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FOR RELEASE

THE DISCLOSURE STUDY: WHAT IS IT?

Remarks by

Commissioner A. A. Sommer, Jr.

Midwest Securities Administrators

San Diego, California

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It is not news to you securities administrators that the core of the federal securities laws is disclosure. Back in 1933 and 1934 Congress made a very conscious decision that it would rely principally upon a sophisticated system of disclosure, administered by an independent regulatory agency, to correct the defects in the securities markets exposed after the 1929 debacle. In doing this Congress rejected the course which the legislatures in your states adopted in giving to you broad powers to make qualitative judgments with regard to the securities proposed to be offered in your states. Because of the primacy of disclosure in the federal system it has always been important that every effort be made to assure the effectiveness of the disclosure system and that the system fulfill the expectations which Congress had for it when it developed the statutory scheme administered by the Securities and Exchange Commission.

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Over the years, this disclosure system, I think has served the public well. It has been reasonably responsive to changes in the business world; it has recognized the shifting needs of investors, the growing institutionalization of the markets, the developing concepts in the accounting world and, hopefully also, the costs and burdens inflicted upon issuers. It has been emulated in many countries of the world. The disclosures mandated under the Securities Act of 1933 and the Securities Exchange Act of 1934 have unquestionably warned off investors from unsafe or excessively speculative offerings; more than that, the disclosure requirements have undoubtedly prevented innumerable public offerings from coming to market simply because they could not stand the light of day.

Notwithstanding its successes, the disclosure system has not been without its critics. A number of scholars, preeminently George J. Stiegler of the University of Chicago and George J. Benston, presently at the University of Rochester, have concluded on the basis of their empirical studies, in the case of Stiegler, that the disclosure requirements of the Securities Act of 1933 have not really protected investors,

and in the case of Benston, that the financial disclosures required by the 1934 Act have had no effect upon the price performance of securities. These studies have been questioned, both as to methodology and substance, by equally distinguished scholars, and I guess it is no secret that I think the latter have the better part of the argument.

But there have been other criticisms to which I must say I give greater credence and which cause me greater concern. These are the criticisms voiced by Professor Homer Kripke at New York University Law School and Bruce Alan Mann, a distinguished practitioner in San Francisco. They contend that the disclosure system as developed by the SEC has concealed and discouraged publication of the information most important to investors. Furthermore they have contended the disclosure system has not been adapted to the modern methods of portfolio analysis and investment decision making. For instance, Professor Kripke and Mr. Mann have contended that the Commission should be more tolerant of forecasts since management's evaluations of the future are of extreme importance to investor decisions. Professor Kripke has contended that much of the disclosure that is required does not reflect modern learning, such as the efficient market hypothesis, and is burdened with much information that is really of marginal interest to investors.

Issuers have always been restive with the disclosure requirements, but it would appear that recently they have become even more concerned, partially because of increased concern over costs in an inflationary economy - and unquestionably, each incremental disclosure required has a cost attached to it.

Recently a new force has been added to those suggesting change in the disclosure system, and that is the cry for regulatory reform. There are very few things that liberals and conservatives, Democrats and Republicans, seem to be able to agree upon these days, but one of them is the need for a hard, critical examination of the extent to which the government has intruded upon our lives.

The belief is widespread that government has become too big, too pervasive, too intimately involved in the economic and personal affairs of American citizens. Last summer the President met with both majority and minority leaders of both Houses of Congress to express this concern and they concurred in his judgment. Thereafter, he convoked a meeting of the members of independent regulatory agencies for the purpose of discussing his concerns and securing input from those members concerning the means which might be developed to meet the concerns which he expressed.

The President has urged that there be a concerted effort to reduce the burdens upon business imposed by federal regulation. He does not suggest that regulatory agencies and other agencies of the government abandon their concern with the interests of investors and consumers, but rather that they make a concerted effort to secure effective regulation at a lower cost to the government and to people. With this objective, I heartily concur. Throughout government, I think greater efforts must be made to analyze the costs of government regulation - all of them, not just the federal payrolls - and gain some insight into the benefits that derive from those costs.

Thus in this atmosphere of renewed concern about governmental overregulation, and with the buildup of criticism of the disclosure system which has come from scholars, businessmen, and others as well, the stage has been set for what hopefully will be the most penetrating, multifaceted, extensive study of the corporate disclosure system that has ever been undertaken.

In saying that I am aware that during the hearings which led up to the Securities Act of 1933 and the Securities Exchange Act of 1934, Congress took extensive testimony with regard to the disclosure practices of corporations prior to 1929. Notwithstanding the many volumes of testimony which flowed out of this investigation, in my estimation certain basic issues were not adequately studied, For one thing, my

review of the testimony indicates very little systematic effort to determine the precise needs of investors - the kinds and quantity of information which they should have. True, in Schedules A and B of the 1933 Act, certain types of information to be included in disclosure documents were ennumerated, but it does not appear that this was based upon any sort of empirical research with regard to what it was investors needed or wanted. Similarly, very little attention was given to the costs which would be imposed upon industry as a consequence of implementing a disclosure system. This is not to fault the wisdom of the conclusions that Congress reached, but rather to indicate that even from the beginning, there were certain voids in the factual basis upon which the disclosure system has been built.

During the period from 1967 to 1969, the Commission, through the leadership of Commissioner Francis M. Wheat and the members of the staff who assisted him, engaged in a study of disclosure policies of the Commission. This study was directed principally at the functioning of the Commission's disclosure policies and focussed mainly upon developing the sort of continuous disclosure system that had been proposed by Milton Cohen in his article "'Truth in Securities' Revisited" and rationalizing certain practices which had developed over the years. As we all know, out of that study came an expanded Form 10-K, the Form 10-Q for quarterly reporting, proposals with regard to simplified

registration statements, Rule 144 pertaining to secondary distributions, and Rule 145 requiring the registration of securities issued in acquisition transactions. However, this study was not intended to survey the entire field of corporate disclosure, including disclosure practices not mandated by the Commission. Furthermore, it did not seek through systematic empirical study to ascertain with particularity the needs of various classes of investors, the extent to which market forces would produce adequate disclosure, the impact of market theory upon thinking about disclosure requirements. I have discussed the scope of this current study with former Commissioner Wheat and he has indicated great enthusiasm for it and has indicated that in his estimation it is not redundant or repetitive of the efforts which he and his group undertook. Unquestionably the Disclosure Study, more popularly known as "The Wheat Report", published in 1969 has had a profound impact upon the development of the federal disclosure system. However, as was recognized in that report,

> Finally, this report reflects the conclusion that change in disclosure policy through Commission rule-making should be evolutionary in nature. The results of each stage in that evolution should be tested and evaluated before further changes are made. Thus, in no sense do the recommendations represent a final set of parameters, but only the Study's judgment as to the best practicable steps to be taken at this time.

The new study is seeking to probe the deepest questions that can be asked about the entire disclosure system. While certainly we do not wish to preclude discussion of even the most iconoclastic questions, I would suspect that we start at least with the premise that there must be some disclosure by corporations if we are to have a functioning capitalistic system. This obviously leaves open all questions as to how disclosure shall be secured, what the quantum and quality of it shall be, and all the rest of the questions that the study proposes to examine. Rather than starting with the question whether the portions of the disclosure system which have resulted from the securities legislation and the administrations of the SEC have been of utility, or of sufficient utility to justify their costs, it is our intention to begin from a different point on the compass.

The purpose of this study is not simply to examine the functioning of the disclosure system administered by the SEC, important as that part of the total disclosure system is. Rather the purpose is to examine the entire corporate disclosure system. We recognize that, even were there no SEC requirements, most companies would find it desirable to disclose extensive information to their shareholders and the investing world in

general. Opponents of the SEC disclosure system contend that market forces alone would be sufficient to assure that investors received sufficient information of high enough quality to permit making intelligent investment decisions. We want to find out not only what corporations do because they are required to do it by the SEC and the statutes administered by us, but also what corporations do for reasons unrelated, or perhaps only peripherally related, to the Commission requirements. There is no doubt that increasingly, of course, the total system has been impacted by SEC requirements. For instance, developments under Rule 10b-5 have undoubtedly caused many corporations to disclose more quickly material developments in their affairs and to exercise a greater degree of care with regard to the preparation of press releases and other communications not required under the laws pertaining to securities regulation. However, undeniably, there are significant means of communication that are not directly regulated by the Commission and it is our belief that these must be considered as a part of this study.

In brief, we expect to look at the total corporate system of disclosure, both the parts of it that are regulated directly, such as the requirements with regard to filings in connection

with distributions, Forms 10-K and so on, and that portion of it which is at best only peripherally regulated by antifraud considerations.

As an indication of the depths to which we expect to go, the first questions which I expect will be addressed concern the purposes of the disclosure system. Why should there be disclosure at all by corporations of their affairs? This obviously implies some sort of a cosmic view of the economy. Taking the obverse side of the question, what detriments would society suffer if there were no system of corporate disclosure? Is the only purpose of a disclosure system to provide information to investors to permit them to make intelligent investment decisions? Or is there a broader purpose: efficient allocation of capital? overall fairness of securities markets? inducements to investment by those in society who might be designated as "savers"? disclosure of information of social significance? It seems to me that to some extent it is essential to understand the purposes which we expect a disclosure system to serve before we can make an assessment as to the adequacy of our present system and the ways in which it should be modified.

As a secondary excursion I would suggest that we must, particularly since this is the source of many of the questions

concerning the disclosure system, examine modern theories concerning the securities markets and portfolio analysis. There has been in academic literature in recent years considerable discussion of the so-called "efficient market" hypothesis which is sometimes referred to, in the estimation of some, inaccurately, as the "random walk theory". Without getting into a long academic discussion of this, suffice it to say that in the estimation of many who have worked in this field, the validity of this hypothesis has a direct impact upon the manner in which a disclosure policy is elaborated. Professor Homer Kripke of the New York University Law School, who is also a member of the advisory committee for this study, has conducted a series of round table discussions at New York University over the last two years in which the implications of this hypothesis for disclosure have been explored. We would expect to utilize the insights and the learning which have developed out of those round tables and, hopefully, Professor Kripke will continue these round table discussions, which I am confident will be a rich resource for our study.

In connection with this part of the study I think it is important that we look at the impact which information has on market values and seek to determine the kinds of information

which impact values. As you are aware, at one time, an accepted definition of "material" information was that information which might reasonably be expected to impact significantly the price of a security. That notion has gone into discard in favor of the more subjective standard, namely, information which may have a significant propensity to affect a prudent investor's judgment. Notwithstanding the apparent departure of the courts from the market price standard of materiality, I think it is important for us to determine the manner in which information impacts market prices and the kinds of information which have a significant effect.

Then I think we should study the characteristics which the information produced by a system should have. Very preliminarily I would suggest that we should focus upon such things as reliability, comprehensiveness, accuracy, timeliness and so on. It is possible to construct a model of a system which would achieve to a very high degree these characteristics. However, no study of this sort can simply rest on the creation of models; rather, we must then determine the extent to which the achievement of that model in reality is limited by costs, legal considerations and a host of other real world factors that must affect judgment when developing a viable disclosure system. We must never lose sight of the fact that disclosure is always accompanied

by costs and that each increment in the reliability and comprehensiveness of information increases the costs.

The matters I have just discussed are what I would call the more conceptual or "idea" aspects of the study. In many instances, insights into these problems can be secured by an examination of the available literature on the matter and by the sort of informed discussion that I think the advisory committee is capable of engaging in. However, another essential aspect of this study is what I would describe as the factual portion - the assembly of empirical data concerning the disclosure system. This will involve a whole host of questions. As starters, what kind of information is presently available to persons making investment decisions? The sources are, of course, legion: the files of the SEC; services such as Moody's and Standard and Poor; Compustat; newspapers; opinion rendering publications such as Value Line publications; even, if you will, gossip on the Street. Obviously the corollary question is which of the information available do investment decision-makers actually use? This involves us in a consideration of the utility of the vast amounts of information that is filed with the Commission Here, of course, more subtle questions involving the objectives of the disclosure system become apparent. It may be that the total information available in the files of the Commission is not specifically or even knowingly used by the decision-makers,

but through a process of permeation, such information reaches decision-makers via various media, such as commercial services, without even the identification of the source from which drawn.

Then there is the question, where do investment decision-makers get their information, and this, of course, is closely related to the kinds of information that they use. Do they get it from gossip on the Street? Do they go directly to the Commission files? Do they use intermediaries that rely heavily upon Commission files? All of this, of course, suggests inquiries such as whether regulatory or other changes would result in decision-makers utilizing other kinds of information or different sources of information, with the result that perhaps the information used would be more reliable and thus hopefully lead to better quality investment decisions.

In the course of analyses such as this, of course, we must avoid the temptation to regard the users of information as a single homogeneous group. We know they aren't and we know that their sophistication, their knowledge, their wisdom, their ability to use information is on a continuous spectrum from the legendary Aunt Minnie of Dubuque (complete with tennis shoes) to the most sophisticated analysts handling huge pension trusts and the managers of portfolios of big investment companies. In every instance we must assess the extent to which the information system as it exists today serves the interests of the various identifiable groups and the manner in which perhaps the system could serve

their interests better. As you probably know, the Commission has recognized this problem by developing the notion of "differential disclosure" which explicitly recognizes the differences in the ability of investors to deal with complicated information and has permitted registrants to omit from annual reports to shareholders some of the more intricate financial information which is required to be included in the Form 10-K filed annually.

Obviously, of tremendous importance in any disclosure system is the dissemination process: how does the information reach those who use information in the course of investment decisions? This will involve the examination of the means which technology has made available for the dissemination of information. At the present time, we rely on hard copy and microfiche to get the contents of Commission files into the hands of those who use the information, either for re-transmission or directly for use in investment decisions. We are told by experts in these fields that there are even more sophisticated means available, such as those used in the Lexis system for the storage and retrieval of court decisions and other legal material and in the Compustat system for the storage and retrieval of financial information. As long ago as 1966, Milton Cohen in his article "'Truth in Securities' Revisited" foresaw the possibility that there would develop

mechanisms for the dissemination of information which would rely heavily upon such electronic and computer oriented systems.

Of course, any study such as this cannot be indifferent to the costs that are involved. As I mentioned earlier, each increment in disclosure has an increment of cost attached to it. We could conceive of a perfect or near perfect disclosure system which would result in information having all the characteristics desired, and yet, the result might be a system so complicated, so sophisticated, so comprehensive that the cost would simply be prohibitive. Thus I think we must determine what the total costs of the present system are and, difficult though the job may be, I think we must then determine the extent to which those costs would be incurred even if there were no mandated disclosure. This, of course, is extremely difficult because in many instances the SEC disclosure mandated system and the system which would exist absent such directions are so intimately interwoven, that separating out the cost elements may be a nigh impossible task.

When we are all finished what will we have? I would hope that we will have the most comprehensive conceptual and factual description of the disclosure system as it actually operates

in this country that has ever been developed. But, if there is one thing that I abhor, it is studies that are magnificent in their bulk, appealing of cover, eminent in their scholarship - and utterly devoid of results. Thus I would hope that this study will eventuate in specific recommendations with respect to modifications which should be made in the system, including, if necessary, proposals for legislative change. It may well be that if legislative changes are indicated, these could be folded into the federal securities code that is presently developing under the sponsorship of the American Law Institute and the leadership of Louis Loss. And I would hope that those who are members of the Commission at the time this study is completed will carefully consider the validity of the proposals that result and, if they are found to have merit, will implement them promptly. Doing studies is a tough enough job; translating their conclusions into policy is, if anything, even more difficult. I would hope that the study we are embarking upon will have an intellectual validity that will compel the staff and the Commission as it exists when the study is completed to quickly translate it into policy changes.

The above is the very barest of outlines of the study we propose to make, an outline which the steering committee at

the Commission has developed, but one which may undergo serious modification when it is submitted to the advisory committee on February 24.

There are other questions we hope to ask, but I think I have given you a fair notion of the extent and the magnitude of this study. How do we propose to go about our work? We have organized an advisory committee under the Federal Advisory Committee Act consisting of thirteen people. The committee is a varied lot: there are two practicing lawyers, one law professor, two economics professors, two accountants, one analyst, two people from industry, one from the securities industry, and one from what I would describe as the public interest sector. More important than the professional backgrounds of these people is their experience with the disclosure system. All of them have been intimately involved in it in their respective occupations and professions. Some have been preparers of information, some have been users, some have been reviewers and some have been intensely interested observers of the process. The hard and laborious work will, as usual, be

done by the staff, headed by Mary E. T. Beach, a veteran of the Division of Corporation Finance, who nonetheless has the freshness of approach and the imagination that will serve the study well. She will have at least five fulltime staff members under her and we would hope to be able to draw upon the resources of the staff for other people as we need them for specialized endeavors, such as indepth interviewing work. At the present time we propose tentatively to spend a good deal of time in the field talking with those who prepare information, those who use it, those who are intermediaries, those who review it to assure reliability. Where appropriate we may use questionnaires to secure empirical data which we need. We hope to survey and use the studies which have been made previously in this area and the theoretical writings and determine the areas in which further information is needed.

To assist the advisory committee in coming to grips with these problems we have furnished them with reproductions of some forty articles, a copy of the Wheat Report as well as copies of other publications bearing upon disclosure. Regardless of the outcome of the study I think it is fair to say that a conscientious member of the advisory committee is going to know an awful lot about disclosure before he or she is finished with our work!

There are certain problems which I would not regard as of primary concern to us in the area of disclosure. One of those is the disclosure which relates to the availability of exemptions, for instance, the private placement exemption. Another would be the disclosure aspects of Rule 10b-5. Not considering these areas, at least as explicit parts of our study, is not to diminish their importance. However, I would emphasize again that what we are concerned with is the system of corporate disclosure and I would regard such topics as peripheral to that kind of study.

Similarly, it does not seem to me that a principal focus of this study should be the processing of documents at the Commission, although certainly the manner in which documents are processed bears upon costs and the credibility of information contained in filed documents. I would think it premature to suggest that our work will result in no pre-effective examination of any portion of the registration statements filed with us. As you are aware, we now have a "cursory review" procedure with respect to the filings of companies of proven profitability and stability and which have accepted and complied with our continuous disclosure program. These registration statements receive relatively little examination. This does not result

in my estimation in information that is less reliable; in large measure the reliability of the information derives from the history and nature of the company and I would suggest that it is a prudent use of resources to accord them a less full examination than is given to the registration statements of other companies.

I would emphasize that one of the purposes of this study is to determine how we may better elicit and disseminate information having those characteristics which information in a disclosure system should have, particularly reliability, and I would not expect that any recommendations will come out of this study which will diminish the reliability of corporate information. I think this is of particular importance to you, because through the years, in an effort to divide prudently responsibilities, use the resources available to you and to us most effectively, and avoid duplication of activities, you have come to rely upon the effectiveness of the federal system of disclosure. This allocation of resources and division of responsibility has been further expressed in the proposed federal securities code. Certainly one of the factors which I hope we will keep front and center during our study is the fact that

this proposed code does contemplate a system in which the federal scheme with regard to disclosure has a primacy, a circumstance which in my estimation further justifies a study like this at this time and which also demands that we be doubly sure that in framing recommendations we beware of any actions which would make you less willing to rely upon federal action in enforcing disclosure requirements.

I would hope that as our study develops we may consult regularly with members of your organization and have them comment upon the validity of our work and, as we begin to reach conclusions and frame recommendations, have them express their judgments upon whether they are consistent with a system upon which you can rely as the first line in assuring adequate disclosure.

While the study is a Commission study, in a more real sense it is a study on behalf of everyone concerned with the integrity of our securities markets - and that of course clearly includes you.