SECURITIES AND EXCHANGE COMMISSION
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IMPROVING DISCLOSURES TO INVESTORS

An Address by

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CHICAGO CHAPTER
AMERICAN SOCIETY OF
CORPORATE SECRETARIES

Chicago, Illinois

You people and our Commission have so many things in common, I suspect that almost everything going on in our shop has some interest to you. I cannot talk about them all, of course, and so, for this evening, I thought it might be interesting to discuss our current proposals with respect to the contents of annual reports to shareholders.

We have set a deadline of March 15 for comments upon these proposals, and I hope that all of you with something to say have either submitted your comments or will very shortly. Needless to say, our staff does not refuse to open its mail just because a letter may be received after the deadline, but it is very helpful if you get your comments in on time so that the staff can proceed with the business of analysis and judgment.

As I assume you know, our recent release would require that the annual reports to shareholders now include the following information: the general nature and scope of the issuer's business; the contribution of a company's various lines of business to the company's sales and earnings; a five year summary of earnings; the nature and scope of the liquidity and working capital requirements of the issuer; at a minimum, the name and principal occupation or employment of each director and executive officer; the principal market in which the company's securities are traded as well as the high and low prices for each quarter over the most recent two years, together with information as to dividends paid and a statement of the company's dividend policy; and a statement that the company will send a copy of its Form 10-K annual report to any security holder on request. In addition, we have proposed that financial information and data or financial highlights, in the form of charts, graphs, figures and the like, should not present the results of operations or other financial information in a light more or less favorable than that presented by the actual financial statements included in the annual report to shareholders.

Technically, it is not correct to say that this information must be in the annual report to shareholders. The requirement is that it be furnished to shareholders prior to or concurrently with the solicitation of proxies. We can expect, in the normal course, that it would go into management's own annual report to shareholders. Since we do not have express authority under the periodic reporting provisions of the Securities Exchange Act to require the direct dissemination of annual reports to shareholders, we are once more piggybacking on the company's annual report as a condition to the solicitation of proxies.

In our release, we have tried to adhere to our traditional policy of not intruding upon management's annual communication with its shareholders. We have not tried to restrict so-called free writing, except to point out that charts and graphs and pictures and whatnot should not be significantly different in the financial results and conditions that they portray from what appears in the financial data included in the Form 10-K.

In addition, management sometimes has to be reminded that the annual report, while not a filed document and not subject to liability under Section 18 of the '34 Act, is nevertheless a document subject to Rule 10b-5. The management portion is free writing in the sense that it neither has to be filed in advance nor subjected to processing or comment by the staff, but it is not free, as you all know, in the sense that anything goes.

Most of you, I presume, are generally familiar with the move toward continuous disclosure as the principal emphasis of the federal securities laws, born primarily of the '64 amendments to the Securities Exchange Act that brought under its provisions previously exempt over-the-counter companies of significant size and public ownership. While the full exploitation of the benefits of continuous disclosure may have to await the adoption of the Federal Securities Code now being drafted by Professor Loss and his

advisers under the aegis of the American Law Institute, the Commission has been moving in this direction slowly, but persistently, to the degree possible under existing statutes. Forms S-7 and S-9 have long relied upon the availability of continuous '34 Act disclosure and, of course, the newer Form S-16 clearly does. So also does Rule 144; and the amendment to Form 10-K, which requires the annual description of the corporation's business along with other information, producing, as it does, something approximating an annual prospectus, was an essential element in the program.

The problem with our Form 10-K is that it does not get to enough of the people who could use the information. We have made some significant progress in getting Form 10-K reports, as well as Forms 10-Q and 8-K, available to persons that really want them and are willing to go to some time and expense to get them, but it is still rare for an ordinary investor or an ordinary registered representative actually to have one of these forms in his possession. If he receives the benefit of the information included in these forms at all, it is normally through indirect channels. Or it can be through the annual report to shareholders.

Anybody familiar with our financial markets will agree that the single document providing information with respect to an issuer that by far gets the widest dissemination and is by far the most likely to be available to anybody faced with an investment decision is management's annual report to shareholders. More people get it, more people retain it, and more people know where to find it than any other single document in the whole process of financial disclosure, and it is perhaps ironic that this is the one document that our federal securities law system presently neither requires nor regulates in any respect

except through our proxy rules. Nevertheless, we know that it exists, and we have long taken at least partial advantage of it.

It may seem curious that the Commission does not have any express authority to regulate any such reports or communications to shareholders by ordinary '34 Act-registered companies. It has such authority under the Investment Company Act of 1940 and the Public Utility Holding Company Act of 1945, but not with respect to the Securities Exchange Act of 1934. However, the '34 Act does give the Commission authority to regulate the solicitation of proxies by companies registered under that Act and, for over thirty years, it has used this to intrude upon the annual report to shareholders to a certain degree. The initial requirement was simply that an earnings statement for the last year and a balance sheet be sent to all shareholders prior to, or concurrently with, the solicitation of proxies, and it was well understood that this would probably be done by means of the annual report to shareholders. In 1964, we added the requirement that any discrepancies in accounting principles and procedures between the financials supplied in the annual report to shareholders and in the Form 10-K filed with us be reconciled by a narrative in the annual report.

In addition to the general policy objective of working toward an annual prospectus, in effect, as the ideal to be achieved in continuous disclosure, and the practical significance of the annual report to shareholders as the most effective vehicle for broad dissemination of information to all parties, the Commission has also been impressed with the fact, highlighted in the Wheat Report that disclosure should be provided on two levels - - detailed disclosure of great value to professional securities analysts which, through a filtration process, hopefully would benefit investors indirectly -

- and simplied disclosure in a more summary in form for the average investor. This view was developed by Mr. Wheat and his group as a result of reports received from various types of users of disclosure information as to its relative value. The most dramatic instance in all of this was the response to the value of the typical merger proxy statement, frequently a very long, complex and detailed document with proforma financial statements, summaries of long and complicated legal documents, and accompanied by the full text of the relevant documents attached as appendicies.

While the ordinary investor and even the ordinary registered representative or other person involved in the securities business, tends to regard these proxy statements as the ultimate horror, professional financial analysts in some numbers informed Mr. Wheat that this type of thing was the most helpful and informative single document produced by the entire disclosure system. This seemed to dramatize the conclusion that different things were important to different people. Distinctions could, and should, be made between the degree of detail and technical information that should be required to be distributed at large to all possible persons as against what should be required to be filed with the SEC and made available to professionals.

In addition to these policy concepts, in December 1972, the Report of the Industrial Issuer's Advisory Committee to the Commission recommended that the Commission adopt substantive amendments to its proxy rules to improve disclosure in annual reports to shareholders. That Committee consisted of many distinguished professionals who represented various segments of the securities industry, including the legal and accounting professions, investment, investment banking, government and even

a corporate secretary. It also included my colleague, Commissioner Sommer, who at that time was still gainfully employed as a private practitioner.

Turning now to the specific proposals included in our recent release, the first is that the annual report contain information describing the general nature and scope of the issuer's business.

This will be nothing new to the better prepared annual reports of our well-managed companies, but it did cause some consternation when first proposed in 1964. At that time, the Commission abandoned the idea, not only because of the opposition to it, but also because of our very limited experience at that point, with the effect of the 1964 amendments on the over-the-counter companies recently registered or about to be registered under the '34 Act.

The proposal is not to require a full statutory prospectus description of the business with anything like the same detail appearing in Form S-1, but only that information which management, "in its opinion," believes adequately describes the company's business. This would require, of course, disclosure of the contribution of a company's various lines of business to its total sales and earnings.

Line of business information is already required to be included in reports on Form 10-K and is voluntarily reported in substantially the same manner today in annual reports distributed by many companies to their shareholders. Back in 1969, when the Commission first proposed that '33 Act registrants be required to disclose the contribution of various lines of business to their operations, the Commission was met with the argument that the fast developing trend was to provide line of business

information voluntarily in reports to securityholders and that, therefore, there was no need for the Commission to adopt a requirement along those lines.

It is now more than four years later, and various studies indicate that the trend has not developed to the point where all, or even substantially all, publicly-owned companies are reporting this information. Our proposed requirement would provide for more uniformity, which is in the interest of those companies which presently recognize their obligations to provide meaningful information to their securityholders.

The requirement for a five-year summary of earnings to be included in annual reports was recommended by the advisory committee and was one of the recommendations in the recent New York Stock Exchange White Paper on Corporate Disclosure. '34 Act reporting companies are presently required to provide such a summary of earnings in annual reports filed with us on Form 10-K, so there should be little burden in providing similar information in annual reports to securityholders. If the Commission adopts its proposed guidelines to require a textual analysis of material changes in the summary of earnings to be included in reports on Form 10-K, those guidelines will also apply to the summary of earnings in annual reports to securityholders. The advisory committee has recommended a similar approach.

If adopted, the proposals also would require textual information which, in the opinion of the management, indicates the nature and scope of the liquidity and working capital requirements of the issuer. The New York Stock Exchange White Paper suggested similar disclosures, and information relating to liquidity is presently required to be disclosed in reports on Form 10-K.

Some commentators have objected to this proposal on the grounds that it would require the disclosure of some forward-looking information concerning the company's future prospects. While this may be so, it is not inconsistent with other steps we have taken recently with respect to the disclosure of a company's future prospects. I might also note that at least one company has provided estimates of sales and earnings in its annual report. While we may not agree with the method of presentation in all respects, we do not object to reasonably-based estimates of future performance appearing in annual reports, and our recent proposals would not change this position.

Perhaps I should depart from the discussion of our pending proposals in our latest release to indicate the effect some of our more recent actions with respect to financial reporting will have on annual reports. Those actions reflect our two-step approach to disclosure, which carries over to the question of whether the information required should be included in annual reports to shareholders which are considered by investors in making their decisions, or whether it is information principally of value to professional analysts which need not be included in annual reports to shareholders, if it is reflected in a report on Form 10-K.

Information concerning leases is an example of information which should be included in annual reports to shareholders although, as indicated in the February, 1974, issue of the Journal of Accountancy, we will be administratively flexible this year if the annual report indicates that that information will be included in the 10-K.

Disclosure relating to income taxes and compensating balances on bank loans are examples of the type of information which would appropriately be dealt with in considerably less detail in annual reports to shareholders than in reports on Form 10-K. I

have very much simplified a discussion of a rather complex subject, but our accounting staff is available to discuss these matters with anyone who has questions.

We have also proposed that, at a minimum, the name and principal occupation or employment of each director and executive officer be set forth in the annual report to shareholders. It is reasonable to assume that securityholders want to know the identities of the persons who are managing the company. Moreover, this is substantially less information concerning management than is required in reports on Form 10-K and it does not appear to be a burdensome requirement.

The final substantive requirement which would be imposed, if our proposals are adopted, provides for identification of the principal market in which the company's securities are traded and the high and low prices for each quarter over the most recent two years, together with information as to dividends paid and a statement of the company's dividend policy. Similar information is presently required to be disclosed in registration statements under the 1933 and 1934 Acts. The New York Stock Exchange suggested that a much more comprehensive set of market data be included in annual reports, but we are not prepared to go that far at this time.

Since we recognize that the annual report is management's vehicle for communicating with securityholders, we do not intend to require that an annual report look like a report on Form 10-K. Our proposals would permit management to present the required information in any form it deemed suitable, including placing the new information in an appendix. I cannot emphasize too much the flexibility as to presentation we fully intend to leave up to management.

We do believe, however, that it is very important to provide means by which the improved disclosure we have proposed can be communicated to securityholders. Therefore, we have proposed that the company, when it solicits proxies, be required to determine from the recordholders of its securities the number of beneficial owners and to provide sufficient copies of the report to the recordholders on request, to permit the recordholders to provide a copy to each beneficial owner. Our proposal also would require the company to pay the reasonable expenses incurred by the recordholder in transmitting the reports to beneficial owners.

This is perhaps the most controversial of our proposals, and the one that presents the most practical difficulties to the issuer and others. I assure you that we will give this proposal and the comments on it careful attention. However, as you may be aware, the entire question of record and beneficial ownership has been receiving considerable attention both in Congress and from our staff. Our staff is presently considering whether certain of our disclosure requirements relating to the acquisition or ownership of securities should be modified to require the disclosure of those persons who have the power to vote securities rather than simply the record or beneficial owners, and whether the threshold reporting level, which is now generally ten percent, should be lowered to five percent. Resolution of those questions might have some effect on the proposal in question. I also recognize that this new proposal will not change things much for the listed company or the over-the-counter company whose nonbeneficial recordowners are primarily members of national securities exchanges, where the practice and the obligation of forwarding material after having received information as to quantities required and the

undertaking of the company to pay reasonable expenses is well-established. Our proposal would extend this beyond that group of large companies.

The objective of wide dissemination of annual reports could most easily be achieved by requiring that the company send a copy of its annual report on Form 10-K to all shareholders and other interested persons. Popular opinion to the contrary notwithstanding, we are conscious of the cost and trouble that our requirements may impose upon issuers, and we are reluctant to go this far. Instead, we have proposed in our recent release that the company's proxy statement indicate that the company will send a copy of the annual report on Form 10-K to shareholders on request.

Although some comments have suggested that this might be an expensive proposition, we do receive many complaints from securityholders indicating that they cannot obtain information from the company and that they would like to obtain a copy of its 10-K. Of course, they can obtain a copy from the Commission or one of the companies providing such services, but this is apparently awkward and time-consuming and difficult for many ordinary investors.

As you know, some issuers already provide copies of the 10-K to all securityholders, sometimes charging a fee calculated to be something less than the copying charge for the same document ordered from the Commission, and in some instances the 10-K actually serves as the substantive portion of the annual report.

As an aside, our staff has indicated administratively that it would not object to an annual report to securityholders being filed to satisfy the 10-K filing requirement, if certain standards are met. If you are interested in this approach, you may want to obtain

a copy of the staff's letter to Teradyne, Inc., dated December 11, 1973,* setting forth the standards which should be followed if the annual report is to be accepted as a 10-K.

I should emphasize that these are only proposals. The several dozen comments we have received to date, however, have generally been favorable, with the exceptions I have noted.

Whatever our final determination, however, I believe that the concept of improving the disclosure readily available to securityholders is essential to the development of the continuous disclosure system that obviously is going to be the pattern for the future. Our proposals are at least a step in the right direction. After all, we see so many fine examples of annual reports containing useful information in very readable form, we are only proposing that all publicly-owned companies adhere to similar standards.

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* [Current] CCH Fed. Sec. L. Rep. ¶79,660.