, considering revisions of the proposed rules in response to the comments, and forwarding their recommendations to the Commission. We have quite a bundle of them already. The staff will probably complete the process of their work on the revisions within a month. My remarks today should therefore be qualified by the caveat that they do not necessarily reflect my ultimate thinking (nor that of my colleagues) about the shape of the proposed reforms.

I know that to some of you it may appear that it is taking the Commission a long time to act on the Wheat Report proposals. There has indeed been a vast investment of thought and time by large numbers of people both in and outside of the Commission in this program. Perhaps some of you who will share the burden as well as the benefit of these new requirements may not be entirely disappointed by the delay. I think it important to point out that the administrative reforms, to the extent they are forthcoming, will be among the most significant in the Commission's 35-year history, and that the integrated nature of these reforms compels careful study and deliberation by the Commission as well as its staff. Not only disclosure policy but practical implementation problems must be dealt with. The number of thought-provoking public comments we have received reinforces our desire to act constructively and in the fullest appreciation of the broad impact of any major changes we may adopt on the corporate and investment communities.

As you may well imagine, promulgation of the Wheat Report proposals as modified by the Commission, generated a great deal of public comment. About 350 letters have been received, many of them quite lengthy. . .and meaty. I know that a number of you took the time and effort to review the proposed rule and form changes and to write letters of comment. Quite apart from the provisions of law which require us to consider and reflect upon public comments on rule proposals, the Commission believes that the public comment process serves an important and valuable purpose. We welcome comments responsive to our desire to further the objectives of federal securities regulation in a manner most consistent with the public interest. Although the comments which we have received are by no means entirely favorable, I think it is fair to say that most are in accord with the basic theses of the Wheat Report and--although to a somewhat lesser extent and with vigorous exceptions--with the Commission's proposed implementation.

For example, the American Society of Corporate Secretaries, while reserving to its individual members the right to raise specific objections to various aspects of the proposals, advised us that the Society considers the Commission's "proposals constructive and well designed to achieve the objectives of the [Wheat Report] Study, with which. . .the Society is in general agreement."

The proposals also received the general support of the Investment Bankers Association, the American Institute of Certified Public Accountants (which specifically endorsed the inclusion of a source and application of funds statement in Form 10 and 10-K financials), the Financial Analysts Federation and the major self-regulatory bodies, the New York and American Stock Exchanges and the National Association of Securities Dealers. The American Bar Association at its 1969 Annual Meeting had previously endorsed in general terms the Wheat Report proposals, and had urged the Commission to proceed promptly with its consideration of those proposals. Approximately 150 individual companies have commented on the proposed reforms, and while most of these have been larger listed concerns, the spectrum has been broad enough to ensure adequate representation of the views of most segments of American business. Most of their comments were directed at specific provisions rather than the general program of reform. The Financial Executives Institute was in general disagreement as was the National Association of Manufacturers.

There is a growing--in my view a healthful--appreciation of the importance of continuing corporate disclosure on a basis which is meaningful, timely and accessible. As I have already noted, such disclosure is indispensable to other needed reforms which would serve to expedite and simplify certain areas where registration delays and complications now exist.

Unfortunately, most of the public commentators seem to have restricted their comments either to the new forms for '34 Act registration and periodic reports on the one hand or to the proposed new rules on secondary offerings of reporting company stock--the 160 series rules--and the proposal to change Rule 133. In general, corporate commentators limited their suggestions to the content and timing of the reports which they would have to file with the Commission, while attorneys and the organized bar tended to focus on the proposed new rules for secondary distributions and corporate combinations. I suppose that this form of segregated commentary was predictable since it is the corporate officials who bear the responsibility in the usual case for filing reports while the securities bar is burdened with inquiries from clients who wish to dispose of restricted stock.

What all the public commentators must realize is that we cannot diminish our dependence on '33 Act registration statements unless there is an acceptable substitute in the form of current and comprehensive disclosures which would be afforded by more and better periodic reports under the '34 Act. At the same time, I think it is clear that even without a rationalization of the rules on secondaries, the improvement of periodic reporting is a desirable development with independent merit.

What, then, have been the principal criticisms of the Commission's proposals? I shall begin with periodic reports since they are obviously of greater concern to those of you in this room and also because they constitute the sine qua non of '33 Act administrative reform.

You will remember that the present system calls for the filing of the annual 10-K within 120 days after the fiscal year end, a semi-annual 9-K containing abbreviated unaudited income figures, which is filed 45 days after the period, and the Form 8-K, which requires disclosure of specified material events, to be filed on the tenth day following the month in which the event occurs. The proposals contain a substantially broadened

Form 10-K be filed annually that would contain textual material comparable to that contained in a '33 Act prospectus. It would be filed within 90 days after fiscal year end, or, if earlier, within 5 days after the mailing of the annual report to shareholders. The proposals also would scrap both the 9-K and 8-K forms and replace them with a new Form 10-Q, which would be required to be filed within 45 days after the end of the fiscal quarter. It would contain unaudited quarterly income statements in relatively summary form as well as the end of the quarter capitalization figures. The fourth quarter 10-Q would contain no financial information but would be required to be filed within 10 days after the end of the quarter (rather than 45 days). 10-Q would also be required to be filed within 10 days after a significant (10%) acquisition or disposition of assets and would be limited to a description of the transactions and accompanying financial statements of any acquired company.

The criticisms have focused on both the timing and content of the proposed new periodic reports. Certainly the largest number of letters commenting on proposed changes in periodic reporting have attacked the shorter periods within which reports are to be filed. It has been suggested that the accelerated filing schedules may be impossible to meet, particularly in view of the increased amount of information that would have to be furnished. The proposal that the new Form 10-K be filed within five days after the mailing of the annual report to shareholders--if that date is earlier than the 90-day maximum filing date--has come under especially heavy criticism. Many companies have indicated that they would probably delay mailing of the annual report rather than attempt to meet the five-day deadline.

I appreciate the candor of those who have commented and will certainly consider carefully the added burdens which accelerated filing would impose and seek to minimize them. But one of the prime shortcomings of our present system of periodic reports is that they are often filed so late that the information which they contain is stale. Compliance with effective reporting requirements of any government agency I guess necessarily entails the expenditure of time and money.

The content of the proposed new reports has also been the target of criticism. Some of this has come from particular

industry groups such as mining and oil and gas. Some of it is of a more general nature. As many commentators pointed out, some of the requirements of proposed Form 10-K exceed the existing requirements of Form S-1 and of the Guides For the Preparation of Registration Statements. It has been suggested that the Commission should not broaden the requirements of disclosure beyond those contained in Form S-1. Others have stated that the Commission should defer action on any additional disclosures until there can be a general appraisal of the importance and utility of such disclosures, preferably in conjunction with a reappraisal of S-1.

Of course, the staff of the Commission has, in appropriate cases, requested disclosures which are not set forth as such in registration forms. The primary areas which are covered by proposed Form 10-K, but are not similarly articulated in Form S-1 and the Guides, although they have often been disclosed in prospectuses as material, concern:

the disclosure of the sources and availability of raw materials;

the importance and effect of material patents, licenses, franchises and concessions;

the estimated amount spent on material research activities;

the number of employees;

material operations in foreign countries;

detailed data on the operations of businesses engaged in mining and in oil and gas;

the ages and family relationships of executive officers;

the family relationships of directors and information during the last ten years concerning bankruptcy, criminal proceedings, or securities violations involving directors;

and the inclusion of a source and application of funds statement.

The Commission's staff is giving some consideration to revision of Form S-1 designed to bring the disclosures currently required under that form into line with the proposed disclosures in Form 10-K. There is, to the best of my knowledge, no advertent attempt by the Commission to impose any greater disclosure requirements on periodic report-filing companies than on '33 Act registrants.

The objections of not a few public commentators are not directed merely to the discrepancy--however temporary--which may exist between the disclosure patterns proposed by Form 10-K and those prevailing under S-1. It has been suggested by some that the additional disclosures in some instances unnecessarily impinge upon matters of justifiable corporate secrecy and might even generate anticompetitive effects, especially against smaller companies. Indeed, some of the disclosures already required under S-1 and the Guides--such as those relating to business line reporting and order backlogs--have been critized as unwarranted extensions of S-1 requirements to periodic reporting. And considerable critique was aimed at the requirement to restate and update each year the 10-K's business and property descriptions.

So far as the substance of proposed Form 10-K is concerned, the commentators are correct when they point at the increased quantity of information called for by the form. Actually, Form 10-K was designed to provide a virtually self-contained disclosure document on a reasonably current basis, as supplemented by the even more current information to be provided during the year by quarterly reports on proposed Form 10-Q until that was subsumed on the next year's 10-K and so on. Until now, unless a company had a recent registration statement in effect, the only way to obtain a comprehensive picture of its corporate history and business was to wade through old registration statements, proxy statements, successive periodic reports and annual reports to shareholders--which, as you know, are not technically filed with the Commission. Even then, the picture which emerged was rather blurred. The hope is that the new system of periodic reporting will generate meaningful documents which will enable their users to make informed investment decisions without having to refer back to older and often incomplete reports.

From the standpoint of the corporation, I would expect it will actually prove easier to present the company's business in a straightforward manner each year than to cull through earlier reports to determine what, if any, information ought to be updated, revised or added. In the long run, as one commentator has suggested, it may be possible to generate a 10-K which can be used as an all-purpose disclosure document, forming the foundation of the proxy statement and annual report to shareholders and, with the addition of underwriting and price information, even serving as a kind of instantaneous Securities Act registration statement.

As to specific items of disclosure called for by the proposed form, there have been numerous suggestions. Many of these suggestions were made and considered by the Commission in the course of earlier revisions of Form S-1 already adopted, such as the requirement of business line reporting.

Another example of a problem-area which has generated public comment is the disclosure of material research activities. It has been said that this would involve the disclosure of confidential matters. The Commission has recognized that certain confidential matters may be excluded from public disclosure--and has provided by rule and also in the proposed new forms for such exclusion under certain circumstances. At the same time, it has always been recognized that at least some diminution in corporate secrecy is the inevitable price of obtaining public capital. It is simply not possible to reconcile totally a policy of nondisclosure of corporate affairs with the concept of public corporate ownership.

Some of the public commentators have critized disclosure requirements on the grounds that they have no business significance. For example, it is said that the disclosure of order backlogs--currently required by the registration statement Guides--is susceptible of misinterpretation. A large backlog may indicate production difficulties just as readily as it may indicate a growing demand for the company's products. The response to these comments could, of course, take the form of deleting the requirement completely. On the other hand, it might be appropriate for companies to explain the significance, if any, of order backlog data. The public investor might then

have yet one more basis for evaluating his investment or prospective investment and one more hard number to compare with the numbers in the reports of other companies.

The concept of quarterly reports on proposed Form 10-Q has met with relatively little dispute. However, in some instances, a longer time within which to file and changes in required disclosures have been suggested. As you may recall, the Commission asked for public comments on the desirability of requiring financial information in the fourth quarterly report. The corporate community appears to be almost universally opposed to such a requirement. One reason for this opposition is the additional year-end burdens which it would entail. Another is the possible difficulties which might arise if there were a substantial discrepancy between the unaudited figures in the fourth 10-Q and the figures in the certified financials filed with the 10-K. Since the 10-Q would have to be filed each quarter regularly, unlike the existing 8-K, the likelihood of obtaining financial and other disclosures on a current and more extensive basis should be very much increased.

Before leaving the subject of periodic reporting, I think that I should touch on the subject from the standpoint of the Commission's responsibilities. With the enormous number of '33 Act registration filings, our staff has frankly not had the time it should have to review carefully periodic reports. Although these burdens are not decreasing materially, I would be hopeful that the proposed system of reporting companies' filings could be reviewed with greater attention, particularly since the information which they contain in many ways parallels that to be found in a Form S-1. To the extent that reporting companies are periodically exposed to the full spectrum of disclosure problems, the staff may be able to focus disclosure policies for each company on a more regular basis. This may then create at least the possibility of more efficient clearance of '33 Act registration statements when they are filed. Such a result would prove a great benefit to the corporate community as well as to the Commission's own administrative processes.

Reporting companies would also be able to take advantage of Form S-7, a short-form registration statement, to a greater extent. At present, this form may only be used by issuers having gross revenues of at least $50 million and net income

of at least $2,500,000. It was proposed that the form be made available to issuers having net income of at least $500,000 for the last five years. This proposal has met with general approval.

The public comments on the proposed rules for secondary distributions and business combinations, as I have indicated, came primarily from attorneys, in over 100 comment letters. The proposed 160 series rules would establish objective tests for determining when secondary offerings of the securities of reporting companies could be made without the necessity of '33 Act registration. In general, limited amounts of such securities could be sold after a one-year holding period subject to two related conditions being met: one, the amount is small enough to be readily absorbed by the market, and two, no selling effort is used.

As you may know, one of the questions raised by the Wheat Report study group was whether the Commission has the authority to adopt the proposed rules. In the opinion of the Commission's General Counsel, the Commission has adequate authority, and only two commenting attorneys have disagreed with that conclusion. I think that my faith in the legal profession would have been shaken if someone had not disagreed, but I tend to adhere to our distinguished General Counsel's conclusion that the Commission may adopt rules such as those proposed.

It is fair to say that the securities bar is virtually 100% in favor of the new rules on secondary distributions, and merely want to go even further. That to me doesn't seem to be in the cards. A large number of the suggested changes are rather technical in nature and since the Rule 160 series is essentially technical itself, I don't propose to go over many of the suggestions.

One surprising criticism of the proposed rules is that they seem to some attorneys to discriminate against companies whose securities are not registered with the Commission under the Exchange Act. In such cases, the company is not filing periodic reports (unless it has had a '33 Act registration statement, which triggers the reporting requirements). There is therefore no publicly filed information about the issuer available to the investment community. The holding period for restricted securities of such companies is five years under the proposed rules.

On the other hand, under the proposed rules, in the case of a company filing periodic reports under the '34 Act, limited amounts of restricted securities may be sold without registration on a secondary basis after just one year.

Obviously, these rules do discriminate between reporting and non-reporting companies. However, in light of the purposes of the federal securities laws, the discrimination seems to me entirely justified. Indeed, it is the essence of the changes proposed. The basic thesis of the proposed rules is that if there is adequate timely information about the issuer in the Commission's public files, relatively small secondary offerings of restricted securities may be safely permitted without the filing of a '33 Act registration statement and the dissemination of a statutory prospectus. But where there is no reliable public information available, a great deal more caution must be observed before the securities may be offered publicly.

Thus, I do believe that it is entirely consonant with the policies and purposes of the securities laws to create a distinction between reporting and non-reporting companies and, without doing violence to the literal language of the law, to make it somewhat easier to dispose of reporting company stock. I might point out that any company may voluntarily become a reporting company by registering under the Exchange Act, even if it is not required to do so. Thus, by assuming the responsibilities of periodic reporting and other '34 Act requirements, any company may secure to its shareholders the benefits of the rules on secondary offerings, if adopted.

Several commentators have noted that the new rules leave much still undefined. For example, the rules do not specifically define the concept of "control" or give an exclusive definition of "underwriter." The original Wheat Report proposals would admittedly have provided greater guidance in these areas. Although the Commission does not anticipate any wholesale abuse of the proposed rules, if they are adopted, there may be some reluctance to dictate with complete precision at this time what circumstances might indicate the need for Securities Act protection. In a sense, the proposed rules represent a kind of experiment, and the experience which is gained from their operation and implementation may well provide a foundation for further modification and reform.

One immediate benefit which should flow from adoption of the proposed rules on secondary offerings will be the reduction of uncertainty in the application of the Securities Act registration requirements to such offerings and the accompanying reduction in the administrative burden of no-action letters. As you probably know, the Commission's staff regularly receives an enormous number of requests, usually from attorneys, seeking guidance on whether restricted securities can be sold without registration. The whole subject of no-action letters is presently under consideration by the Administrative Conference of the United States, which is formulating recommendations on the use and disclosure of such letters as a part of the administrative process. The Commission has reached no conclusions on these matters, but it is fair to say that the proposed rules on secondaries, if adopted, would relieve the Commission's staff from much routine inquiry and permit greater time and deliberation to be devoted to less repetitive interpretive problems of securities regulation.

Because of the limitations of time, I have not attempted to cover all of the Commission's proposed rule and form changes--such as new rules on publicity during registration (the "gun-jumping" doctrine). I shall only say that the business combination area and proposed new Rule 133 cannot be said to have generated the same enthusiastic support as the rules on secondaries.

Neither have I attempted to discuss in detail the public comments which we have received and are examining. I do hope that my remarks have conveyed to you the dimensions of the undertaking which currently confronts the Commission and our appreciation of the public support and even criticism we have received. We approach the structuring of these administrative reforms in a spirit of rededication to the philosophy of full and fair corporate disclosure as a cornerstone of our free enterprise system--a system whose vitality depends in large measure on the continued cooperation and informed conscience of the corporate community.

Thank you.