NEWS

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IS THE SEC ANTI-BUSINESS?

An Address By

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When John Bartels wrote to ask me to stop by for lunch and say a few words, he mentioned several topics of possible interest. Nestled among a list of five was this little honey -- "Is the SEC anti-business?" I have puzzled over the question ever since.

It is not the answer that has been puzzling. The answer is easy -- NO. The puzzle is what led to the question. What have we said or done that would generate a feeling that the Commission as a whole, or any significant part of it, is against business in general? And what is being "anti-business," anyway? Obviously, we are against certain types of business activity, but so are most people. We are against fraud, violations of the law, improper financial reporting, self-dealing to the detriment of investors -- all those things. But being "anti-business" must mean being against our system of private enterprise, as opposed to a system of government ownership, or increased direct government control over, business activities, and that we are not and never have been.

On the contrary, I suppose more than almost any other agency of government, we are devoted to the preservation of a system of non-governmental ownership and management of economic activity. As an agency, we owe our very existence to this system, and, among other things, we have no secret, psychopathic longings to commit suicide by contributing to the disappearance of our reason for being.

What have we done that suggests otherwise? Considering publicly-owned companies in general, and not the particular problems of the securities industry, we have challenged false and misleading financial reporting. We have worked to improve the quality of all corporate reporting to more nearly achieve the ideal of providing investors with the information they need to make investment decisions and exercise their franchise as voting shareholders. We have asserted the view that corporate activity which violates our laws is something investors ought to know about, unless it is no more than trivial. We think the hazards, in addition to the ethical quality, of procuring material amounts of foreign business through bribes, fixes, and kickbacks, likewise of substantial interest to investors, and so on.

All of this may be "anti" the behavior of a particular business company, or "anti" a particular business practice, but it is not anti-business. It is pro-business. It is pro-business because it contributes to the confidence of investors and the public that they know what business is doing, that business is being managed in accordance with the fidicuary obligations appropriate to those who handle other peoples' property and money, and that business is law-abiding and not contributing to corruption.

The truly anti-business attitude is one that maintains that company managers must cheat, steal, lie and cover-up in order to be successful. If a system of private ownership and management means that, it is not going to survive very long in the atmosphere of our times. But it does not mean that -- not at all. Most businessmen want to operate in a manner true to their trust, in accordance with the law, and in accordance with high ethical and moral standards. We must maintain an environment where this conduct is the road to success by eliminating any competitive pressure to behave otherwise.

All of this is not to say that every particular thing we do should be welcomed by business in general, or certainly that every thing we do is right, or the best thing we could do. But let me discuss several things we recently have done or propose to do that will be of interest to you.

We have proposed to permit, under certain circumstances, disclosure of projections or forecasts of earnings in filings with the Commission by publicly-held companies. We also recently proposed rules which would require certain companies to identify the beneficial owners of their securities in reports filed with us. We have amended our proxy rules to require additional information in annual reports to shareholders. And just this week, we published for comment proposals to make

certain of the Commission's short forms for registration of securities available to a larger number of issuers, and we adopted new rules which we believe will result in substantial improvements in interim financial reporting. All of these actions, as well as others we have taken or are contemplating, represent significant steps toward our goal of maintaining and increasing investor confidence in American business and our capital markets.

Our recent proposals relating to projections represent an attempt on our part to bolster confidence in the fairness of our securities markets, by providing some assurance to investors that others participating in the markets do not have the unfair, and sometimes unlawful, advantage of receiving information about a given company's future prospects which is not available to the public. While some commentators have questioned the wisdom of certain specific details of our proposals, few disagree with our objective: to assure that if management's assessment of a company's future performance is disclosed to some investors, it is disclosed to all, whether they be large or small.

To accomplish this objective, we have proposed a rather elaborate disclosure system which would require, among other things, that documents be filed with the Commission to report the disclosure of a projection, its revision or its abandonment.

In brief, we proposed that if an issuer releases a financial projection to any person, with certain limited exceptions, the issuer would be required to file a current report on Form 8-K within ten days of the initial disclosure. An 8-K also would be required to be filed if the projection were revised, or if the issuer decided to discontinue issuing projections. And, unless and until an issuer determined to discontinue issuing projections altogether, it would be required to continue to provide, and to update, its projections to investors through its annual report to shareholders, in its annual report on Form 10-K, and in registration statements for offerings of its securities. This is where we have encountered the most disagreement with our proposals.

Numerous commentators have pointed out that inclusion of information, particularly information likely to have a significant market impact, in filings with the Commission is an inefficient means to disseminate such information to the public. Others have said that our proposal is insufficient to insulate a company from possible liability under the anti-fraud provisions of the federal securities laws, which as you know generally prohibit a publicly-held company from making false or misleading statements. Some contend that our proposals, as presently drafted, are so complex and burdensome that few companies will voluntarily take advantage of the

opportunity to use our disclosure system as a means to disseminate projection information to investors, and, indeed, that the great majority of companies will go to extremes to avoid doing so. Some persons even have suggested that the inevitable result of our proposals will be a "blackout" of information communicated to the investment community, and they point to several surveys to support their conclusion. In the words of one commentator: "This Mississippi of information will be reduced to a rivulet."

While some of the fears expressed seem a bit overstated, they raise a legitimate question whether our proposals, at least if adopted in their present form, would be counterproductive to our goals. We certainly do not want and did not intend the unhappy results which have been suggested to us. But, we are trying to deal with a troublesome problem -- the selective dissemination of information which is highly significant to investors. And, despite the urgings of those who want us to abandon this project and simply rely instead on the prohibitions of Rule 10b-5, we intend to continue our efforts to formulate a workable proposal.

Turning to another of our proposals, there has been renewed interest in "Who Owns Corporate America?" In addition

to concerns expressed by certain members of the Congress, and others, as to the role of institutional investors in corporate affairs, a considerable number of bills have been introduced during the last several sessions of Congress which deal with foreign ownership of American corporations. Undoubtedly, many of these bills have been inspired by the fear of foreign control of domestic companies, which has been heightened by the rapidly changing world economic conditions we have been experiencing in recent years. Some of these bills would forbid all foreign control of domestic companies; some would establish procedures to screen proposed foreign takeovers; others would require disclosure of all foreign ownership, or various combinations of the foregoing.

Regardless of the approach taken, however, this type of legislation involves sensitive national policies. For example, any deterrents to foreign investment in the United States could have an adverse impact on the future ability of U.S. corporations to raise capital, and impair the depth and liquidity of the trading markets. And it could lead to the enactment of protectionist measures by other countries which would impair the ability of United States companies to raise or invest capital abroad.

Against this background of Congressional concern and increased public interest in foreign and domestic ownership

of public companies, the Commission last fall ordered a Public Fact-Finding Investigation in the Matter of Beneficial Ownership, Takeovers and Acquisitions by Foreign and Domestic Persons, to determine whether we should exercise our rulemaking authority under the Securities Exchange Act, or recommend legislative changes in order to bring about additional disclosures of corporate ownership.

On August 25th, the Commission published a series of proposals relating to disclosure of the identity of beneficial owners and record holders of voting securities of publicly-held companies. These include a rule which would provide standards for determining who is a "beneficial owner" for purposes of triggering the ownership and tender offer reporting requirements, as well as for purposes of disclosing principal shareholders, as is required by various reporting, registration and proxy forms under the Securities Act and the Securities Exchange Act. Under our proposal, a beneficial owner of securities would include a person who has or shares the power to direct the receipt of dividends or the proceeds from the sale of such securities.

In addition, these proposals would require additional disclosure in connection with a tender offer for, or sizeable acquisition of, securities. The disclosure would relate to the nature of the beneficial ownership and would identify other beneficial owners of the same securities and the record holders

of the securities reported on. The proposals would also permit filing of one document reporting different owners of the same securities; would deem certain persons, including members of a group, who become beneficial onwers of securities through non-purchase transactions to have "acquired" such securities for reporting purposes; would provide a short-form acquisition notice to be used by certain persons, particularly financial institutions, who acquire securities in the ordinary course of their business and not for purposes of control; and would provide an exemption from the filing requirements for certain underwriters who acquire securities in the ordinary course of a firm commitment underwriting.

In addition, the Commission proposed to add an item to the various reporting, registration and proxy forms under the Securities Act and the Exchange Act calling for disclosure of the identity of all beneficial owners of more than five percent of a class of voting securities, including their names, nationality, and the nature of their ownership. The proposed definition of beneficial owner I mentioned earlier would apply for purposes of this disclosure item. Disclosure of the aggregate beneficial ownership of securities by management of the issuer also would be required, along with disclosure of certain pledge agreements.

The Commission also proposed to include another item, in various reporting, registration and proxy forms, which would require disclosure of the thirty largest record holders, subject to a de minimis exception, of each class of an issuer's voting securities, as well as their voting authority. If the record holder had no voting authority, the owners of the ten largest blocks of securities held of record by such record holder would have to be disclosed, to the extent known. If the reporting company had a parent, similar information would be required to be disclosed about the record holders of the parent's securities.

Just as important -- if not more so -- as our proposals to require disclosure of additional information in filings with the Commission, are the steps we have taken to assure that investors receive, and have an opportunity to examine, significant information included in the reports filed with us. So, last fall, we amended our proxy rules to require that additional information be included in annual reports to shareholders, primarily because the annual report seems to be the best available vehicle for providing information to investors on a regular basis, and in a readable manner. As a result of those rule changes, annual reports to shareholders now must contain a minimum quantum of meaningful business and financial information, almost all of which previously was required to be filed with the Commission in reports on Form 10-K.

Most large, publicly-owned companies now must include at least the following information -- in any form deemed suitable by management -- in their annual reports to shareholders:

> certified financial statements for the last two fiscal years;
>
> 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;
>
> 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;
>
> 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;
>
> the name and principal occupation or employment of each director and executive officer of the company;
>
> 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.

Our rules permit management as much flexibility as possible in communicating effectively with shareholders through the annual report. The rules make 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 in the rules encourages 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.

To date, the Commission's staff has not conducted any extensive survey of the degree of compliance with the new proxy rules. But the annual reports that have come to my attention have generally complied with both the spirit and the letter of the Commission's rules. And I believe that the vast majority of the Commission's rules with respect to annual reports are not overly burdensome and, in fact, merely reflect the standard practices of many well-run companies. The additional disclosures have not made annual reports worthless, as was suggested by some commentators at the time we initially proposed these changes, but instead have made annual reports more worth reading.

The Commission also recognized that certain shareholders would be interested in more detailed information about a company's business and operation than would be included in the annual report, even under our new rules. And so we require that the annual report to shareholders, or the proxy statement, contain an undertaking to provide, without charge,

a copy of the company's annual report on Form 10-K or 12-K, except for the exhibits thereto, to any security holder as of the record date. Companies also must undertake to make copies of the exhibits to their Form 10-K or 12-K available to shareholders, but they may charge a fee covering their reasonable expenses for doing so. Some companies include the Form 10-K in their annual report. A few companies file the 10-K in the form of an annual report, which is fine with us.

The matters I have discussed thus far generally relate only to one area of concern to investors -- that is, improved disclosure of accurate and current information about issuers of securities. But, equal in importance to investor confidence is the manner in which the capital markets serve the needs of issuers. The Commission believes that issuers deserve efficient means for capital raising. To the end, the Commission has tried to simplify the registration requirements while maintaining adequate disclosure.

As you probably know, in 1970, the Commission adopted the current short-form registration statement, Form S-7, under the 1933 Act. The idea was to establish a means by which certain companies might satisfy the registration requirements without continually being faced with the full-blown registration process, otherwise required of companies going public for the first time.

To assure that the short-form registration statement would be available only in appropriate circumstances, the Commission imposed rather stiff conditions as prerequisites to the use of the form. Among other things, we required that the company have been subject to the periodic reporting requirements under the Securities Exchange Act of 1934 for at least three fiscal years, that the company have maintained a record of substantial earnings for the prior five years; and that there have been continuity of the company's management for the last three years.

The requirement that the issuer have been subject to the 1934 Act reporting requirements for the prior three years reflected a new disclosure concept: that the continuous disclosure obtained through the periodic reporting requirements under the Exchange Act should be considered, in certain circumstances, to be roughly equivalent to the disclosure requirements of the Securities Act, and that issuers meeting the tests for Form S-7 could be assumed to have made such adequate disclosures in reports and proxy statements filed over the years pursuant to the 1934 Act.

This basic idea of simplifying the 1933 Act registration requirements, in reliance upon the disclosures already and otherwise obtained pursuant to the 1934 Act, was carried one step further in 1970 through the adoption of Form S-16. This form is probably the ultimate step in integrating the 1933 Act with the 1934 Act. A typical Form S-16 prospectus is only about four or five pages long, but does incorporate by reference a considerable amount of material filed under the 1934 Act. Basically, S-16 is available only to issuers which meet the conditions I have described above relating to Form S-7. And, it may be used only for particular types of transactions -- namely, those in which an existing security holder of the company is making a registered secondary offering, or in which the company issues securities in exchange for its outstanding warrants or convertible securities.

Despite concern in some quarters that a few issuers may wish to use Form S-7 to avoid further dissemination of embarrassing or unfavorable information, the Commission believes that the overwhelming number of issuers who meet the standards for use of the form, and who regularly file information under the 1934 Act, deserve a less burdensome form of 1933 Act registration. Accordingly, this week the Commission determined to issue for public comment new proposals to amend Form S-7 to further relax the conditions for the use of this form and to make it available to a larger number of companies.

The principal condition on the use of Form S-7, which we propose to relax, is the income test. At present, the registrant must have had net income of at least $500,000 for each of the last five years. We propose to reduce that to $250,000 for the last three years, but to continue to require audited five-year financial statements, which include audited statements of income and source and application of funds, in the prospectus.

We also propose to eliminate the requirement that the registrant have had income for the last five years adequate to cover dividends paid. And, we propose to modify the present requirement that the issuer not have defaulted in the payment of any dividend or sinking fund installment on preferred stock, or in the payment of any principal, interest or sinking fund installment on debt, or in the payment of rentals under long-term leases during the past ten years. Issuers who have had no such defaults during the past three years will now be permitted to use Form S-7.

As a result of the proposed changes in the S-7 standards, our Form S-16 also will be available to a larger number of companies, since one condition of the use of Form S-16 is that the issuer meet the S-7 requirements.

On September 10, the Commission also adopted new rules which will make substantial changes in interim financial reporting -- an important element of the continuous reporting process under the Securities Exchange Act. We extended the financial statement requirements of Form 10-Q to require the filing of summarized financial statements quarterly. This will enable investors to see a quarterly balance sheet and funds statement, where previously neither were required. In addition, a full income statement will be included, instead of limited sales and profit data.

Our new rules also require that certain limited quarterly data be included in the annual financial statements of large companies, whose securities are actively traded. This information will enable investors to see trends within a year and to obtain a better understanding of seasonal and other variations in the issuer's business. Our rules will require independent accountants to be associated in a limited fashion with quarterly data, even though the note may be labeled "unaudited," since professional standards require certain steps to be taken whenever unaudited data accompanies audited financial statements. This auditor involvement was perhaps the most controversial aspect of our proposed rules and received the greatest amount of comment, both in written

responses to our two proposals and in the public hearings which we held in June. And, after careful consideration of costs and benefits which likely would result from our proposals, we decided to adopt rules which would require auditor involvement with interim data only in the case of large listed companies.

We concluded that the involvement of auditors would improve systems of quarterly reporting and that their expertise would lead to better solutions to interim reporting problems. In addition, we believe that annual audits will be improved by the increased analytical work undertaken, and that, as a result, problems might surface in a more timely fashion, rather than at year end. Finally, we believe our rules will enhance the auditor's and the client's recognition that the public responsibilities of the independent accountant are not limited to an annual visit, but include some concern with all public financial reports of a client for whom the accountant is "auditor of record." While costs will not be trivial, we believe that with improved planning of annual audits and the integration of interim and annual auditing procedures, the incremental cost will not be very large, particularly after the first year. As we observe the results of these rules in action, we will appraise the desirability of changing them or extending them to a larger group of registrants.

In adopting these rules, we emphasized our desire that the standard-setting bodies of the accounting profession develop appropriate standards for auditor association with interim results. While we have proposed standards and procedures which we are prepared to adopt to give guidance to auditors, we expressed our willingness to withdraw these proposals if the AICPA's auditing committee comes up with adequate standards. We have been assured that this is likely to happen, and we hope that it will.

We can reach our goal of investor protection and the maintenance of confidence in the market, and, at the same time, make investors' money reasonably accessible to issuers, but the balancing process the Commission must go through to achieve this goal represents one of the most difficult tasks we face. The Commission is committed to preserving our free enterprise system, but the system will only remain viable if there is public confidence in that system. Corporate disclosure is an important element of the process, and I hope that the actions and activities of the Commission I have mentioned today will make a significant contribution to preserving our present economic structure, and avoiding far less desirable alternatives to it.