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"REQUIRED DISCLOSURE IN THE STOCK MARKET": THE OTHER SIDE

An Address By

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I have been asked this evening to discuss what information there is a "need to know." This is the sort of question that can be answered with frustrating generality - for instance, an investor needs to know that which is material to his decision to buy, sell or hold a security - or with insufferable particularity: he needs to know the amount of sales, cost of goods sold, the method of computing earnings per share, the lease commitments, the extent of compensating balance arrangements, and so on ad nauseam.

I'm going to sidestep the difficult choice of whether to deal with the question with particularity or in general and substitute for the advertised topic a broader, somewhat different, and perhaps today more important, question: does the investor need to know <u>anything</u>?

Increasingly there is question being raised concerning the fundamental assumption upon which our federal scheme of securities regulation has been built, that of disclosure. I would imagine all of us have some acquaintaince with the history of the Securities Act of 1933 - how Congress, confronted with the choice between a "blue sky" type of regulation which would put the federal government in the uncomfortable role of passing judgment on the worth or fairness of securities offerings, and a system of corporate disclosure akin to

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that found in England, opted for the latter.

The choice made in 1933, which was furthered in the Securities Exchange Act of 1934, and which has remained the touchstone of the system since then, albeit with sometime aberrations such as the Investment Company Act of 1940 which supplemented disclosure requirements with meticulous regulation, was for disclosure.

The choice was not then without its critics. Then Professor, later SEC Chairman and Supreme Court Justice, William O. Douglas said in connection with the enactment of the 1933 Act, "Those needing investment guidance will receive small comfort from the balance sheets, contracts, or compilation of other data revealed in the registration statement. They either lack the training or intelligence to assimilate them and find them useful, or are so concerned with a speculative profit as to consider them irrelevant."

The critics of disclosure are, in my estimation, more numerous and more vocal now than ever before. This criticism has many origins. For one thing there is, in the light of market events of the last few years, increasing disillusionment with so-called "fundamental analysis". More and more you read, as in a recent issue of Forbes, of the so-called "random walk" theory of Professor Malkiel of Princeton or the investment ideas of Professor James Lorie of the University of Chicago who says that it does not matter which particular stocks an individual buys, but rather what does count is the type of stocks he buys. And another source of criticism of the disclosure mechanism is the demonstrable fact that most individual investors - and perhaps some not so individual - rarely avail themselves of the information available in

Commission filings. Thus, it is contended, substantial cost is encountered without a corresponding benefit.

Professor Homer Kripke of the New York University Law School has been a persistent and effective critic of the present disclosure scheme and has faulted the Commission for apparently seeking disclosure directed to "everyman" instead of the professionals, for failing to sufficiently identify the behavioral characteristics of investors and their consequent informational needs, and for prohibiting from its filings forward looking information, such as forecasts of earnings, appraisals of assets and fair- or market-value accounting practices.

Quite recently, in the March 1973 issue of the American Economic Review, Professor George J. Benston of the University of Rochester mounted another attack, not so much perhaps on the principle of disclosure in general, as on the value of the disclosure scheme mandated by the federal statutes and implemented by the SEC. His viewpoints have been given wide popular circulation through an article by Professor Henry Manne, who is a colleague of Professor Benston at the University of Rochester, in a recent issue of Barron's. Professor Manne concluded his praise of Professor Benston's work by raising this horrible specter (one from which I shrink, so recently transported as I am from the practice of law with the expectation of returning some day to that life):

"The correct kind of studies [of the economic impact of securities laws on the public], of course, would have to come from economists, or at least from economists working in collaboration with lawyers. Securities lawyers as such simply lack the skills necessary to make reliable or authoritative findings about the economic benefits of most of this legislation.

"But that suggestion raises the dangerous possibility that the economists might come to the same kind of conclusions for other aspects of securities regulation as Benston reached. Then what would the securities lawyers do? Even to the non-economist, one statistical conclusion is readily apparent in the securities files. There is a very high positive correlation between the complexity of the securities laws and the income of the securities bar."

I for one think it is good that this fundamental premise of our regulatory system be reviewed and criticized. After all, forty years have passed since its initiation at the federal level and in that time we have foregone a number of other touchstones that once seemed as sacred and sure as disclosure. It is imperative that, even if there is a renewed conclusion that disclosure as a premise, a philosophy, serves a useful public purpose at a tolerable cost, we constantly seek to refine our understanding of its role, its effectiveness, its utility; we must constantly seek means of making it more meaningful and useful. That I think we can confidently say the Commission has been doing at an accelerating rate since the publication of its study, Disclosure to Investors, the so-called Wheat Report, in 1969. Revisions and extensions of the disclosure requirements of the Commission have since then been tumbling out of the Commission and there is more to come. Much of this results from a critical on-going study of what the investor does need to reach intelligent, informed investment decisions. I would confess that many of our judgments concerning this are not founded in empirical research, but there is considerable evidence in support of our conclusions, much of it from security analysts who are the most sophisticated and increasingly perhaps the most influential students of what is needed by way of disclosure. I assure you we do not operate wholly in the dark.

But back to the fundamental question: is the disclosure system developed and enforced by the Commission useful and worth its cost? Does it give any benefit to the investing public, to the economy at large? Without suggesting that there is not still much more to be said on the other side of these propositions, I would like to offer a tentative affirmation of its utility and discuss wherein I think criticisms such as Professor Benston's, echoed by Professor Manne, are simply wrong.

Professor Benston's method of criticism consists of extensive statistical analysis and the utilization of what to me, a non-economist and non-mathematician, seem to be horribly complicated formulae which seek to prove that there has been no benefit deriving from the federally mandated system of disclosure. I claim no expertise in the particulars of that type of analysis; however, I am convinced that you simply cannot compress the complexity of our securities markets and the multitude of investor decisions into such formulae. In many respects each security has characteristics unique to itself; similarly each investor has a uniqueness. The investment decision of each investor is complex, varied, subject to manifold emotional, intellectual, judgmental influences, varying degrees of information and ignorance. I believe, and I am told by those more attuned to the sort of analysis Professor Benston has sought, that all these variables simply cannot with today's methods be compressed into the compact formulae which stud his work. Let me hasten to add, though, that I am sure there are analytical studies which can be developed which can give us greater insight into the operations of the market and I would hope that both the Commission's staff and private scholars continue to pursue them; I only urge that we avoid claiming too much for them.

A further major weakness in Professor Benston's approach is that he applies very narrow findings broadly to the entire disclosure system. Even if there were not problems in his methodology, and I believe there are, this destroys his arguments. His findings relate only to the securities listed on the New York Stock Exchange; to a one-year period; and to the information in only one of the many required reports, the annual report on Form 10-K. He disregards, among other things, the other exchanges, the over-the-counter markets and requirements for filing interim financial reports and reports of material events. Perhaps Professor Benston's approach is in accord with accepted economic methods. However, Gunnar Myrdal, the distinguished Swedish critic of our economy and society, believes that the syndrome of modern economists who defend their theories by expressing circular arguments in elaborate mathematics will pass and "that much that is now hailed as sophisticated theory will in hindsight be seen to have been a temporary aberration into superficiality and irrelevance."

Professor Benston criticizes the utility and timeliness of the reports required under the 1934 Act by analyzing the movement of security prices during the periods before and after filings. I submit that is fighting a straw man. Everyone knows that the income per share in the Form 10-K of a reporting company does not strike the financial community like a thunderbolt when the Form is filed. It has become known weeks before - and when it did it impacted market prices if earnings reported contradicted expectations; this we know from everyday experience. Why have the Form 10-K filing at all, then, if the guts of the disclosure has been released earlier? There are many reasons. For one thing, the knowledge that a report is going to have to be filed which could result in significant liability will discipline the earlier disclosure and assure its integrity. Further, the Form 10-K provides an abundance of additional information and detail that permits the percolation through the market place of information that permits the testing of the earnings figure as an indication of results which may be expected in the future - and analysts often say that the principal value of historical earnings is what they tell of the future and that their "quality" is of utmost importance. Furthermore, the practices mandated in Forms 10-K, 10-Q and 8-K provide a powerful stimulus - albeit in some instances not powerful enough - for fuller disclosure through press releases and annual reports. The requirement of line of business reporting in the Form 10-K has resulted in a year-after-year increase in the number of companies which voluntarily report on a segmented basis in their annual reports in the same manner in which they report on Form 10-K to the Commission.

Professor Benston uses the same empirical method analysis to prove that the disclosures mandated by the 1934 Act have not been effective in preventing fraud and manipulation. First, of course, there is an inherent difficulty in proving such a negative: none of us knows the frauds that would otherwise have been perpetrated had there been no need of disclosure, and no amount of computer or algebraic analysis will ever uncover those lost occasions for investor distress. Professor Benston further denigrates the effectiveness of disclosure in defeating fraud and manipulation by recounting some recent scandals - BarChris, Yale Transport, Continental Vending, Green Department Store. There is no question that there continue to be frauds, despite forty years of federal effort, but once more this says nothing concerning what the incidence of fraud and manipulation would be had there been no disclosure requirements.

One other thing should be said about manipulation. Most manipulations are not amenable to the therapy of disclosure. The 1934 Act style of disclosure - directed at facts concerning the finances and business of issuers - is not designed to compel letting the sunlight in on such practices as phony orders, improper short selling activity, and the rest of the devices that still occasionally emerge from their musty holes. However, even here the Commission is moving forward forcefully to bring into the open more about market and trading activity. In connection with soliciting public comments on the appropriate utilization and dissemination of undisclosed material information, we raised issues relating to the subject of market related information, among others. Some of the questions we asked were: "Whether and to what extent selected, non-public knowledge about the existing or future markets in particular securities should be treated as material information which must be disclosed by securities professionals or other persons prior to any transactions in those securities" and "The appropriateness of utilizing non-public material information directly related to the future market for a given security, which does not emanate from or concern the issuer of that security."

Furthermore, there is now disclosed in the prospectuses of issuers going public for the first time information concerning the amount of stock that may thereafter overhang the market as a consequence of the "freeing" up resulting from the combination of the registration statement and Rule 144. Also the Commission is presently developing legislation intended to compel disclosure by institutions of their holdings and their transactions, thereby affording to individual investors considerable trading market information that may be important to their transactions. This information and other proposals that are being considered can be significant deterrents to the would-be manipulator. And when the Commission adopted Rule 144 to establish more objective criteria for permitting secondary trading transactions in restricted securities, it recognized the need for informing the market as to the potential impact of sales made pursuant to that Rule. A reporting requirement, therefore, was incorporated in that Rule.

Moreover, there are examples where large losses to investors have been prevented because of the existence of a balanced disclosure system stringently but fairly enforced. No one who has read the Commission's Staff Report to the Congress on the financial collapse of the Penn Central Company will ever forget the courageous stand taken by an attorney representing the underwriters of a proposed Penn Central debenture offering. The insistence by that attorney, whose frame of reference was the disclosure provisions of the securities laws, on full and fair disclosure in the offering circular resulted in the cancellation of the offering and probably saved investors from pouring additional millions into that fatally ill enterprise.

There is also a related, more indirect benefit from disclosure which is often overlooked. Full and fair disclosure results not only in the prevention of fraud, but it reduces conflicts of interests, deters questionable practices and in the words of the Supreme Court, assists in achieving " a high standard of business ethics in the securities industry." Experienced securities lawyers are well aware of the "clean up" or "house cleaning" effect that results from the requirements to disclose transactions with insiders in registration statements covering public offerings of securities. And how frequently has the lawyer representing the public company witnessed the aborting of a proposed questionable transaction involving a registrant and an insider because it would have to be disclosed either in the Form 10-K or the proxy statement? Bayless Manning, formerly Dean of Stanford Law School, recognized this effect: "I believe more members of corporate management are today alive to a perception of themselves as fiduciaries, in substantial part because SEC filing requirements serve as frequent and recurrent reminders. The working lawyer who deals with clients in this field also regularly sees instances in which the prospect of disclosure, the prospect of the necessity of reporting, significantly affects management conduct - and certainly not just in situations of potential fraud or illegality." Conflicts of interest and questionable business practices exposed to public view have what Mr. Justice Frankfurther termed "a shrinking quality."

Professor Benston suggests that a voluntary system of disclosure could be quite sufficient and points to voluntary disclosure practices or disclosure pursuant to contractual agreements with the stock exchanges prior to 1934. I cannot agree that a situation where 38 percent of the issuers with securities listed on the New York Stock Exchange failed to disclose their sales, disclosure that even Professor Benston agrees is important, represents adequate disclosure. Nor is a situation where 54 percent of the issuers failed to disclose their costs of goods sold, disclosure which the federal courts in early challenges to the disclosure requirements adopted pursuant to the Congressional mandate in the Exchange Act found in the public interest, sufficient disclosure.

We have had recent experience with the argument that voluntary disclosure should be permitted in lieu of Commission requirements. Our efforts to improve disclosure of the contribution of various lines of business to a company's operating results, or what accountants refer to as segmented reporting, is a striking example. The Commission, when it proposed amending its 1933 Act registration forms in 1969 to require this disclosure, was met with the argument that an increasing number of companies were already voluntarily disclosing this information in their annual reports to security holders, and that this should be sufficient, particularly if the trend continued. However, the fact remains that when some companies were reporting information of this nature and some were not there was an element of unfairness and possible competitive disadvantage to those who were reporting. Moreover, the lack of uniform standards for reporting prevented comparability between those who did report and those who did not and thus hindered informed investment decisions.

The Commission was not persuaded and adopted requirements for line of business reporting in its principal registration forms and later in its 1934 Act reporting form, Form 10-K. The indications are that voluntary lines of business reporting did not improve to the extent its supporters argued it would. Despite the urgings of the Commission, analysts, the American Institute of Certified Public Accountants and others, and despite the prod provided by the necessity of spreading on the public record in the Form 10-K sales and profits of various lines of business, a recent survey indicated that in a random sampling of 70 multi-line companies which detailed earnings by product or line of business in the Form 10-K, only 45 broke them down in the annual report to shareholders and only 33 of the breakdowns were similar in both the Form 10-K and the annual report.

The Industrial Issuers Advisory Committee in its December 1972 report to the Commission recommended that the Commission require annual reports to security holders to include line of business disclosure consistent with that required in reports on Form 10-K. Our staff is presently engaged in drafting the necessary rules to implement their recommendations for submission to the Commission for its consideration. The Commission, however, has not taken a position with respect to this or any other of the Committee's recommendations. In the interest of full disclosure, I should tell I was a member of that Committee. I should also reveal that the Committee recommended that the Commission's staff review the results of line of business reporting pursuant to the Exchange Act reporting requirements with a view to providing more specific guidelines for defining such lines of business. One of the reasons for the Committee's recommendation was that professional analysts had expressed dissatisfaction with the existing definitions of lines of business.

I think many critics of the disclosure system unwittingly promulgate a misconception, namely, that the totality of the federal disclosure system is somehow or other bounded by the terms of the 1934 Act. The truth is that is only one element of the total pattern. In many respects the 1934 Act and the requirements of the Commission adopted under it have been the goad, the yeast, the stimulus to a multitude of developments in disclosure. Rule 10b-5 has been a medium through which the disclosure requirements have been reinforced and extended. Likewise, the exchanges have continued their efforts to make disclosure more timely and meaningful. The system is a system, a carefully worked out, interrelated series of statutory provisions, rules, disclosure forms, guidelines, interpretive releases, all supplemented by the efforts of the self-regulatory agencies. And I think increasingly this effort is further reinforced by the convictions of many managements that full and timely and candid disclosure is not only legally safe and wise, but has economic merit as well. Certainly, the manner in which the market has treated the securities of issuers whose lack of candor was publicly exposed should be a grim warning of the consequences of anything less than complete honesty with the investment community.

By confining himself to the periodic reporting requirements of the 1934 Act, Professor Benston has particularly ignored the salutary influence of the proxy rules adopted by the Commission pursuant to the Congressional mandate contained in the Act. Through this means shareholders are afforded important information concerning their corporation Merger proxy statements particularly, and now with Rule 145, registration statements on Form S-14, prepared in accordance with our proxy rules provide timely and informative disclosure to those who are called upon to make critical investment decisions, and this information continues long after the transaction to have utility and value in the market place. Professor Benston has concluded that reports filed under the Exchange Act are not informative because of conservative accounting principles applied in the preparation of financial statements and a failure to permit forward looking information such as projections of sales or earnings. However, merger proxy statements are more likely to contain discussions of the merits of a deal and opinions as to current value of assets and other matters than other 1934 Act disclosure documents.

Furthermore, through the proxy rules the Commission has required submission of annual reports with specified financial statements to shareholders. As mentioned earlier, the annual report has been strongly nudged toward fuller disclosure through the reporting requirements of the 1934 Act. In addition, the Commission, once diffidently, now more confidently, is moving in the direction of requiring fuller disclosure in annual reports. The Industrial Issuers Advisory Committee has urged the Commission to press more strongly for the incorporation of more information in the annual report and the New York Stock Exchange in its yet to be released "White Paper" on disclosure is rumored to be pushing in the same direction.

Critics of the disclosure system ignore one of the most important ongoing benefits of the 1934 Act scheme: the creation of an increasingly available pool of detailed information concerning issuers that has been prepared under the powerful stimulus of possible civil, administrative and sometimes criminal liability. It is this pool that investors and their analysts use in making assessments of the individual securities and in drawing broader conclusions concerning industries. This pool of information also serves as a check on the overoptimism of securities brokers. They should and often do consider this information in making recommendations to their customers. Would this pool be as extensive, would it be as accurate, would it be as useful, were it not for the mandates of the 1934 Act? I doubt seriously whether it would be.

Of utmost importance in assessing the critics of Commission policy is the ongoing effort of the Commission to refine and make more useful corporate disclosures. The Commission has been criticized for not permitting forward looking information in 1934 Act reports so as to permit an assessment of the merits of the investment in that security as compared to other securities. Earlier this year the Commission announced its intention to reconsider its long standing policies regarding disclosure of projections of sales and earnings in filings under the securities acts. It indicated that it has no present intention of compelling issuers to prepare and to file projections. However, if an issuer with an adequate history of earnings and budgeting experience voluntarily wants to include carefully prepared, reasonably based projections of sales and earnings covering a reasonable future period in filings pursuant to the securities acts, the Commission saw no reason why he should be prevented from doing it. Our staff is hard at work preparing the rules and forms necessary to accomplish the Commission's announced intentions. They are also working on a rule that would clearly indicate that a carefully prepared and reviewed, reasonably based projection is not a guarantee of future performance subject to liability under the securities laws if it does not ultimately prove accurate. It will be recognized that a reasonable projection is not a guarantee of results.

The Commission has also adopted a number of recent amendments to the registration and reporting forms under the securities acts which would require more meaningful disclosure of a company's competitive position in its industry, the background of its management and the status of the development of important products or new lines of business. We have also proposed an amendment to the guides for preparation and filing of registration statements and a new 1934 Act guide which would require improved disclosure of the nature of the issuer's earnings, including the effects of significant changes in accounting policies.

Moreover, those who are familiar with the recent outpouring of releases from the Commission relating to such matters as lease disclosure; disclosure of the nature of income tax expense; disclosure relating to change in account principles; accounting for real estate transactions and business combinations and disclosure of the details underlying material charges and credits to income would challenge any assertion that we are taking a conservative approach to financial disclosure.

Our staff has taken steps recently to bring to the attention of those subject to the Commission reporting requirements the need for reporting securities transactions promptly. Prior to the staff's efforts the delinquents numbered in the hundreds. The Commission also has taken the lead in encouraging the prompt reporting and dissemination of material information by issuers. We and the major stock exchanges have encouraged prompt reporting of material corporate developments prior to the time reports are required to be filed with the Commission, and the exercise of greater diligence in release of financial information for annual and interim periods. We recognize that the care and effort which goes into the preparation of a statutory filing may preclude its being filed immediately after the basic information is available. However, this does not prevent prompt announcement to stockholders, the press and any appropriate self-regulatory organization.

The Commission also has taken steps recently to foster and, if necessary, enforce the statutory reporting requirements. During the past few years, we have increased our enforcement activity to compel timely filing of required reports, and administratively our staff generally will not process registration statements covering public financings if required reports have not been filed.

We recognize that all this information will be of little use if it is not readily available to investors. Therefore, we have attempted to encourage wider dissemination of the information in our files. This can be accomplished in part by greater use of the microfiche system which provides prompt access to information in our files to institutional users. Improving the content of the most widely disseminated disclosure document, the annual report to security holders, will also serve this end.

These continuing efforts to improve the timeliness and quality of disclosure under the securities acts are designed to promote investor confidence. I do not believe investor confidence can be measured empirically. It is a matter of subtle psychology. Investors should be assured that they are receiving the information necessary to make informed decisions. Perhaps even more important they want assurances that they are being treated fairly and information not available to them is not being "bootlegged" to favored persons. This concept of fairness was one of the stated bases for the Commission's determination to permit certain issuers to include projections of sales and earnings in filings under the Securities Act.

Finally, we can look at the experience of other nations whose disclosure systems and capital markets have not reached the stage of development that ours have. It appears that these nations recognize that a well developed disclosure system is necessary for a sound capital market. Among others, even Great Britain, a pioneer in disclosure, is seeking to improve its comprehensive disclosure laws. Her Majesty's Government, in a recently published White Paper, gave as one of its reasons for proposing a new Companies Bill that "there has been growing appreciation of the need for fuller disclosure of information by companies both as a spur to efficiency and as a safeguard against malpractice." I agree with her Majesty's Government.

When all the polemics among the mathematicians, the economists, and the Commission (both the staff and members) are concluded, I think there stand out several of the most telling justifications for the policies which have characterized federal securities regulation for four decades. The capital markets of this country, despite set backs and traumas, are the soundest in the world and have provided the means of creating billions of dollars for economic expansion. Few will dispute that this has been made possible because of the confidence that investors have in the integrity of the markets and the issuers who have raised money in those markets. I think it would be rash to suggest that this integrity is not in very large measure the consequence of the disclosure system that we have established. Certainly this is the conviction not only here but abroad. Throughout the world nations are calling upon Commission personnel and other experts in American securities law to assist them in developing systems of disclosure that resemble very closely the one we have developed in this country.

If imitation is the sincerest form of flattery, then indeed we should be flattered. But I submit that imitation is more than flattery: it is also an acknowledgement that our approach has been a sound one.

As I indicated earlier, I think businessmen in this country are with rare exceptions persuaded of the value of our disclosure system. They may bridle at this particular or that demand; they may on occasion complain of what they view as unwarranted bureaucratic interference in their affairs, but I believe that most of them know full well that their expansion has been able to be financed out of the capital markets of this country in large measure because of the investor confidence created by the public conviction that it is investing knowingly and that the deck is not stacked against it.

To be sure, disclosure has a cost: accountants, lawyers, and the others who are involved in the process have to be paid. I believe, however, that this cost is minimal in terms of the economic and social benefits which have accrued from the vigor of our capital raising system of this country.