NEWS

SECURITIES AND EXCHANGE COMMISSION
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DISCLOSURE RULES AND NEW CONCERNS

An Address By

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Securities and Exchange Commission

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SECRETARIES, INC.
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Last fall, the Commission amended its rules relating to the contents and distribution of annual reports to shareholders. Since the proxy season is just around the corner, I am certain that many of you are more than familiar with all the particulars of the Commission's recent amendments. Briefly, most publicly-owned companies will now be required to include at least the following information in their annual reports to shareholders:

> certified financial statements for the last two fiscal years;
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> a summary of operations for the last five fiscal years and management's analysis of the summary with special attention to significant changes occurring during the most recent three years;
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> a brief description of the company's business which, in the opinion of management, indicates the general nature and scope of the company's business;
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> a line of business breakdown of total revenues and of income (or loss) before income taxes and extraordinary items for the last five fiscal years;
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> the name and principal occupation or employment of each director and executive officer of the company;
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> the market price ranges and dividends paid for each quarterly period during the last two fiscal years with respect to each class of equity securities entitled to vote at the company's annual meeting.

In addition, the annual report to shareholders, or the proxy statement, must contain an undertaking that the company will provide, without charge, to any security holder as of the record date, upon written request, a copy of the company's Form 10-K or 12-K annual report, except for the exhibits thereto, as filed with the Commission. Companies must also undertake to make copies of the exhibits to their Form 10-K or 12-K available, but companies may impose a fee limited to their reasonable expenses for providing the copies.

Finally, these companies will be required: to contact known record holders, such as brokers, banks and their nominees, who may be reasonably expected to hold securities on behalf of beneficial owners; to inquire of them as to the number of sets of material needed for distribution to beneficial owners for whom they hold securities; to furnish the material to them; and to pay the reasonable expenses of the record holders for distributing the material to the beneficial owners.

This has long been standard practice for well run companies, but there are enough who do not do this to justify a rule. A note to this requirement calls the attention of issuers to the fact that broker-dealers have an obligation

pursuant to applicable self-regulatory requirements to obtain and forward proxy statements and annual reports in a timely manner to beneficial owners for whom they hold securities.

The Commission had several objectives in adopting these relatively far-reaching amendments. Basically, the Commission has attempted to assure that all annual reports to shareholders contain at least a minimum quantum of meaningful business and financial information. Beyond this, the Commission has also attempted to improve the distribution of reports so that all security holders, including beneficial owners who hold their securities in nominee accounts or "street names," receive an annual report to shareholders and, if interested, have ready access to the more detailed information contained in the company's Form 10-K or 12-K annual report filed with the Commission.

Since these amendments were adopted on October 31st, several commentators have inevitably referred to the "trick-or-treat" aspects of our Halloween rulemaking. While few government regulations can be considered treats, I can assure you these rules are not the Commission's idea of a Halloween night prank. Rather, they reflect the thorough consideration and hard work of many individuals -- both inside and outside the Commission -- during the past decade.

Based upon the work of the Wheat Report, our Industrial Issuers Advisory Committee, and the analyses and recommendations of the New York Stock Exchange, as well as our own experience, the Commission, in January 1974, published various proposals relating to the annual report for public comment. The Wall Street Journal immediately reported that the Commission, in a "controversial move to better inform the investor, . . . [was] attacking one of the most sacred cows on the corporate scene: the annual report to stockholders."

The proposed amendments drew more than 165 letters of comment from interested persons, including a letter on behalf of the American Society of Corporate Secretaries and letters from approximately 95 public companies. I might also add that the Commission received a relatively large number of letters -- 26 to be exact -- from private individuals, most of whom were presumably small shareholders. Based upon our consideration of all the letters of comment and based on our own experience, the Commission adopted the previously described amendments.

Far more serious and disturbing to me than the trick-or-treat comments, are other views that have been expressed by various public companies. For example, corporate executives, in commenting on the proposals, stated that:

the rules will mark the beginning of making the annual report into another government report;

annual reports will become too detailed, confusing and complex;

the rules represent a substantial infringement upon the free-writing aspect of the annual report.

In my judgment, these comments reflect a serious misconception of the Commission's intent in adopting the recent amendments.

We are not attempting to bootstrap our almost plenary authority over proxy statements in order to gain direct jurisdiction over the contents and format of annual reports. And we certainly do not want to transform the annual report into a prospectus or "another government report" filled with legalistic and technical terminology.

To the contrary, we are aware that annual reports have substantially improved over the years without any SEC rules, except with respect to financial statements, because many companies have presented meaningful data in an understandable, and often innovative, form. I might note that the release announcing the amendments "continues to encourage issuers to improve voluntarily the content and format of their annual reports to security holders." The Commission recognizes that

annual reports are probably the most effective means of communication between management and shareholders, and the Commission is sensitive to the free-writing aspects of the annual report and does not want to infringe unnecessarily upon management's discretion to choose the content and format of annual reports.

Parenthetically, last spring I saw several reports of informal surveys on annual report readership. They were, to me, surprisingly negative, suggesting that even the annual report does not get much attention from ordinary shareholders. Even so, it at least gets more attention than any other disclosure device.

You may well ask, if all that I'm saying is true, why did the Commission adopt disclosure rules for annual reports? It is quite simple. Without attempting to review and study all annual reports, the Commission has become aware through publications and our own case-by-case experiences of:

> companies whose annual reports to shareholders are inconsistent in material respects with the annual reports filed on Form 10-K with the Commission;

> companies which issue flashy and detailed annual reports for good years, but which issue sparse annual reports containing limited information for bad years; and
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> companies which consistently present little meaningful information regarding their operations other than the basic financial information previously required by the Commission.

Because of the recurring frequency of these situations, the Commission felt it appropriate to adopt rules embodying the good reporting practices of most public companies so that all companies subject to the proxy rules would be required to disclose certain basic information regarding their business, management, operations and financial position.

In adopting these requirements, we have attempted to permit management as much latitude as possible in communicating effectively with its shareholders. For example, the rules are quite clear that the annual report may be in any form deemed suitable by management and that the required disclosures may even be presented in an appendix or separate section of the annual report. A note has been included in the rules encouraging the use of tables, charts and graphic illustrations to present financial information in an understandable manner so long as the presentation is consistent with the underlying financial data.

As an administrative policy, the Commission's staff, which is available for assistance in this area, will be interpreting the new requirements liberally during this first proxy season which will serve as a shake-out period for the new rules.

Lest I lull you into thinking that "anything goes" for the 1974 annual reports, I should mention briefly the applicability of the antifraud provisions of the Securities Exchange Act. The recent amendments have not changed the legal status of annual reports. While these reports are not "filed" documents under the Exchange Act and are not ordinarily soliciting material under the proxy rules, so that annual reports to shareholders are not subject to Section 18 of the Exchange Act, they continue to be subject to the broader antifraud provisions of Rule 10b-5.

As to the future, I think there is a strong temptation to utilize the annual report to shareholders for a multiplicity of purposes. For example, during Senators Metcalf's and Muskie's hearings on corporate disclosure in May, 1974, it was suggested to Commissioner Sommer, when he testified for the Commission, that the annual report to shareholders would be a suitable vehicle for disclosing all corporate affiliations of officers and

directors; the 30 largest shareholders; all control relationships including any management contracts with other companies; all debt obligations; and environmental responsibilities and litigation.

While the Commission will be considering these proposals and, pursuant to a court order in the recent Natural Resources Defense Council case, will be particularly reviewing its present regulations regarding environmental and equal employment opportunity disclosures, I think the Commission will probably focus its attention in these areas on the Form 10-K requirements rather than imposing additional rules on annual reports to shareholders.

During this coming year, the Commission' staff will be issuing interpretative letters on, and making any necessary recommendation for technical changes to, the recent amendments, but I don't think the Commission will substantively amend the annual report rules, with the possible exception of requiring additional liquidity and working capital disclosures in annual reports, if objective standards can be developed in that area.

During the past three months the Commission's staff has conducted a public fact-finding investigation In the Matter of Beneficial Ownership, Takeovers and Acquisitions by Foreign and Domestic Persons. One of the specific inquiries of that proceeding was whether the Commission should adopt rules to facilitate

communications between issuers and the beneficial owners of their securities. Based on the testimony during the hearing and the written comments on that inquiry, it appears necessary for the Commission to take some direct or indirect action to improve the distribution of annual reports to the beneficial owners who hold their securities in nominee accounts or street names.

And something more may be expected with regard to disclosure of stock, and perhaps long-term debt, ownership. We are, of course, well acquainted with the futility of simply requiring more disclosure of record ownership, and any meaningful solution may well require legislation, but the pressure for more information on corporate ownership and control is growing.

The desire of corporate management for direct communication with its security holders and the desire of others to smoke out informal affiliations and control are now joined by a widespread desire for at least the identification of foreign involvement. How this will work out I cannot say at this time.

As to the last of these, the Departments of Commerce and Treasury are presently engaged in a two-year study of all foreign ownership of American business. Perhaps some device usable for

corporate disclosure purposes will come from this, although we can expect legislation to be proposed in this Congress for restrictions on foreign ownership without awaiting the results of the study. Similar bills in the last Congress did not receive much support, but it may be different this time.

I mentioned earlier the lawsuit brought against the Commission by the National Resources Defense Council, seeking the adoption of rules requiring more disclosure of facts relating to envionmental and equal employment opportunity matters. Without presuming to tell us what, if any, rules to adopt, the court has ordered us to give more attention to these issues, which we will do.

The controversy involves more than may at first appear. The plaintiff Council is challenging the fundamental rationale that has implicitly governed the Commission's disclosure philosophy for 40 years. The effect of the challenge can be seen by considering the basis for the Council's dissatisfaction with our present rules. Our present rules are insufficient, in the Council's view, because they are aimed at only one kind of investor, namely, the investor whose sole concern is profits, earnings. They do not completely satisfy the so-called "ethical investor". They are right. There is a legal question concerning just how far the Commission can go in this direction.

When environmental and equal employment matters became of such widespread concern, the Commission's eventual response was to require disclosures in these areas largely to the extent that the company had problems that might materially affect its earnings. The ethical investor, it is argued, wants to know if the company is behaving badly in these respects, whether or not its earnings appear to be threatened.

Who are these ethical investors, and are they entitled to such consideration? I suppose anyone can be an ethical investor, but the outspoken and self-styled ones seem to be universities or other educational endowment funds, certain church funds, some pension funds, public interest groups (who may not in fact be investors except in a nominal sense) and several new investment companies set up to invest only in companies whose activities meet a set of prescribed ethical standards. Of course, there has always been some of this. All investors have never been pure "economic" men. Church funds have avoided investments in tobacco and liquor companies, and so on. But the degree of concern today may be sufficiently increased to make it a new problem.

It is also true that the Commission has not been solely concerned with the economic investor. At least we have required, and do require, some disclosures where the dollar amount is insignificant so that the requirement must be based on something else, whether or not that something else is clearly articulated by us. Indeed, this additional rational for compulsory disclosure has been around from the beginning.

Everyone is no doubt familiar, perhaps too familiar, with Justice Brandeis's oft-quoted dictum about sunshine being the best disinfectant, and it is true that disclosure may deter certain questionable business transactions from occurring. I doubt that there is anyone left today who questions that basic utility of disclosure. After all, the practical alternative may well be substantive federal regulation of corporate business transactions that the authors of the federal securities laws thought ought primarily to reside with the states. And I am inclined to agree.

As a recent example of this basis for disclosure, the Commission has no direct substantive responsibility to police the federal campaign contribution laws. Nevertheless, we have brought suit against a number of companies, and are investigating

a fair number of other companies, concerning their failure to disclose possible violations of these critical federal statutes. In all cases of which we are aware thus far, companies that have engaged in unlawful conduct have generally failed to disclose their conduct, which we think is material, for obvious reasons. The amounts of money involved are, as a general matter, insignificant from the company's point of view. And, in terms of practical benefit to shareholders, the money may have been well spent. Why, then, require disclosure?

It is possible to relate such disclosures to the concerns of the purely economic investors. It may affect earnings if the president is sent to jail. It may affect the quality of earnings if they are dependent to any significant extent on illegal expenditures. If a company can prosper at its present business only by successfully bribing the local fire inspector, or what have you, that information is material to even the most heartless and amoral investor. But, in bringing our cases, we have not attempted to base the need for disclosure on any such analysis. We simply think reasonable investors want to know if management is making illegal political contributions, and we think the need for disclosure will discourage these contributions.

But how far should we go down this road? Illegal political contributions seem obvious and of much current concern. Perhaps the same rationale should apply to any clearly illegal conduct. At least there we have a reasonably concrete standard, although so many things can be illegal in a technical sense that some notion of "material" illegality seems necessary. I shouldn't think, for instance, that we would require a trucking company to disclose that its drivers regularly exceed the 55-mile-per-hour speed limit. (Maybe that's a poor example inasmuch as such disclosure would be mere surplusage, but you get the point.)

But, even if material illegality is a workable concept, what about "material unethicalness"? Is this workable at all? Of course, the present controversy over environmental and equal opportunity matters also involves putative illegality, but its supporters argue for the ethical investor who, I presume, has higher standards than mere illegality. He might, for instance, be concerned with doing business in South Africa. The trouble is that he may be concerned as well with a lot of other things, many of which might be unexpected and idiosyncratic. Dollars and serious criminal conduct we can all

understand. What is ethical for modern business is something else. I know people who seem to think it's unethical to make a profit or even to want to.

We have a further quandary whether exposure of material undersirable corporate conduct is sufficient. Let me give you an example.

The whole trend involved with companies desiring to "go private" raises a question about the basic fairness of the transaction to minority shareholders. If a company fully discloses to its shareholders how unfair a particular transaction may be, and that the transaction is being entered into solely for the benefit of the insiders of the company, should the Commission be content simply with full disclosure, particularly where the shareholders involved may not be in a position to prevent the transaction in question from occurring. At least one court has said that, if full disclosure is made, this is no concern of the federal government under our general antifraud powers, and there are many who agree with that proposition. But, the court in question was a district court, and its opinion is presently on review by the Court of Appeals in New York.

To sum up, is it accomplishing all of the purposes of disclosure if we continue to employ a test of materiality limited solely to economic, and perhaps illegal matters? There are certainly numerous areas of corporate activity today that are not precisely unlawful, but are ethically or morally odoriferous. Yet this conduct may not adversely affect the economic well-being of the company. Worse, the conduct might actually enhance the corporation's status. Should the full disclosure concept be used to deter these kinds of activities? And, if so, can we adhere to the standard of materiality that we have employed so effective for so long?

The difficulty is that, unless a careful balance is drawn, something the Commission tried to do when it last considered environmental disclosure proposals, our disclosure documents could really become unduly cumbersome and bloated. And, at some point, even if the Commission did want to assume responsibility for deterring unethical or immoral conduct, we would be forced to recognize that some corporate activities, however troublesome, are the substantive responsibility of either other federal agencies or of state governments and

that, if appropriate and complete disclosure has been made, the Commission's role is, and should be, at an end.

I think we all share a deep concern for establishing confidence in American business management, not just to make money, important as that is, but to achieve socially desirable goals. And I don't need to remind you of the widespread disenchantment with, and even hostility toward, our present system of economic organization. The total process of rehabiliation involves much more than the federal securities laws, but it surely includes them. Corporate disclosure is an important part of the process, the importance of which is by no means limited to enabling individual investors to make simple buy or sell decisions. We are concerned with preserving our present economic structure as against the disastrous alternatives.