

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

CURRENT PROBLEMS OF DISCLOSURE

An Address By

A. A. Sommer, Jr., Commissioner

Securities and Exchange Commission

National Association of Securities  
Dealers, Inc.  
Los Angeles, California

November 12, 1974

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Commissioner  
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In a sense, disclosure was 40 years old last July; at least that was when disclosure as what might be called a “federal” concept came into legal existence with the enactment of the Securities Act of 1933. The idea that corporations should make more disclosure about their affairs had been bouncing around for a long time. As far back as 1914, then lawyer (later Justice) Brandeis had suggested that “publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants; electric light the most efficient policeman.” It was not until the collapse of the financial community between 1929 and 1933 that this notion found itself incorporated in federal law. The Securities Act of 1933 mandated that in connection with public distributions of securities by issuers and those who controlled them there would thenceforth be required extensive disclosures with respect to the corporation’s affairs, including balance sheets, income statements, information about officers, directors, promoters and large shareholders, and a multitude of other matters which in many quarters before then had been jealously guarded secrets. Some of the contents of this Act were bitterly disputed, but relatively little of the battle pertained to the principle of disclosure; rather, the disputes were about such things as the potential

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liabilities of directors, whether recovery should depend upon reliance upon the misstatements, limitations upon the liabilities of underwriters and so on. The principle itself seems to have been little disputed, although there were disagreements with regard to particulars.

In 1934, Congress enacted the Securities Exchange Act of 1934. This was a potpourri of many disparate elements. While the Securities Act of 1933 was a relatively homogeneous statute almost totally designed to accomplish effective disclosure in connection with distributions, the 1934 Act touched numerous areas. It was concerned with the regulation of credit in connection with securities transactions, it incorporated reporting requirements with regard to transactions by “insiders” and penalized them severely for short-term trading, it required the registration of exchanges and specifically forbade some previous practices such as wash sales and subjected others to severe limitations. It created the Securities and Exchange Commission and accorded it substantial power over the securities markets of the country and those who were engaged professionally in them.

Almost incidentally, and the legislative history of this statute would indicate that such was not the principal focus of those responsible for the drafting and enactment of the 1934 Act, it provided for a system of continuous disclosure of their affairs by issuers who were listed on registered securities exchanges. The Securities and Exchange Commission was given broad powers to require the filing of periodic reports by such issuers, a power which the Commission quickly implemented with a system of continuous reporting which has been steadily strengthened and embellished. In view of the relatively minor role played by the over-the-counter market in 1934, and

because of the history of efforts by the exchanges, principally the New York Stock Exchange, to bring about fuller disclosure by issuers whose securities were listed, little attention was given to the possibility of imposing comparable disclosure requirements on O-T-C issuers. It was only in 1964, 30 years later, that the legislation caught up with the securities world and imposed similar requirements upon most publicly-held companies, regardless of where their securities were traded. With the exception of this extension, the disclosure system which has been elaborated to date has been the result of the initiative and the imagination of the Securities and Exchange Commission. Since the time of the Disclosure to Investors Study (popularly known as the Wheat Report) in 1969, the Commission has moved strongly in the direction of pulling together the disclosure requirements of the 1933 Act and those of the 1934 Act, looking toward a truly continuous reporting system which would create a continuously growing and updated fund of information readily available for use by all in making investment decisions.

During most of the 40 years since the commencement of a federal disclosure policy, there has been little question raised about the desirability of disclosure in general, although there have been repeated disagreements with regard to the specifics required by the Commission. Only recently has the entire system been called into question, principally by the economists who have sought to establish by economic and mathematical analysis that the mandated disclosure has been of no benefit to investors and has only imposed unconscionable costs upon issuers. Another group of critics has insisted that, while disclosure in general is a desirable social policy, the Commission has erred in the restrictions that it has placed upon disclosure. These

critics would opt for more disclosure of so-called “soft” information -- forecasts, estimates, projections, appraisals -- on the theory that this information is of far greater relevance to investment decisions than the generally historical and current information, so called “hard” information, traditionally required by the SEC. Some have suggested that the Commission should expand its requirements and allow or mandate in documents filed with it more information about the industries in which the issuer operates, relevant statistics with regard to market share, rates of growth, analysis of trends and the like.

The Commission is not unaware of these criticisms and, I should add, it is not unresponsive to them. We recognize that as times change, as our experience with disclosure practices deepens, a case may well be made for substantial changes in our disclosure policies. Some of the critics are very persuasive; others of them, in my estimation and in the estimation of others associated with the Commission, simply do not make a tenable case. However, I think it is important that in this 41st year of the Commission’s existence, and in the 42nd year of federally mandated disclosure we review past practices and and current theories and try to determine the directions in which we should go in the future.

First of all, I can assure you the Commission does not live on the moon. We know full well that the overwhelming bulk of investors do not read prospectuses. We know full well that most new issues (and some of us even remember when there were such!) are sold on the basis of a telephone call, a face-to-face conversation, or some medium other than a prospectus. We have adopted rules in the not distant past to assure that with respect to first offerings, a document substantially conforming to the

final prospectus be in the hands of potential purchasers not less than 48 hours before the offering, but we know that giving a prospectus to someone does not guarantee it will be read. Similarly, we are well aware that the existence of a fund of information in our files does not necessarily make it a part of the consciousness of those who make investment decisions, although I must say that we are encouraged by the evidence that increasingly those responsible for investment decisions or advising those who make investment decisions have access to and use the information which is filed with the Commission. Furthermore, we know that even the most attractive and elaborately prepared annual report may only be read by a small fraction of the shareholders and that in particular the financial statements continue to be forbidden territory for most investors.

You may well ask, if we know all these things, then why do we bother implementing a disclosure policy? Why not jettison the whole thing and start over with sounder practices?

I think there are good solid reasons why this would be a great mistake. Imagine a world in which there was no information available concerning your companies or any other issuers of securities. How would an investor make a decision as to whether he would commit his dollars to one issuer over another? How would you communicate to potential investors a rational basis upon which they should prefer to invest in your company versus other companies? One of the functions of the securities markets that we have developed in this country is that of efficient allocators of capital resources. This efficiency is maximized to the extent that we achieve an economically efficient market. By economists' definition, this kind of market is characterized by the

presence in it and the availability of all material information concerning all issuers whose securities are traded in the market, and the market approaches most closely maximum efficiency if that information is available to all potential investors simultaneously. Were there no funds of reliable information available about corporate issuers, the markets would be influenced to a much greater extent than they are now (and God knows it is too much now) by rumor, speculation, conjecture, “inside information,” gossip and irrationality.

Once it is realized that information in the market place is a sine qua non of an efficient market (and an efficient market is in turn a sine qua non of an efficient allocation of economic resources) then the question becomes how it can be assured that such information is available in the market place and that it is accurate. Despite assertions to the contrary, the simple fact is that prior to the advent of federal securities regulation reporting practices of companies were lamentable. For example, in 1933 barely half of the corporations listed on the New York Stock Exchange filed quarterly earnings statements -- and if this was true of the New York Stock Exchange companies, you may be sure the number was far fewer on regional exchanges and in the over-the-counter market. In 1933, only 308 listed companies reported annually, although the Exchange had urged the virtue of semi-annual statements since 1927. In 1934, 38% of the listed corporations failed to report gross sales. Furthermore, depreciation policy was not usually disclosed, reserves were lumped together, inventory figures were set forth without stating the method of evaluation or the nature of the goods carried, and earned and capital surplus were usually combined in one figure. Fifty-four percent of the companies listed on the New York Stock Exchange failed to disclose their cost of

goods sold -- again, such necessary disclosure was most certainly less common in the over-the-counter market. While the New York Stock Exchange was in the 30's making efforts to upgrade the reporting practices of companies, these efforts were modest and relatively ineffective. In the face of this, it is quite apparent that the only appropriate answer to such a problem was federal intervention and the establishment of uniform standards, accompanied by a power sufficient to police and enforce them.

Notwithstanding the fact that the principle of disclosure was firmly established 40 years ago, the Commission is still struggling with root problems, such as what should be disclosed, how should it be disclosed, where should it be disclosed and when should it be disclosed?

First, what should be disclosed? The simple fact is that we are strangely ignorant of how information is assimilated in the investment community and the manner in which it influences investment judgments. We have relatively little empirical data indicating the information which is regarded as important by ordinary investors and by professionals. In this respect a recent study by a graduate student at the University of Colorado, Mr. Larry Godwin, is of extreme interest to me. Mr. Godwin sought to make such an empirical analysis and reached conclusions with regard to the importance of various items of information to financial analysts and to shareholders at large. Without discussing extensively his conclusions, it is noteworthy that the fact of corporate political contributions looms relatively large in importance for the average shareholder but is relatively unimportant to the financial analyst. Management's forecasts are important to both groups, but more so to the analyst. Information about investment in loss divisions is important to both groups. While prior

to any addition to disclosure requirements we use procedures to gain the benefits of analysts' and businessmen's thinking concerning relevance and importance, nonetheless I would hope that we may be able to develop techniques that will afford stronger empirical bases for disclosure requirements.

Many times businessmen complain about what seems to them to be an endless succession of additional requirements for disclosure and I must confess that certainly there sometimes appears to be a basis for this complaint. However, I would suggest that these expanded requirements are the result of very understandable factors and circumstances. In the first place, the art of financial analysis has become steadily more sophisticated, and as that has happened, analysts have had need for more information in order to make meaningful analyses. The fact that even the information which corporations now make available publicly is not sufficient in the eyes of some analysts is evidenced by the amount of time that both analysts and issuers spend meeting with each other supplementing (hopefully not with material information not disclosed to the public) that information which is otherwise available. Furthermore, as we well know today, economic conditions are in a constant state of flux and as these developments occur new kinds of information become necessary for meaningful analysis. For example, as interest rates have risen it has become increasingly important for analysts to know what the effective cost of money is to a corporation, with the result that we have required additional disclosure with regard to compensating balance arrangements and the cost of short-term funds. Similarly, as inflation has moved into double digits, we believe it is important that investors know the impact of this upon profits, so we suggested, but did not mandate (largely because of the interest of the

Financial Accounting Standards Board in the subject), that supplemental information be supplied concerning the extent to which inflation was resulting in inventory profits. Similarly, as new methods of doing business emerge, new problems of disclosure come with them. For instance, as leasing expanded, the Commission required disclosure of the capitalized amount of financing leases and the impact of income on capitalizing them. Furthermore, the concept of “materiality” is the subject of constant reassessment. In a fairly recent case, a Federal District Court indicated that that information is “material” which significant numbers of investors found meaningful in making investment decisions. One of the controversies which has attended our disclosure policy has been the extent to which information about environmental problems is material. While we have taken action to expand the disclosure requirements in this area, nonetheless there are those who wish that we would go even further. Their argument is very simple: to many investors it is a matter of transcendent importance whether an issuer is adopting affirmative policies with regard to environmental matters or is simply doing the minimum to assure legal compliance. Similarly, we have filed a complaint asking for an injunction against an issuer which had been involved in illegal political contributions, not because the amounts involved themselves were material in relation to the size of the issuer, but rather in the belief such conduct was material because of the insight it gave into the morality of management. Our investigation of similar matters is yielding a number of instances in which corporations have had long term practices of diverting corporate funds illegally. We think this is a matter of considerable importance to investors, even though the amounts may seem relatively small.

In determining what should be disclosed, we are constantly confronted with the necessity of a “cost versus benefit” analysis. I am sure that to many of you it appears that cost always loses. I can only give you my assurance that in every instance in which it is proposed that additional disclosure requirements be adopted, the Commission invariably asks the question as to the cost of securing the information and the extent to which it will be of benefit to investors.

The second continuing problem that we have is that of how information should be disclosed. This question manifests itself in a number of ways. One manifestation of it is the question whether information should be disclosed in financial statements or otherwise in disclosure documents. Through the years the Commission has generally taken the attitude that the accounting profession should be primarily responsible for the elaboration of accounting principles and for the format of financial statements, although through Regulation S-X the Commission has substantially influenced that format. In the not distant past we have had a difference of opinion with the Financial Accounting Standards Board concerning our respective jurisdictions. We have taken the attitude, which I think is confirmed by history, that while the Commission has deferred to the accounting profession with regard to the establishment of accounting principles, which generally involve the measurement of economic data, the Commission regards itself as paramount when it comes to matters of disclosure. Very often, the implementation of our concepts of disclosure involves expansion of data in the financial statements, particularly in the footnotes. In other instances, we opt for textual explanation, such as the new requirement that summaries of earnings in Form 10-K and registration statements under the 1933 Act include an analysis by

management of the significance of material changes from period to period in the amounts of items of revenue and expense in the summary of earnings and information about the impact of changes in accounting principles or practices and their application.

Also involved in the “how” of reporting is the question of complexity. We recognize that in many instances financial information as presently related is relatively incomprehensible to the average investor. We are constantly searching for means of providing to him, while furnishing to the analyst all of the data necessary to satisfy his professional responsibilities, simplified information which can be useful. Thus we now require in prospectuses the use of graphs and charts to show proposed uses of proceeds and other data.

The third continuing problem that we have is that of where information should be disclosed. Presently available to us in choosing the medium of disclosure are these documents: Form 10-K (the annual report required to be filed with the Commission which resembles in many respects a registration statement under the 1933 Act), the proxy statement, the annual report to shareholders, Form 10-Q (the quarterly income statement required to be filed) and Form 8-K (the episodic statements required to be filed upon the occurrence of certain events). The Commission’s powers with regard to Forms 10-K, 10-Q and 8-K are for all practical purposes unlimited and it is a very easy thing for the Commission to mandate that information be included in any of these. Similarly, the Commission appears to have virtually plenary power with regard to the contents of proxy statements. The problem is that all of those documents are legalistic, usually prepared with meticulous care by lawyers, and singularly unappealing to read. On the other hand, the annual report to shareholders is frequently

quite appealing, employs constructively all the arts of the public relations specialist, the printer, the photographer, the lithographer and the skilled writer. Until fairly recently, the Commission had a relatively “hands off” policy with regard to annual reports to shareholders and confined its regulation of them very narrowly. More recently, the Commission, with I might add the concurrence of an advisory committee appointed by Chairman Casey which included businessmen, lawyers, accountants and securities dealers, and the encouragement of many in business, as well as the New York Stock Exchange, has expanded significantly the information which must be contained in annual reports to shareholders. Among the additional information is an analysis of the earnings statements such as I discussed above, information about profitability and sales of lines of business, data about accounting principles and the consequences thereof, increased information about officers and directors and information concerning dividends and stock prices for the past two years.

A month ago we proposed that the proxy statement should include considerable information about the circumstances attending changes of auditors. The Commission is very concerned that auditors fulfill their statutorily assigned role of independent public accountants. We feel that the best way in which this can be accomplished is to assure that changes of auditors, and the reasons therefor when accompanied or preceded by disputes concerning the appropriate accounting principles to be used in reviewing a corporation’s financial statements, be fully known to shareholders so that they can determine whether management is seeking to “rig” the financial statements in a manner that is unacceptable to the auditors.

Also, the Commission has developed a concept of “differential disclosure” under which detailed data is included in the financial statements as a part of the Form 10-K and thus is readily available for use by skilled analysts (although I hasten to note that such information is available to any investor, not just professionals), while summaries of such information are contained in the financial statements appearing in the annual report to shareholders. In an ideal world, all investors would be Wharton Business School graduates and skilled in the arcane arts of financial analysis, and further all of them would receive all information concerning a corporation at precisely the same moment. Since we do not live in such an ideal world, we must cope with the world that we have and that is a world peopled by investors with varying degrees of sophistication and ability to cope with complex information. The needs of the less sophisticated must be met, as well as those of the financial analysts. Consequently, we are trying through this concept of “differential disclosure” to satisfy the needs of both groups. To further assure the equal availability of the more sophisticated information contained in the Form 10-K, we now require that corporations offer to make a copy of this filing available to any shareholder upon request without charge. Indications are that very few -- usually far less than 1% -- of the shareholders avail themselves of this opportunity when it is made available to them. Consequently, I doubt if anyone need fear undue expense in complying with this requirement. I might add that I for one would very strongly oppose mandating the furnishing of 10-K's to all shareholders, since in the overwhelming number of cases I am sure it would end up in the wastepaper basket and have no influence whatsoever on investment decisions.

Finally, the last question we cope with is when should information be made available? Corporate events do not wait to occur until a filing is due or the annual report to shareholders is about to be issued or a proxy statement is on the press. Corporate events in this economy occur swiftly, often unexpectedly, without warning. There is nothing in our statutory mandate, as I read it, which requires that regardless of all other considerations corporations must promptly disclose all material information. The Commission did in 1970 in Release No. 34-8995 urge very strongly that corporations adopt a policy of promptly disclosing material developments, both favorable and adverse, and noted the consequences which might flow from the failure to follow this policy, including, among others, exposure of executives and directors to liability for trading on material undisclosed "inside" information. However, the Commission has not otherwise adopted any rules or requirements that would compel corporations to make prompt disclosure. However, I would suggest that courts are increasingly developing the law in this area. First of all, in the case brought by the Commission against the Texas Gulf Sulphur Company in 1968, the Court of Appeals for the Second Circuit held that an issuer could be enjoined from further violations of the federal securities laws if it negligently prepared and issued a press release involving a material development. Furthermore, other courts have indicated that a corporation was justified in withholding disclosure of material information, but only if the information was withheld for sound business reasons -- in one case, in order to have time to buy up leases on adjacent land, in another in order to have an opportunity to check the accuracy of the proposed disclosure. I would suggest that in our economy in which so much emphasis is placed upon the integrity of the market place, the necessity

of informed markets, the social desirability of efficient markets which, as I indicated before, means informed markets, it is not unlikely that somewhere down the road a court is going to hold a corporation liable for its failure to make prompt disclosure of material developments when a sound business reason was not present. Consequently, it seems to me it would be a prudent management that would adopt a policy of making prompt, full and careful disclosure of all material developments whenever they occurred unless there were extremely compelling business reasons to refrain, in which case the moment such business reasons ceased to be of significance, disclosure should be made. The principal exchanges have indicated clearly the desirability of such a policy in protecting the integrity of their markets. Consequently, the answer to “when” should information be disclosed is twofold: (1) obviously, it should be disclosed whenever the rules of the Commission require it, and this means, particularly in the case of a Form 8-K, within the 10-day time limit after the end of a month in which a reportable event occurs; and (2) desirably as soon as possible after the event without awaiting the end of the month or some other time for a filing.

Finally, there is the question of meetings with analysts and equality of disclosure. Shortly after the decision of the Court of Appeals in the Texas Gulf Sulphur case, there developed a rash of statements by corporation managements throughout the country to the effect that this decision posed so many perils that they would thereafter decline to meet with analysts and would only disclose the absolute minimum required. Fortunately, and in some measure as a result of soothing words from the Commission, this tendency did not become epidemic and many companies which initially appeared to have adopted it retreated from it. The Commission considers meetings with analysts

desirable and necessary for the smooth functioning of our securities markets. However, the Commission strongly opposes disclosure to analysts of any material information which is not simultaneously made available to all investors. In my estimation -- and I would mention that there is perhaps some needless confusion about this -- availability does not mean simply that the company will give the same information to anyone who asks the same question as the analyst. Rather, if material information has been disclosed to an analyst, then it is incumbent upon management, in my estimation, to see to it that the information is promptly published for all to see and that the analyst is strongly warned against use of such information until it has been publicly disseminated. In making disclosures of material information, management should not discriminate among classes of shareholders. In one recent injunctive proceeding the Commission charged that information had been made available to analysts who called which would not have been available to ordinary shareholders who might ask the same question.

This has been a brief, much too brief, ramble through some of the thickets of disclosure. While, as I suggest, the Commission is amenable to a review of disclosure practices, nonetheless it remains persuaded that the disclosure which Congress made a matter of national policy in 1933 and 1934 has served investors well and continues to do so. This disclosure has succeeded because by and large, and overwhelmingly so, businessmen have recognized its benefits and have cooperated in its achievements. I would strongly urge that when the Commission proposes new standards for disclosure, it be judged not solely on the basis of the inconvenience and cost which may be occasioned, but on the broader basis of the benefit that such

additional disclosure affords the investment community and the integrity of the investment process.

We hear a great deal about the state of the markets, the absence of the individual investor from them, the desirability of expediting his return. I would suggest to you, without minimizing the importance of interest rates, inflation and the ruthless beating which all investors have taken in the market in the last year or two, that it is the grossest injustice to beckon the individual investor back into the market place without providing him with assurance that corporations will level with him and provide to him and his advisers, as well as to institutional investors, the fullest information available which will be material in investment decisions. Repeatedly we are told, and this is confirmed by formal surveys, that the small investor is convinced that large investors and institutional investors have informational advantages that are denied him. While I believe that investors will return to the market place when it seems apparent to them that there is money to be made there, I would also suggest that that return will be quicker, surer and more lasting if it is accompanied by a belief that there is a fair shake in store for everyone in the market place.