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DISCLOSURE AND THE CHANGING  
BUSINESS ENVIRONMENT

An Address By

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Securities and Exchange Commission

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Corporate Secretaries  
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I am pleased to have this opportunity to speak to the New York Regional Group of the Society of American Corporate Secretaries and to share with you our concerns about a process that is so simple in its concept and so complex in its implementation: informing the investor. As corporate officials and attorneys, close to the securities laws, you may appreciate a story one of the SEC division heads tells about a speech he gave recently. After the talk, a young law student, full of enthusiasm, came up and told him he wanted to make a thorough study of the securities laws. He asked the SEC official how he could go about it. Our man explained that there were two basic acts, the Securities Act of 1933 and the Securities Exchange Act of 1934.

"Good," said the law student. "Send me a copy of the 1934 Act. It's the most recent."

Even though the workings and the interpretations of the Federal securities laws on disclosure are complicated, their thrust is simple. Congress, in creating the Commission 40 years ago, wanted to try to assure that the

buyer and the seller of a security were on comparable ground in the information that was available to them about that security -- so that what took place in the markets would be as a result of investment judgment and not of an unfair advantage in information. This has meant that the Commission has sought over the years to assure that the 10,000 companies who regularly file reports with us tell their story fully, fairly, and meaningfully. It has also meant that there must be a continuous effort to ensure that the disclosure process keeps pace with the constantly shifting business environment and the changing structure of the corporations. As the conditions of doing business change, the disclosure process must also change so that the investor gets a clear picture. Today, a great deal more is at stake in the disclosure process. Forty years ago, the value of corporate securities on exchanges was 63.3 billion in stock and 44 billion in bonds. Today, it is one trillion 169 billion in stock and 250 billion in bonds. These values increasingly represent the savings and assets of many millions of people. That is why keeping the disclosure process current

and meaningful is such a crucial matter and one in which you as corporate secretaries share responsibility with the Commission.

I would like to talk tonight about a disclosure system which is continuous, tied to the real economic and competitive conditions confronting corporations, and which provides for the widest possible dissemination of information. Over the years, the Commission has increasingly sought to bring about a system of continuous disclosure by means of greater integration between the 1933 Securities Act, which involves the public offerings of corporations, with the 1934 Securities Exchange Act, which concerns trading activities. After all, a person buying a security from a corporation in a public offering has the same desire as one buying a security from another investor in the trading markets: both want meaningful, current information. Some examples of this increasing integration of the two sets of disclosure requirements are the short-form S-16 registration statement, through which larger corporations can satisfy 1933 Act disclosure requirements by reference to 1934 Act filings, and Rule 144, which permits the resale of restricted and control stock

without registration. As you know, that rule requires that material information be publicly available, the requirement being satisfied if a reporting company is currently in compliance with the periodic disclosure provisions of the 1934 Act.

Making the financial information from the corporations to investors more meaningful and pertinent is perhaps our biggest challenge. It may involve new rules such as those we will soon release requiring companies to describe the economic impact of compliance with federal and state environmental laws. It can take the form of accounting rules and disclosure guidelines aimed at giving the investor a better picture of the quality of a company's earnings. It may involve changing a long-standing Commission policy such as our recent decision to allow at a subsequent date corporate earnings projections in Commission filings. Sometimes it means simply making a basic disclosure document more readable and informative, and this, as many of you know, will be the thrust of our forthcoming new rules and guidelines on the preparation of prospectuses by companies selling shares to the public for the first

time -- the result of our "Hot Issues" hearings from last year.

I would like to discuss the matter of corporate earnings projections with you in some additional detail. As you are aware, the Commission last February issued a broad statement of policy on projections. We said no corporation has to make such projections. But once the company decides to tell outsiders -- securities analysts, brokers, institutions, stockholders -- about its expected performance, it must tell everybody. Our policy contemplated the filing of the projection information with the Commission, and its updating upon the occurrence of material changes in these expectations, as well as a section in the company's 10-K report which would cite the projection, compare it with actual results and make appropriate comment on the differences, if any. We said a company can stop making projections any time it wishes to do so by informing the Commission and stating its reasons. And we concluded by saying that the Commission considered the well-known "It's in the ballpark" and "I

think your estimate is reasonable" responses to securities analysts as projections by the corporation which would be subject to our reporting requirements.

Our policy release followed extensive hearings last fall where more than 50 representatives of the corporations, the legal profession, securities analysts, the academic community and the accounting profession gave us their views. Generally, there is a recognition of the reality about projections: corporations make them but usually don't take responsibility for them. In other words, projections exist, they are in circulation, they affect market values and they are material, yet these very important statements about future economic performance are subject to no uniform disclosure requirements and in fact are disseminated behind a cloak of informal procedure. As a result, what we have at best is an unfair and uneven flow of corporate earnings estimates and at worst the movement of inside information. Even the investor who has access to a great deal of analytical material about a corporation and actively follows his investment has little way of telling which estimates represent the views

of the corporation and which reflect the independent judgment of outsiders. There can be little argument about the right of the investor to know what a company is saying about its future earnings -- at the time these statements are being made -- and why the company thinks it will earn the estimated amount. Achieving this very desirable situation -- equal access to information -- is the purpose of our policy and of the implementing rules and guidelines we will be releasing for comment.

Understandably, there has been concern by those of you in the corporations about just what our rules and guidelines will say, and unfortunately, there has been an overreaction by a number of corporations and their legal counsel about the potential impact of our future rules in this area. We know that one law firm has advised corporations not to make any statement about earnings to anyone, pending the issuance of the Commission's detailed rules and guidelines. This firm was concerned that such guidelines might be applied retroactively. Some companies which have issued forecasts have said publicly that they will no longer do so because they fear that their procedures will turn out to be in conflict with those which



are later formally adopted. I will say here and now that the Commission will not allow itself to be used as a foil. Companies which issue earnings forecasts should continue to do so if they desire. There has been no change in the company's most basic responsibility about forecasts -- that they be made in good faith and based on reasonable assumptions. Full disclosure will be the thrust of any rules and guidelines established by the Commission on projections. And let me emphasize that our implementing releases would only be adopted after publication for and consideration of comments. Moreover, it is not the Commission's practice to apply new rules retroactively.

When the guidelines are issued for comment later this year, they will also deal with one of the persistent concerns brought out at the hearings on projections: corporate liability for forecasts which turn out to be wrong. It is the Commission's conviction that when a company makes a forecast in which it firmly believes and bases the forecast on reasonable assumptions, the fact that the actual operating results do not match up should

not make the company liable. I believe the law is reasonably clear in this area, but at the same time I feel companies are entitled to a greater sense of security for forecasts made in good faith. We anticipate development by the Commission of a "safe harbor" rule which will set forth clearly what constitutes a forecast and the steps required once the forecast has been made. So, despite the concern of some corporations and lawyers today about potential liability that could result from the Commission's rules and guidelines on forecasts, I think the results will be quite the opposite: by clarifying and bringing more uniform procedures to corporate forecasting, we will lessen the problem of liability.

The question of inside information, and how it should be handled -- particularly since it is generally of a forecasting nature anyway -- has become a critical topic of discussion since the recent Equity Funding scandal. I cannot, of course, go into the Equity Funding

matter, since it presently is in a preliminary stage, but I do think it is appropriate to share with you some of my views concerning the ramifications of corporate discussions with financial analysts. And as you know, we are preparing a release for public comment which will set forth in some detail our views on matters such as this involving the federal antifraud laws.

The onslaught of antifraud cases has generated some tendencies on the part of corporate officers to refrain from discussing anything concerning their companies with financial analysts. I frankly reject the notion that the antifraud provisions of the federal securities laws were intended to preclude or should be viewed as precluding such discussions. Nevertheless, I think a bit of circumspection is crucial in this area.

Financial analysts play a critical role in interpreting and disseminating corporate information to the investing public. Without these professionals, I think the market for your company's stock would suffer and the public would be less informed. But that does not mean that financial analysts should be treated as conduits for the selective dissemination of nonpublic inside information. The officers and directors of your corporations should be sensitive to the important dichotomy between information which already is in the public domain, on one hand, and information soon to be, but which has not yet been disclosed, on the other hand.

Thus, I believe that corporate officials can serve a valuable public purpose by clarifying and interpreting existing public data relating to their companies. But future earnings, pending negotiations for important contracts or possible mergers, recent corporate product discoveries, and the like, which are not yet publicly known, should not be confided to these financial analysts, unless the company is willing to make a public pronouncement at the same time

regarding these otherwise nonpublic matters.

I recognize that these kinds of broad suggestions may require difficult, on-the-line decisions, in many instances. But, if corporate officers develop an appropriate sensitivity to the dichotomy between public and nonpublic information, I believe this essential task will not be overly cumbersome.

I am often asked if this responsibility extends to the correction of misleading information -- like rumors or faulty projections -- which circulate in the market. These rumors are generated outside of the corporation -- sometimes by analysts, sometimes by malicious competitors, even sometimes by disgruntled ex-employees. In any event, they do circulate and often have a dramatic effect on stock prices.

If it can be done without damage to the corporation, the Commission favors the idea that companies set the record straight. I am not suggesting that a corporation has an affirmative obligation to scotch every rumor that grows up about its prospects. Such a rule would be an open invitation to abuse: all an analyst would have to do would be to put forth an outlandish idea and threaten to circulate it, whereby management would be forced to clarify and give

the facts, perhaps prematurely or otherwise to its detriment. However, we believe that the reverse of the coin is also true. That is, if management knows that there is a rumor circulating and that the rumor is significantly affecting the price of the stock, insiders who are aware of the true facts should refrain from trading the stock until the facts are revealed. In other words, insiders should not be able to "trade into the rumor."

Now I am not suggesting that any wild outlandish rumor will prevent insider sales. But where a widely circulated rumor has pushed a stock up or down by a significant amount and insiders are aware of its falsity, the Commission would have real concern if insiders traded during the period prior to the release of corrective information, whether it be through filings with the Commission or a corporate press release. One could, and perhaps should, look upon this self-denying rule as a countervailing balance to the absence of direct corrective responsibility for rumors.

I would like to close with a comment about the corporate annual report, the work of art for which many of you are directly responsible. We all know that these masterpieces reach a far wider audience than filings with the Commission. Over the years, we have been requiring

that more of the information we get be included along with the pretty pictures and the encouraging words from the company chairman, in an effort to make the shareholder report more comparable to the stodgy, but fact-filled, Form 10-K.

Last April, the Commission proposed an amendment to Form 10-K that would have required issuers to list by subject matter the items of information contained in the 10-K that were not contained in the annual report to shareholders. I'm sure many of you remember that proposal. It did not meet with universal acclaim. There were numerous comments about the burdens imposed, but perhaps the most significant comment was: "What good does it do to put the information in the 10-K where nobody will see it anyway?"

During the time that that proposal was pending, former Chairman Casey appointed several advisory committees, made up of people from outside the Commission, to report to him on the forms and reports required by the Commission. One of those -- the Industrial Issuers Advisory Committee -- submitted their report in December 1972, containing a series of recommendations concerning the annual report to stockholders.

The committee recommended that the present system of submitting, but not filing, the annual report be maintained and that the annual report remain separate from the proxy solicitation material. As the committee made clear, this recommendation was not based on a concern for increased liability. The primary basis for liability in this area, realistically, is Rule 10b-5, and for purposes of Rule 10b-5, it does not matter whether the document is actually filed with the Commission or not. Rather, the committee felt that if the annual report were officially filed with the Commission, it would lead to pre-filing conferences and staff review of the annual report, which would be undesirable and unnecessary.

Although the Committee recommended retaining the status quo for procedural matters, they did recognize the increased importance of the annual report as a disclosure document and the increasing discrepancies between the report and the 10-K. Thus they recommended that the Commission overcome its traditional reluctance and require the inclusion of certain information in the report, such as the line of business disclosure and the five-year summary of operations from the 10-K, and in addition, a brief description of the



business, a comment on significant changes in management, and a statement of the affiliations of outside directors. The committee also urged that 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, and 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 those policies.

A task force of the staff of the Commission is now in process of evaluating the recommendations of the Industrial Issuers Advisory Committee, and those of the other advisory committees. It is anticipated that the Task Force will present its conclusions this summer. One approach to implementing the committee's recommendations might be to require that certain information contained in specific items from the 10-K, such as lines of business or summary of operations, also appear in the annual report. The hope would be that this would not greatly increase the reporting burden on management since the information must be prepared for the 10-K anyway.

The Commission has not yet made any decision on this matter, but I think it can be said that there will be new requirements on annual reports. At the same time, these changes will recognize your success in making the annual report the most effectively disseminated and readable disclosure document available. They will also recognize that the annual report should be a direct communication between corporate management and the investor.

It is my firm hope that by these changes and full disclosure practices, not only in forecastings and the annual report but also in the new sense of responsibility for insider information and its effects on the market, that the confidence of all investors in our markets, and in your securities, can be increased or in some cases restored -- which is the hope of all of us involved in the business of capital raising, capital retaining and capital trading today.