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OF THE

ADVISORY COMMITTEE ON CORPORATE DISCLOSURE

TO THE

SECURITIES AND EXCHANGE COMMISSION

NOVEMBER 3, 1977

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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

ADVISORY COMMITTEE ON CORPORATE DISCLOSURE

November 3, 1977

Chairman Harold M. Williams
Commissioner Philip A. Loomis, Jr.
Commissioner John R. Evans
Commissioner Irving M. Pollack
Commissioner Roberta S. Karmel
Securities and Exchange Commission
Washington, D.C. 20549

Dear Mr. Chairman and Commissioners:

It is our deep pleasure and privilege to present to you, on behalf of your Advisory Committee on Corporate Disclosure, its Report.

This Report is the fruit of twenty-one months of intensive effort by 17 Committee members (later 16, upon the appointment of Committee member Williams to the Chairmanship of the SEC) and variously eight to ten members of the Commission's staff. In addition to that, the work of the Committee was greatly assisted by the American Institute of Certified Public Accountants, the Financial Analysts Federation, the Financial Executives Institute, the New York Stock Exchange and the Securities Industry Association, all of whom contributed generously in advising the Committee and, in some cases, in developing extensive surveys and reports that were of great help. The Committee wishes to thank Dr. Paul A. Griffin of Stanford University and William Van Valkenberg, formerly

of the Commission's staff and currently associated with Messrs. Bogle and Gates in Seattle, Washington for the papers they prepared for the Committee. Finally, the Committee wishes to thank all the organizations and individuals who participated in the Committee's case study or responded to the Committee's request for comments on certain issues set forth in Securities Act Release No. 5707, for their valuable advice and assistance.

Although not all members agreed unreservedly, the Report concludes that the disclosure system established by the Congress in the Securities Act of 1933 and the Securities Exchange Act of 1934, as implemented and developed by the Securities and Exchange Commission since its creation in 1934, is sound and does not need radical reform or renovation. However, this conclusion does not dictate that the Commission should be indifferent to research which some would suggest has already or may in the future suggest a radical modification of this disclosure system. Further, as is evident from the contents of the Report, it does not suggest that there is no need for significant changes in the Commission's procedures, rules, emphases and approaches to disclosure problems.

We would like to commend the Commission for its initiative in creating the Committee, in shaping its broad charter and in supporting its labors. You were generous in furnishing staff and financial resources; we hope that our product is worthy of the support and resources which you gave.

This Report should not reach you without recognizing expressly the members of the Committee's staff, some recruited expressly to work on this Report, others taken from their ongoing activities at the Commission to work on the Report. These fine people were Bruce Baggaley, Paul A. Belvin, Hugh Haworth, Robert P. Luneseh, Edythe B. Macchiavello, Eugene Pillot, Jon C. Richards, Michael P. Rogan, S. James Rosenfeld, Patricia C. Rubini, Charles C. Tuck and Charles R. Wehner. All of these people worked unstintingly, enthusiastically, uncomplainingly and creatively and the Report bears a significant imprint of each of them.

The most resounding gratitude and recognition must belong to Mary E.T. Beach. Mrs. Beach, as nearly as any one

person, has been the central, couldn't-have-done-without, ingredient in the work of the Advisory Committee and the preparation of its Report. She has led the staff brilliantly. She has borne with the members of the Committee with unlimited patience, she has contributed her vast experience to the achievement of our work product. A large portion of the good of the Report is to be attributed to her; none of its shortcomings should be.

All of us are appreciative to the Commission for the pleasure of this experience and the opportunity to contribute to the ongoing work of the Commission which has earned a remarkable reputation as a responsible and responsive agency. All of us stand ready to lend whatever further assistance we may be able to render in carrying out the recommendations of this Report.

Respectfully submitted,

W. A. Sommer, Jr.

Arthur Fleischer, Jr.

William B. Beaver

Ray J. Groves

Warren E. Buffett

Deborah E. Kelly

John C. Burton

Alan B. Levenson

Victor H. Brown

Martin Lipton

David Norr*

Robert A. Malin*

Elliott J. Weiss*

Roger Murray*

Frank T. Weston*

*These members have prepared separate statements expressing their views on certain issues examined by the Committee. Their statements are included in the Digest of the Report.

Committee member Homer Kripke dissents from this Report for the reasons set forth in his statement which begins at page D-49 of the Digest of the Report.

DIGEST OF THE REPORT

This digest summarizes a full report consisting of an Introduction and four parts.

The Digest states the Advisory Committee's charge and its response to that charge. It includes a summary of the Committee's observations and conclusions, and a list of its recommendations. It also includes a dissent from this report signed by Committee member Kripke and separate statements by Committee members Malin, Murray, Norr, Weiss and Weston expressing their views on certain issues examined by the Committee.

The Introduction considers whether there are presently economic and public policy justifications for the existence of a disclosure system that, at least with respect to company-originated information, is characterized by a mandatory dimension administered by the SEC.

Part One, "Participants in the Disclosure Process," is comprised of six chapters describing the roles of the principal participants in the corporate disclosure system: companies, financial analysts, portfolio managers, information-disseminators, registered representatives, and individual investors. These chapters were written by the Advisory Committee staff based upon its questionnaire and interview study and supplemented through studies by the Financial Analysts Federation and the Securities Industry Association.

Part Two, "Recommendations Concerning Commission Procedures in Developing Disclosure Requirements and Standards," and Part Three, "Recommendations Regarding Substantive Disclosure Requirements," together contain twelve chapters. These chapters, also prepared by the Committee staff, are based principally upon the proceedings of Advisory Committee meetings, discussions with the Committee members and responses to the request for public comments made in Commission Release No. 33-5707. These chapters reflect the Committee's observations and the underlying philosophy and rationale for the Advisory Committee's recommendations. The views expressed in these twelve chapters are not uniformly supported by Advisory Committee members, and therefore should not be considered as official Committee statements.

Part Four, "The Disclosure Environment," consists of four chapters discussing the evolution of the present system, current economic theories on disclosure, the liability provisions of the securities acts and the impact of disclosure of questionable foreign payments by certain companies on the market price and trading volume of their securities. These chapters are papers prepared at the request of the Advisory Committee.

THE ADVISORY COMMITTEE'S CHARTER

The charge to the Advisory Committee on Corporate Disclosure is:

(1) to identify the characteristics and functions of the present system of corporate disclosure and the role of the Securities and Exchange Commission within that system;

(2) to assess the costs of the present system of corporate disclosure and to weigh those costs against the benefits it produces;

(3) to articulate the objectives of a system of corporate disclosure and to measure the Commission's present disclosure policies against those objectives;

(4) if necessary, to formulate recommendations to the Commission for adjustments to Commission policies to better effectuate those objectives.

The Advisory Committee met for a total of 18 days during its 11 meetings between February 1976 and September 1977, conducted a comprehensive questionnaire and interview study of the primary participants in the corporate disclosure system, consulted with experts and examined pertinent studies and research reports, some prepared especially for the Committee. The Advisory Committee believes that it has accomplished its charge to the extent that it is presently practicable to do so, and hopes that its research results, analyses, observations, conclusions and recommendations will be of assistance to the Commission.

Interpreted broadly, the Committee's charter could encompass all types of corporate disclosures regardless of purpose. However, the Advisory Committee believes that the role of the Securities and Exchange Commission in

the corporate disclosure system is oriented by statute primarily to the investor and security-holder. Therefore, since the Committee was created by the Commission for the purpose of advising it, the Committee determined that it should focus on the disclosure system as it pertains to investment and corporate suffrage decision-making.

The Present System:

The present disclosure system is complex and involves many persons and organizations who perform various roles. These include companies, analysts, portfolio managers, disseminators, registered representatives, and individual investors having varying degrees of sophistication and access to information.

Companies, as the principal source of firm-oriented information, are at the center of the corporate disclosure system. Their willingness (as opposed to their obligation) to provide information is a function of management's perception of the utility of the disclosure to the company and the user, the hard and soft dollar costs associated with the disclosure and the feasibility of communicating the information.

Analysts combine the information provided by companies with industry and macroeconomic data. They provide an interpretation of the information and frequently conclude with a buy-sell-hold recommendation directed to specific portfolio objectives. The interest of analysts

and disseminators in particular companies is influenced by the company's market capitalization or the potential for unusual return on investment.

Portfolio managers in large structured organizations select industries which will benefit from an assumed economic scenario and utilize analysts' recommendations for individual company selection appropriate to the characteristics of specific portfolios.

Information disseminators condense, summarize and disseminate available information and thereby assist analysts and investors in obtaining investment decision-making information in forms suitable to their respective needs and abilities to use it.

Individual investors use various methods in making investment decisions, ranging from fundamental analysis and replication of the activities of portfolio managers, to total reliance on the advice of registered representatives.

The Securities and Exchange Commission administers a mandatory disclosure system intended to assure that reliable firm-oriented information is available to the public. It does not purport to administer a system designed to produce all information used in investment decision-making. Further, information filed with the Commission has often been widely disseminated before filing.

The Committee considered the significant studies concerning the functioning of securities markets, theories concerning capital asset pricing and portfolio

organization and belief in some quarters that market forces may adequately provide sufficient reliable firm-oriented information, and determined that the basics of the present system should be continued and that major change in the federal securities laws or their administration is not needed. The Committee concluded, with some dissent, that:

(1) The "efficient market hypothesis" -- which asserts that the current price of a security reflects all publicly available information -- even if valid, does not negate the necessity of a mandatory disclosure system. This theory is concerned with how the market reacts to disclosed information and is silent as to the optimum amount of information required or whether that optimum should be achieved on a mandatory or voluntary basis;

(2) Market forces alone are insufficient to cause all material information to be disclosed;

(3) Commission-filed documents often confirm information available from other sources. The Commission's filing requirements, while often not a source of new information to investors, assure that information disclosed by publicly held companies through many means is reliable and is broadly accessible by the public.

Cost/Benefit Considerations

An effort to analyze costs and benefits was a part of the charge to the Committee. While reducing costs and benefits to objectively measurable terms would be highly desirable, the Committee was generally unable to do so. The Committee's

staff successfully isolated only a few costs, principally legal and audit fees associated with registration statements and periodic reports. Efforts to go deeper were frustrated because methods of allocating internal costs are so varied that gathering comparable cost data from even a small sample of companies would have required far more time and resources than were available, and the data might still have been of doubtful reliability. Further, the Committee was unable to quantify such costs as competitive disadvantage and management disincentive to innovate and such benefits as confidence in the markets and efficient security pricing. The difficulties of evaluating costs and benefits, however, have not caused the Committee to reject the desirability of the Commission continuing its efforts to measure them more definitively. Further, inexact though they may be, perceptions about cost/benefit tradeoffs do underlie many of the recommendations found in this report.

SEC Objectives in the Investor Oriented Corporate Disclosure System (Chapter VII)

The Committee's charge includes the articulation of a statement of objectives to guide the Commission in its administration of the investor oriented corporate disclosure system. A statement of objectives is essential as a guide to rational, consistent problem-solving and policy-making, and as a standard for evaluating whether the Commission's programs are effective and appropriate to its jurisdiction. Such a statement also may reduce the number of inappropriate

demands made of the Commission by those who misunderstand its function.

The Advisory Committee recommends that the Commission adopt the following statement of objectives:

> The Commission's function in the corporate disclosure system is to assure the public availability in an efficient and reasonable manner and on a timely basis of reliable, firm-oriented information material to informed investment, and corporate suffrage decision-making. The Commission should not adopt disclosure requirements which have as their principal objective the regulation of corporate conduct.

This statement reflects the Committee's belief that the Commission's present statutory mandate extends only to information material to informed investment and corporate suffrage decision-making. The Committee recognizes that many constituencies look to the corporation for a variety of information, but believes attempts to serve groups other than investors would exceed the Commission's statutory authority.

Further, some argue that if information oriented to audiences other than investors or shareholders were required to be included in filings with the Commission, investors and shareholders would be compelled to sift out that which is relevant to their views, thereby hampering investment and corporate suffrage decision-making. This approach would lower the materiality threshhold and "simply . . . bury the shareholders in an avalanche of trivial information--a result that is hardly conducive to informed decision making." TSC Industries, Inc. v. Northway Inc., 426 U.S. 438, 448-49 (1976).

The phrase "firm-oriented information" is an acknowledgement by the Committee that although general macro-economic information is critical in investment-decision-making, the Commission should not prescribe it as a part of the mandatory component of the corporate disclosure system it administers. Reporting companies should not be held responsible for information which is not within their expertise. The "firm-specific" language is intended, however, to encompass disclosure of macro-economic factors to the extent they have a special or unique impact on the company.

The proposed statement recognizes that corporate filings need not be, and are unlikely to be, readily understandable in total by uninformed investors. The Commission should emphasize disclosure of information useful to reasonably knowledgeable investors willing to make the effort needed to study the disclosures, leaving to disseminators the development of simplified formats and summaries usable by less experienced and less knowledgeable investors.

Finally, the proposed statement reflects the Committee's belief that the Commission should not mandate disclosure requirements which result in non-material information and which have as their principal objective the regulation of management conduct. If the Commission perceives a need to regulate directly corporate conduct, it should request from Congress the authority to do so.

Materiality (Chapter VIII)

The materiality concept serves a variety of functions,

operating both as a principle for inclusion and exclusion of information in investor and shareholder disclosure documents and as a standard for determining whether a communication omits or misstates a fact of sufficient significance that legal consequences should result.

Although there may be some uncertainty associated with the application of the materiality concept because its current formulations are not readily translatable into objective criteria, the Committee is of the view that it is not possible to develop an objective definition of materiality that will have general applicability to all fact situations. The materiality of a particular fact must be determined after considering the importance of that fact in the context of the present and future business and financial circumstances of the company. Because the information necessary to make this evaluation is available to management, it has the major responsibility for making this determination.

To the extent that uncertainty among users and preparers of disclosure documents concerning the application of the materiality concept in an area is present and widespread, the Commission should promptly amend its disclosure requirements to reduce uncertainty. This may be done by specifying a new type of information which is considered material or through the establishment of numerical benchmarks for materiality of certain categories of information.

RECOMMENDATIONS AND SUMMARY OF OBSERVATIONS AND CONCLUSIONS

This summary of observations and conclusions and the list of recommendations which follows reflect the consensus of the Advisory Committee as to modifications in Commission policies which would improve the operation of the corporate disclosure system and enable the Commission to more fully and effectively achieve its objectives. The nature of the issues, the Committee's observations and recommendations, and the rationale for and intention of those recommendations are explained. Comprehensive discussion of these matters can be found in Parts Two and Three of this report. Since several of the recommendations call for increased or improved review of information filed with the Commission additional staff may be necessary.

Rule-Making and Monitoring Practices (Chapter IX)

The Advisory Committee believes that the effectiveness of the Commission's disclosure programs can be increased if disclosure problems are more promptly identified, public input into the solution of these problems is maximized and a program for monitoring the effectiveness of new rules is implemented.

The Advisory Committee's recommendations include the following points:

(1) after identifying a disclosure problem of general significance, the Commission should initiate rule-making procedures and not rely for unduly prolonged periods on such ad hoc procedures as commenting on filings

and enforcement actions;

(2) prior to proposing a specific rule to deal with a major conceptual issue, the Commission should publish a concept release discussing the problems it perceives, the reason it proposes to proceed to rule-making, possible alternatives and should request public comments;

(3) the Commission should withdraw promptly proposals not adopted;

(4) as a part of its release announcing adoption of a disclosure rule, the Commission should state that after a specified period it will review the extent to which the rule has yielded the benefits expected and the manner in which and the standards by which such a determination will be made;

(5) academic research should be encouraged to aid in the monitoring efforts; and

(6) results of the monitoring process should be described in the Commission's Annual Report to Congress so that necessary remedial action can be taken if undesirable consequences are revealed.

The Committee believes that several benefits will result from these proposals. First, public input secured at the earliest possible time increases the likelihood that the resulting rule will be effective. Further, by acknowledging a monitoring obligation, major requirements which become unnecessary, ineffective, or have outlived their usefulness can be eliminated; and those which are not being complied with can receive added attention through

the Commission's enforcement program. Finally, if monitoring reveals possibly undesirable consequences not amenable to remedy by exercise of the Commission's powers, legislators will have a means of being alerted and may respond if necessary.

This set of recommendations is not intended to suggest that the Commission should initiate rule-making before it has sufficient experience with or understanding of the issue before it, and it does not suggest that the Commission should be unconcerned with or should not assist registrants in dealing with individual disclosure problems on a case-by-case basis.

Industry Guides (Chapter IX)

The Committee recommends that the Commission cooperate with preparers and users of information in developing disclosure guides for specific industries, with the goal of tailoring disclosure requirements to differing industry characteristics. When accomplished, this approach would have these advantages:

(1) disclosure requirements not meaningful in a particular industry situation would be minimized;

(2) vital disclosures in a particular industry would be obtained, and not obscured by detail irrelevant to that industry; and

(3) the Commission's staff would have a ready reference for a particular industry, and thereby be better able to apply uniform disclosure requirements to all registrants in that industry.

The Committee recommends that the Commission experiment with a few industries and monitor the effectiveness of the approach before embarking on a program for development of guides for all industries.

Forward-Looking and Analytical Information (Chapter X)

The traditional policy of the Commission has been to permit disclosure of virtually only "hard" information in filings (i.e., objectively verifiable historical facts) as distinguished from "soft" information (e.g., opinions, predictions, analyses, and other subjective evaluations). In recent times the Commission has departed from this constricting practice. The Advisory Committee endorses this departure and recommends that the Commission actively and generally encourage the publication of forward-looking and analytical information in company reports to shareholders and in Commission filings. It believes that the SEC staff should encourage responsible experimentation with disclosure of soft information and that the experimentation should be monitored to determine the usefulness of the information which results and the cost of producing it. To further encourage disclosure, a safe harbor rule is proposed for adoption. The rule would provide protection from liability for forward-looking and analytical information, unless it is proved that the disclosure was without a reasonable basis or was made other than in good faith.

In addition to recommending that the Commission

generally encourage disclosure of soft information, the Committee identifies several categories of information for special Commission attention. Management forecasts of sales and earnings seem to be of special interest to investors and analysts. The Committee's case study shows that there exists a widespread, informal system for communicating information about management projections. Although most managements have mixed emotions about discussing their projections, mainly because of credibility and liability concerns, some will, at least indirectly, convey their expectations to analysts. If the publication of projections becomes more widely accepted, communication among management, analysts and investors regarding management's expectations about the future can be more direct. Furthermore when companies formally publish projections they are likely to exercise greater care in preparing the information, and this would be a benefit to investors.

Thus, the Committee recommends that the Commission develop an experimental program to encourage the disclosure of information concerning future company economic performance. A public statement should be issued encouraging public companies to disclose projections in filings with the Commission subject only to the conditions that the projections be prepared on a reasonable basis, be disclosed in good faith, and be accompanied by an appropriate cautionary statement.

The Committee recommends that the Commission encourage but not require, registrants to publish major assumptions

underlying projections, comparisons of previous projections with actual results, and management analysis of the variances. The items of information to be forecasted, the time period to be covered by the forecast, and the decision to discontinue forecasting would also be discretionary with management. Third party review would be permitted but not required. The Commission should, however, require that previously issued projections still current at the time a registration statement is filed be included in the registration statement with appropriate updating if necessary.

A voluntary projections disclosure program is more appropriate than a mandatory program for the following reasons:

1. A mandatory system would necessitate the formulation of specific disclosure rules and regulations. The Committee is of the opinion that the Commission does not now have an appropriate basis for formulation of such rules and regulations, and that a period of experimentation is warranted.

2. All public companies should not be required to sustain the expense and other burdens that may be associated with a program for the public disclosure of projections. In some instances, companies might reasonably find that the burdens of projection disclosure would outweigh any corresponding benefits.

3. Public companies should not be compelled to expose themselves to the potential risks of liability and litigation for inaccurate projections.

4. Many companies would find it difficult, if not impossible, to prepare reasonable projections due to a lack of operating history, general economic factors or industry conditions.

The Advisory Committee also gave considerable attention to management analysis of financial information. In its case study, the Committee found that management analysis of the summary of earnings (Guide 22 under the 1933 Act, Guide 1 under the 1934 Act) is regarded by many investors and analysts as one of the best disclosure concepts ever adopted by the Commission. In some cases, however, the resulting discussion has not been meaningful. In part this may be because the numeric materiality standards included in the guides encourage mechanical compliance.

The Advisory Committee believes that the most effective management analysis results when management explains the events behind the financial statements rather than complies mechanisticly with the detailed items included in the present guide. Therefore, the Committee recommends that the guides be modified to delete the numeric tests and to emphasize that broader latitude will be given to registrants in implementing the analysis requested.

An important feature of the management analysis is the identification of significant facts which have affected reported results and are not expected to have a significant impact in the future and significant facts which have not affected results in the past and are expected to have a significant impact in the future. Accordingly, the Committee has drafted an instruction indicating that the analysis should focus "on facts and contingencies

known to management which would cause reported financial statements to be not indicative of future operating results or of future financial condition." In connection with the recommendation to revise Form 10-K discussed below, the Committee recommends that the management analysis become Item 9 of Form 10-K. Accordingly, the revised text appears in the new Form 10-K which is included in the recommendation section of the Digest.

In a further effort to improve the quality of the management analysis the Committee recommends that the guides be amended to require the submission of a letter signed by the chief financial or accounting officer with each appropriate filing stating that due regard was given to all aspects of the requirement. The requirement for a letter should be terminated three years after its promulgation unless expressly extended by the Commission.

Other voluntary disclosures recommended are (1) planned capital expenditures and financing; (2) management plans and objectives; (3) dividend policies; and (4) capital structure policies.

Segment Reporting (Chapter XI)

Statement of Financial Accounting Standards No. 14 requires the inclusion of specified segment information in the financial statements, but there may exist a continuing problem with regard to these disclosures. A possibly significant gap remains between the level of segmentation some managements are willing to provide and the information

which users assert is needed for investment decision-making.

After dialogue with both analysts and management the Advisory Committee concluded that in some cases past levels of segmentation need improvement. Thus, the Committee endorses SFAS No. 14, with the hope that improvement will result from its application.

In addition, the Committee recommends that the Commission attempt to develop on an industry by industry basis a standardized product line classification for presentation of both dollar and, where appropriate, unit sales of each product line (within a segment) whose total sales comprised a certain percentage of consolidated sales in the previous fiscal year. This should be done in the process of developing industry guides so that the advice of both users and management of registrants can be considered.

The Committee believes this approach is beneficial in several respects. First, the problem of standardization will be approached on an industry-by-industry basis so that Commission action is limited to those industries where product line standardization is desirable and possible. Also, rather than imposing an arbitrary classification system, the development of standard product line reporting requirements could be accomplished by analysts and managements of registrants familiar with the particular industry.

Because the evaluation of a company consists of the

analysis of each segment and the relationship of those segments to the whole, the Committee recommends that the narrative discussions in reports and registration statements filed with the Commission be presented on a segment basis, thus organizing the information according to the way it is used.

Finally, the Committee recommends that the Commission require unaudited segmented financial statement disclosures in Form 10-Q quarterly reports. The Committee believes that timely segment information assists users in evaluating earnings statements and forecasts.

Disclosure of Social and Environmental Information (Chapter XII)

Recently, controversy has arisen about the extent to which the Commission should require disclosure of company activities and policies regarding environmental matters and other aspects of corporate social performance.

A part of that controversy involves the kinds of information which are material to investment and corporate suffrage decision-making. Some argue that investors are primarily concerned with information that will help them evaluate the future financial performance of the company and that social and environmental performance is material only when it may affect that performance in a significant way. Others argue that shareholders may use this information in exercising their corporate suffrage rights even if it does not appear that the information reflects on future financial performance,

because it assists in evaluating the performance and qualifications of management and candidates for election to the board of directors, and the social responsibility of the corporate entity.

The Committee recommends that the Commission require disclosure of social and environmental information only when the information in question is material to informed investment or corporate suffrage decision-making or required by laws other than the securities laws. Generally information is material to investors only when it relates significantly to future financial performance or when a corporation's activities in these areas reflects a management engaged in a consistent pattern of violation of law.

The Advisory Committee also endorses the Commission's conclusion reached after its hearings on this issue that there are no broad categories of social and environmental information not now covered by mandatory disclosure requirements that should be made the subject of new requirements.

The Committee believes that the shareholder proposal rules provide an appropriate means for shareholders who are interested in social and environmental matters to influence management to disclose it.

Proxy Statement Requirements (Chapter XIII)

Deliberations about the proxy process brought out marked

differences of opinion among the members of the Advisory Committee. The Commission has broad authority in the proxy process, but this process is so interwoven with corporate governance procedures -- historically within the jurisdiction of the states -- that there are difficult questions about the extent to which the Commission should exercise its authority.

There also are difficult questions about the purpose of proxy statement disclosures as they relate to corporate governance. On one side are those who believe that proxy disclosures should focus on matters directly related to economic performance. Others argue that since boards of directors serve as monitors of management, information should be furnished about the organization and role of the board so that shareholders may evaluate the effectiveness with which the board carries out this function.

The Committee recommends, by a slim majority, that the Commission should develop disclosure requirements that, taken as a whole, will strengthen the ability of directors -- as the representatives of shareholders -- to serve as the independent, effective monitors of management. This focusing on the monitoring role is not intended to imply that management should not serve on the board of directors. The minority with respect to this proposition agree with the desirability of reform in the corporate governance process, but question the effectiveness of disclosure as a means of achieving it.

Because of the substantial differences of opinion

on the Advisory Committee as to the need for new disclosure requirements or exactly what their substance should be, only the two disclosures discussed in the paragraph below are specifically recommended to the Commission for adoption. However, certain additional proposals, illustrative of the general approach to the area that the Committee believes the Commission should consider after the completion of its proposed public hearings on corporate suffrage and proxy disclosure issues, are included in Chapter XIII.

The Committee recommends that shareholders be given information about the nominating committee (if any) of the board of directors, and that companies be required to file with the Commission a director's letter of resignation if the director so requests.

The Advisory Committee believes that the disclosures in proxy statements about management proposals, particularly those where management may have a conflict of interest, such as option and other similar type plans, anti-takeover proposals, and plans for going private, are not always adequate. The Commission should closely review proxy materials on management proposals and assure that there is adequate discussion of their disadvantages.

Finally, the Advisory Committee concludes that the current Commission rules and practices regarding shareholder proposals provide a workable means for a shareholder to communicate his concerns to management and to other shareholders

So that fewer shareholder proposals are excluded because of procedural technicalities, the Committee recommends that registrants be required to state in their proxy materials the date by which proposals must be received to be eligible for inclusion in the proxy materials for the next annual meeting.

Further Integration of the 1933 and 1934 Acts (Chapter XIV)

Criticisms persist about the amount of time required to complete the registration process and about duplication in 1933 Act documents of information already filed in 1934 Act documents. In addition, registration statements for exchange offers and mergers are criticized as extraordinarily long and complex. In recent years the Commission staff has reduced some of these problems, principally by more closely integrating the disclosure requirements under both acts. The Advisory Committee believes that the Commission's initial steps have proved successful and that further integration is possible and would be beneficial.

In order to maximize the integration of the registration requirements of the Securities Act and the periodic reporting requirements of the Exchange Act, the Advisory Committee recommends the development of a single coordinated disclosure form -- Form CD ("Coordinated Disclosure").

The content of registration statements, periodic reports, and material distributed in conjunction with shareholders meetings would be prescribed by the form, assuring that disclosure requirements are uniform among filings.

Form CD would classify registrants into three levels for

1933 Act registration purposes. With respect to offerings for cash, companies which have not been 1934 Act reporting companies for three years (Level 3) would be required to file the information currently prescribed by Form S-1; companies meeting certain asset size and earnings requirements (Level 1) would be permitted to use a short form registration statement similar to the current Form S-16, incorporating certain 1934 Act reports by reference; all other companies (Level 2) would file the information currently required by Form S-7.

For exchange offers or merger proposals, information regarding the transaction would be included in the prospectus. Information furnished to shareholders regarding the parties to the transaction would vary according to each company's status as a Level 1, 2, or 3 company. Level 3 companies would be required to furnish in the prospectus the information currently required by Forms S-1 or S-14. If any party to the transaction is a Level 1 or 2 company, the registration statement would incorporate by reference that company's most recent proxy or information statement and periodic reports. These documents would be made available on request for a Level 1 company and furnished with the prospectus for a Level 2 company.

The proposed availability to some companies of the incorporation by reference option reflects the Committee's belief that when a company has a public offering of its securities the disclosures involved should recognize the extent

of information about the company already available.

An effect of incorporation by reference is the subjection of 1934 Act filings to the liability standards of the 1933 Act. Whereas the 1934 Act imposes liability on persons responsible for a false or misleading filing unless they can prove they acted in good faith and had no knowledge of a misrepresentation, the 1933 Act establishes an obligation of inquiry on all participants in the registration process. Representatives of investment banking firms have expressed their concern about this matter.

The Advisory Committee's interest in furthering integration of the 1933 and 1934 Acts through incorporation by reference leads it to recommend that the Commission adopt a definition of a standard of reasonable investigation under the 1933 Act, taking into account the fact of incorporation by reference and the nature of the underwriting arrangements. Proposed wording for this definition is included in the list of recommendations.

Reporting Requirements Under the 1934 Act (Chapter XV)

The Commission requires companies to file annual and quarterly reports on Forms 10-K and 10-Q, respectively. In addition, most companies prepare separate annual and quarterly reports for their shareholders. Although the Commission's Forms 10-K and 10-Q are intended to communicate basically the same information as the company's reports to shareholders, there often are significant differences between them. In general the writing style in shareholder reports is more

readable than that in 10-K's and 10-Q's. On the other hand, the information filed with the Commission frequently is more complete.

The Advisory Committee believes the Commission can change its rules and procedures to improve both filed and non-filed periodic reports without hampering the more communicative writing style found in reports to shareholders. Accordingly, it recommends that registrants be encouraged to use their annual and quarterly reports to shareholders as filing documents in lieu of preparing separate 10-K's and 10-Q's. If this option is widely used, the information content of corporate reports to shareholders would be upgraded and the burdens of compliance with Commission requirements reduced since one report would serve two functions.

The Advisory Committee also believes the Commission's forms should be revised to improve the quality of their content and to present the information in a more useful format. To illustrate the suggested revisions the Advisory Committee approved a revised Form 10-K. The changes proposed for the 10-K could also apply to other forms, if Form CD were amended to reflect them.

The proposed 10-K would have five sections:

(1) a fact sheet -- principally capsule financial data and a brief description of the business;

(2) background about special risks or uncertainties and about distinctive features of the registrant's

(3) management's analysis of the financial statements and forward-looking information;

(4) information currently found in Part II of 10-K (details of management's security holdings, options, remuneration, and similar data) which may be omitted if a proxy statement has been filed; and

(5) the audited financial statements.

In addition to the reorganization of 10-K, certain information is noted for deletion, certain additional information is required, and the proposed disclosure requirements are written to minimize duplication and boilerplate. The text of the revised form is included in the digest following the list of recommendations.

Financial Statement Requirements (Chapter XVI)

The Advisory Committee addressed three topics related to financial statements:

(1) communication of uncertainties;

(2) considerations for evaluating accounting standards; and

(3) deletion of rules which cause unnecessary differences between financial statements prepared in accordance with Regulation S-X and those prepared in accordance with generally accepted accounting principles.

The communication of uncertainties inherent in nearly all accounting measurements is an important disclosure problem. The Committee believes the Commission can contribute to its solution if the financial statement disclosures called for

by the industry guides for companies with extended operating cycles highlight the economic assumptions underlying asset valuation and liabilities subject to greatest uncertainties, information permitting evaluation of the impact on operations resulting in changes in those assumptions and amounts included in the current year's income which are adjustments of estimates included in prior years' income statements.

The second topic in this chapter, considerations for evaluating accounting standards, is a complex one which the Financial Accounting Standards Board is addressing in its Conceptual Framework Project. To further those efforts the Advisory Committee offers some observations and recommendations based upon its case study and also on the collective experience of its members. The Committee believes that in evaluating accounting standards consideration should be given to, among other things, (1) uncertainties inherent in the measurement process, (2) the amounts and timing of historical cash flows, and (3) the liquidity of the reporting entity.

The third topic in this chapter relates to Regulation S-X. In some cases financial statements prepared in accordance with Regulation S-X differ from those prepared in accordance with generally accepted accounting principles ("GAAP"). The Advisory Committee recommends that the Commission undertake to eliminate all financial statement disclosure required by Regulation S-X which duplicate GAAP, critically

review all S-X requirements which are supplementary to GAAP, and eliminate those which are not necessary to investment decision-making.

This recommendation reflects the Committee's view that although Regulation S-X must necessarily supplement GAAP because of the Commission's ability to deal quickly with emerging problems, some information currently required may not be useful to investors. This includes a number of the schedules to the financial statements.

Special Problems of Small Companies (Chapter XVII)

There is ample evidence, including the results of the questionnaire and interview study, that the cost burden of periodic reporting to the Commission is relatively greater for small companies than for large companies.

The Advisory Committee strongly supports the idea of reducing the reporting burden for small companies. However, it recognizes that there must be an evaluation of several factors, including whether such a reduction is consistent with the Commission's objectives, and whether analysts' interest in small companies, already limited, would be further reduced.

The Advisory Committee concludes that more study is needed to assess the tradeoffs for small companies between reducing reporting burdens and the benefits of having a reliable public data base. Accordingly, the Commission should initiate an inquiry, including public hearings,

to determine if it is desirable and possible to define a small company class of registrants, and if so, how to reduce the reporting burdens for such registrants.

The Advisory Committee believes it important for the Commission to be more cognizant of the differences among registrants. Differentiating registrants by size, like differentiating by industry as discussed in the industry guides recommendation, may improve the corporate disclosure system to the benefit of both investors and registrants.

Dissemination of Information (Chapter XVIII)

The Advisory Committee believes that the Commission has a responsibility to maintain a comprehensive, accessible repository of filed information, but that such information should also be reasonably accessible directly from registrants. To improve their usefulness, the Commission's public files should be converted from a statutory basis to a "company" basis, and a "current" company file should contain each company's latest Form 10-K and subsequent 1934 Act (10-Qs and 8-Ks) and 1933 Act filings. The Commission should also require registrants to make all 1934 Act filings available to shareholders on request and to non-shareholders at a reasonable cost.

Finally, the Advisory Committee recommends that the Commission be responsive to the information needs of holders of debt securities and warrants. All company

reports normally made available to equity holders should also be made available to debt holders. These recommendations are based upon the Committee's recognition of growing volume of new corporate bonds and the greater interest in fixed income securities.

RECOMMENDATIONS

Chapter VII

That the Commission adopt the following statement of objectives:

The Commission's function in the corporate disclosure system is to assure the public availability in an efficient and reasonable manner on a timely basis of reliable, firm-oriented information material to informed investment and corporate suffrage decision-making. The Commission should not adopt disclosure requirements which have as their principal objective the regulation of corporate conduct.

Chapter IX

Regarding Commission rule-making and monitoring practices:

The Commission should initiate the rule-making process promptly after identifying a disclosure issue of general significance rather than proceeding exclusively through administrative or enforcement procedures.

Prior to developing the text of a rule involving a major conceptual issue with which the Commission has had limited experience and concerning which there is limited conceptual literature, the Commission should publish a "concept release" identifying the matter being considered, discussing the issues presented and alternatives available and requesting public comment on the "concept" of the proposed new requirement.

Rules proposed for comment should be deemed withdrawn if not adopted or reproposed for comment in modified form within a specified period of time after the expiration of the most recent comment period. A release should be promptly issued to explain why no action was taken. Similarly, concept releases should be withdrawn if no action is taken after a specified period of time and reasons for the withdrawal should be announced.

The Commission should expand the information content of releases announcing the adoption of a rule to include certain additional information and undertakings related to monitoring of the consequences and costs of new disclosure requirements. (The monitoring undertaken may be informal and non-empirical and need not be limited to economic analysis.)

The Commission should continue to be aware of research that is relevant to its statutory mandate and, if necessary, actively encourage such research.

The Commission's annual report to Congress should reflect the information developed by these recommendations.

Regarding industry guidelines:

The Commission should develop disclosure guides for specific industries to encourage uniform textual and financial statement disclosure of material items which are unique to a particular industry.

A mechanism should be established by the Commission to assure that it receives appropriate input from the users and preparers of information in the specific industry prior to the articulation of guidelines.

A few industries should be selected initially as an experiment for these recommendations.

The effectiveness of this experimental program and the guidelines should be reviewed by the Commission within a reasonable time after adoption.

Chapter X

Regarding forward looking information:

The Commission should encourage issuers to publish forward-looking and analytical information.

Experimental programs to encourage certain types of information such as projections and future-oriented analysis should be initiated.

Monitoring of these programs is encouraged for the purpose of determining the usefulness of the information to investors, the costs to issuers, and the responsiveness of issuers to user needs.

The SEC staff review process should be coordinated to assure proper implementation of Commission policy and uniform treatment of issuers.

A safe harbor rule should be adopted to provide maximum incentive for disclosure of management projections and other forward-looking information, whether or not filed with the Commission. The purpose of the safe harbor rule would be to place the burden of proof on the person seeking to establish liability for the disclosure of a management projection, management's analysis of financial information, plans and objectives, and other items of forward-looking and analytical information. The safe harbor rule should be applicable to all registrants and should provide protection from liability unless it is proven that the information was prepared without a reasonable basis or was disclosed other than in good faith.

Regarding Projections:

The Commission should develop an experimental program to further encourage the disclosure of information concerning future company economic performance, including the following steps:

A public statement should be issued to encourage public companies to disclose statements of management projections of future company economic performance in their filings with the Commission on a voluntary basis. These disclosures should be subject only to the conditions that the projections be prepared on a reasonable basis, be disclosed in good faith and be accompanied by an appropriate cautionary statement regarding the inherent uncertainty of the information.

The Commission's statement encouraging the voluntary disclosure of management projections

should state the following:

a. Disclosure of material underlying assumptions and comparisons of projections with actual results, including management analysis of any significant variance, should be encouraged but not required;

b. The items of information to be forecasted should rest within the discretion of management, but should be those most relevant in evaluating the company's securities and should not be items whose projection would create materially misleading inferences;

c. Third party review of management projections should be permitted but not required;

d. Projections previously issued by management having currency at the time a registration statement is filed should be required to be included in the registration statement in their original form or, where necessary, in modified form;

e. The time period to be covered by the projection should rest within the discretion of management; and

f. Inclusion of projections in one Commission filing should not "lock" the registrant into including projections in future filings; likewise, registrants should be permitted to resume the inclusion of projections in filings after a prior discontinuance. However, companies should be encouraged not to discontinue or resume projections in filings without good cause.

The statement should remind companies issuing projections of their obligations under the Federal securities laws to keep such information from being or becoming misleading and to disclose projections on an equitable basis.

Regarding management analysis of financial information (Guide 22 of the Guides for the Preparation and Filing of Registration Statements under the Securities Act of 1933 and Guide 1 of the Guides for Preparation and Filing of Reports and Registration Statements under the Securities Exchange Act of 1934):

The requirement for management analysis should be modified to emphasize that registrants will be given broad latitude as to implementation of the disclosures requested.

It should also be modified to explicitly recognize two separate aspects of management analysis: (1) quantitative analysis (e.g., variance analysis) and (2) discussion of historical facts.

The requirement should be amended to call for a letter, signed by the Chief Financial or Accounting Officer of the registrant and submitted with each appropriate filing, stating that due regard was given to the requirement and in particular to that part which calls for the disclosure of any facts and contingencies known to management which would make the historical record not indicative of the future. This requirement for a letter should terminate three years after its promulgation unless it is expressly extended by the Commission.

Regarding management's plans and objectives:

The Commission should encourage disclosure of planned capital expenditures and method of financing by business segment for the current fiscal year and the succeeding four fiscal years indicating: (a) amounts thereof related to environmental control facilities; and (b) the expected effects on production capacity.

The Commission should encourage disclosure of management plans and objectives.

Regarding dividend policies and capital structure policies:

The Commission should encourage registrants to publish statements of dividend policies.

The Commission should encourage registrants to publish statements of capital structure policies.

Chapter XI

Regarding segment reporting:

The Commission should integrate textual disclosures required in Commission forms with segmented financial statement disclosures required by Statement of Financial Accounting Standards No. 14;

In developing industry guides, the Commission should consider: (1) requiring, as necessary, disclosure of both dollar and, where appropriate, unit sales of each product line within a segment whose total sales comprised a certain percentage of consolidated sales in the previous fiscal year; and (2) developing on an industry basis the most effective product line breakdown for displaying sales information.

The Commission should require segment data in interim reports (Form 10-Q) filed with the Commission.

Chapter XII

Regarding disclosure of social and environmental information:

The Commission should require disclosure of matters of social and environmental significance only when the information in question is material to informed investment or corporate suffrage decision-making or required by laws other than the securities laws. The Advisory Committee endorses the Commission's conclusion that there are no broad categories of social and environmental information, not now covered by mandatory disclosure requirements, that should be made the subject of new requirements.

Chapter XIII

Regarding proxy statement requirements:

The Commission should require each registrant to state in its proxy material or in its annual report to shareholders, whether there is a nominating committee of the board and, if so, who the members of the committee are.

The Commission should require registrants to file under cover of Form 8-K a letter of resignation received from a director when the director requests that the registrant file the letter.

The Commission should direct the SEC staff to review intensively proxy materials which contain certain management proposals, with a view to requiring more uniform and adequate disclosure of the advantages and disadvantages of proposals which may substantially affect the interests of shareholders, including disclosure of estimated costs of any option or similar type plan and the possible impact such plan may have on the behavior of management.

The Commission should require issuers to include in their proxy materials a statement of the date by which shareholder proposals must be received by an issuer in order to be eligible for inclusion in the issuer's proxy materials for its next annual meeting.

The following recommendation passed by a slim majority:

The Commission should develop a package of disclosure requirements that, taken as a whole, will strengthen the ability of boards of directors to operate as independent, effective monitors of management performance and that will provide investors with a reasonable understanding of the organization and role of the board.

There are substantial differences of opinion on the Advisory Committee as to exactly what the substance of the new disclosure requirements should be. For that reason, and also because the Advisory Committee has not engaged in any extensive field research relating to these issues, only the disclosure requirements described above are being specifically recommended to the Commission for adoption. Certain additional proposed disclosure requirements are included in this report to illustrate the general approach to the area that the Committee believes the Commission should consider after the completion of its proposed public hearings on corporate suffrage and proxy disclosure issues.

Chapter XIV

Regarding further integration of the 1933 and 1934 Acts:

The Commission should adopt a single integrated disclosure form to be used for compliance with the registration, reporting and proxy solicitation requirements of the Securities Act and the Exchange Act.

Registrants should be classified into Levels 1, 2, and 3 (proposed definitions are offered in the text of the report) for purposes of compliance with the Securities Act.

Level 1 registrants should be allowed to use a Form S-16 type short form registration statement for primary offerings. Level 2 registrants should be allowed to use a short form registration statement containing the disclosures required by current Form S-7.

In any exchange offer or transaction subject to Rule 145(a):

(a) Level 1 companies should be allowed to utilize short form registration statements containing the disclosure currently required by Form S-16 and certain additional information with respect to the nature of the transaction, which incorporates by reference the company's most recent proxy or information statement and periodic reports, and which undertakes to furnish such documents and the company's annual report to stockholders on request;

(b) Level 2 companies should be allowed to utilize registration statements containing the disclosure currently required by Form S-16 and certain additional information with respect to the nature of the transaction and which incorporates by reference the company's most recent proxy or information statement and periodic reports, provided such reports and the company's most recent annual report to stockholders are furnished with the prospectus; and

(c) Level 3 companies should be required to utilize registration statements containing the disclosures currently required by Form S-1.

The following rule should be enacted to clarify the extent of responsibilities of officers, underwriters and others for materials incorporated by reference in a 1933 Act filing:

> In determining what constitutes reasonable investigation or care and reasonable ground for belief under the Securities Act of 1933, of information incorporated by reference into a registration statement or prospectus, the standard of reasonableness is that required by a prudent man under the circumstances, including (1) the type of registrant, (2) the type of particular person, (3) the office held when the person is an officer, (4) the presence or absence of another relationship to the registrant when the person is a director or proposed director, (5) reasonable reliance on officers, employees, and others whose duties should have given them knowledge of the particular facts (in the light of the functions and responsibilities of the particular person with respect to the registrant and the filing), (6) the type of underwriting arrangement, the role of the particular person as an underwriter, and the accessability to information with respect to the registrant when the person is an underwriter, (7) the type of security, and (8) whether or not, with respect to information on a document incorporated by reference, the particular person had any responsibility for the information or document at the time of the filing from which it was incorporated.

Chapter XV

Regarding reporting requirements under the 1934 Act:

The Commission should encourage companies which file periodic reports on Forms 10-K and 10-Q to substitute, as official filing documents, their annual and quarterly reports to shareholders.

The Form 10-K should be reorganized and the disclosure requirements should be written in a way that will minimize duplication and boilerplate language. The reorganized 10-K should contain five sections: (1) a fact sheet consisting principally of capsule

financial data and a brief description of the registrant's business; (2) background information about special risks or uncertainties and special or distinctive features of the registrant's operations or industry; (3) an analysis of the financial statements and forward-looking information; (4) information currently found in Part II of 10-K which may be omitted if a proxy statement has been filed [this includes details about management's security holdings, options, remuneration, and similar data); and (5) the audited financial statements.

Chapter XVI

Regarding uncertainty in financial statements:

In drafting industry guides for companies with extended operating cycles, the Commission should call for disclosures which will focus on the uncertainties related to certain financial statement amounts. Financial statement disclosures called for by the industry guides should highlight: (1) economic assumptions underlying asset valuation and liabilities subject to greatest uncertainties; (2) information that will enable investors to evaluate the potential impact upon income from operations resulting from changes in those economic assumptions, and the likelihood of such changes; and (3) amounts included in the current year's income statement which are adjustments of estimates included in prior years' income statements.

Regarding criteria to be used by the Commission and the FASB in evaluating accounting standards:

The Commission (and the FASB) in evaluating accounting standards, should consider among other things: (1) the adequacy of disclosures regarding the uncertainties inherent in the measurement process; (2) the adequacy of information concerning the amounts and timing of historical cash flows; and (3) the adequacy of information useful in assessing the liquidity of the reporting entity.

Regarding Differences Between Regulation S-X and GAAP:

A continuing goal of the Commission should be the elimination of rules of general applicability which cause differences between financial statements prepared in accordance with Regulation S-X and those prepared in accordance with generally accepted

accounting principles (GAAP). When the Commission requires an extension of disclosures beyond those required by GAAP because of an emerging problem, the reasons for the extension and the underlying accounting issues involved should be stated. The Commission should then ask the FASB to consider the issue.

Chapter XVII

Regarding Special Problems of Small Companies:

The Commission should hold public hearings to determine: (1) whether, and to what extent, the Commission should attempt to define a category of "small companies" for the purpose of requiring less burdensome reporting; (2) how such a classification, if desirable and possible, should be defined; and (3) if definition is possible, what reductions of reporting requirements are possible, consistent with the purposes of the Federal securities laws.

Chapter XVIII

Regarding Dissemination of Filings with the Commission:

The Commission should convert its filing system from a statutory reporting basis to a company basis and should maintain a "current file" for each Exchange Act reporting company containing the company's latest Form 10-K annual report and all subsequent filings, excluding exhibits, under the Securities Act and the Exchange Act.

The Commission should require public companies to make their filings with the Commission under the Securities Exchange Act available to the public upon request.

Regarding Disclosure to Holders of Debt Securities:

The Commission should be sensitive to the information needs of holders of debt securities and, if deficiencies are identified, corrective action should be undertaken.

The Commission should assure that all company reports available to equity holders are available to debt and warrant holders if requested.

Revised Form 10-K*

PART I: FACT SHEET

ITEM 1. CAPSULE FINANCIAL DATA

(a) Present in comparative columnar form the following financial data for the registrant and its subsidiaries (if any) consolidated for each of the last five fiscal years of the registrant (or for the life of the registrant and its predecessors if less): Net sales; income from continuing operations; net income; working capital; cash flow; total assets; total indebtedness; and shareholders' equity.

(b) Present in tabular form for at least the two most recent fiscal years any operating statistics called for by appropriate Industry Guide(s).

ITEM 2. PRODUCTS AND SERVICES

Present a list of all business segments identifying principal classes of products and services within each segment. For each reportable industry and homogenous geographic segment state for the registrant's last five fiscal years the approximate amount or percentage of (i) total sales and revenues, (ii) income (or loss) before income taxes and extraordinary items and (iii) identifiable assets attributable to each business segment.

INSTRUCTIONS:

1. Definitions of "reportable business segments", "principal classes of products and services," "identifiable assets" etc. would be included. The definitions set forth in Appendix A "Definitions and Guidelines for Compliance with Industry and Homogenous Geographic Segment Reporting Requirements" to the Commission's Release on Segment Reporting (1933 Act Release No. 5826) would provide an appropriate reference.

ITEM 3. MARKET FOR THE REGISTRANT'S SECURITIES

(a) State the appropriate number of holders of record as of the end of the period for which the report is filed and the number of shares outstanding of each class of equity securities of the registrant and the average weekly trading volume during the previous fiscal year.

(b) Furnish the following information, as of the most recent practicable date, with respect to any person (including any "group" as that term is used in Section

*Instructions only appear in this draft where necessary to explain modification proposed and are not inclusive of all instructions in the revised form. A number of existing instructions will be carried over into the new form.

13(d)(3) of the Securities Exchange Act of 1934) who is known to the registrant to be the beneficial owner of more than five percent of any class of the registrant's voting securities: (i) the title of class of securities owned; (ii) name of owner, (iii) the total number of shares beneficially owned, and (iv) the percent of class so owned. Of the number of shares owned, indicate by footnote or otherwise, the amount known to be shares with respect to which such listed beneficial owner has the right to acquire beneficial ownership, as specified in Rule 13d-3(d)(1) under the Exchange Act.

ITEM 4. PROPERTIES

If applicable, identify by appropriate unit or class of units manufactured the registrant's productive capacity by segment and the extent of utilization thereof.

INSTRUCTION:

The location and general character of the principal plants, mines, and other materially important physical properties of the registrant or its subsidiaries shall be filed as an exhibit to this report. A list of all subsidiaries should also be filed.

ITEM 5. PENDING LEGAL PROCEEDINGS

Briefly describe any material pending legal proceedings, other than ordinary routine litigation incidental to the business, to which the registrant or any of its subsidiaries is a party or of which any of their property is the subject. Include the name of the court or agency in which the proceedings are pending, the date instituted, the principal parties thereto, a description of the factual basis alleged to underlie the proceeding and the relief sought. Include similar information as to any such proceedings known to be contemplated by governmental authorities.

INSTRUCTION:

Registrants are encouraged to incorporate by reference any discussion of legal proceedings appearing in the footnotes to the financial statements, however, that discussion should be supplemented by any information required by the item but not appearing in the information incorporated by reference.

ITEM 6. EXECUTIVE OFFICERS AND DIRECTORS OF THE REGISTRANT

(a) List the names and ages of all executive officers and directors of the registrant who have not held their current office with the registrant prior to the beginning of the period reported.

(b) Give a brief account of the business experience during the past five years of each executive officer named in (a) including his principal occupations and employment during the most recent five year period and the name and principal business of any corporation or other organization in which such occupations and employment were carried on.

(c) List the names and positions held of all officers and directors who terminated their employment with the registrant during the previous year.

PART II

ITEM 7. INFORMATION CONCERNING SPECIAL RISKS OR UNCERTAINTIES

Describe by business segment those factors, if any, which cause investment in the company securities to be high risk or highly speculative in nature. Examples of appropriate factors which might be discussed include the absence of an operating history of the registrant, an absence of profitable operations in recent periods, the financial condition of the registrant (including recent adverse changes therein), lack of management experience and the speculative nature of the business in which the registrant is engaged or proposes to engage.

ITEM 8. INFORMATION CONCERNING SPECIAL OR DISTINCTIVE FEATURES OF THE REGISTRANT'S OPERATIONS OR INDUSTRY

(a) Describe by business segment those distinctive or special characteristics of the registrant's operations or industry which may have a material impact upon the registrant's future financial performance. Examples of factors which might be discussed include dependence on one or a few major customers or suppliers (including suppliers of raw materials or financing), existing or probable governmental regulation, expiration of material labor contracts or patents, trademarks, licenses, franchises, concessions or royalty agreements, unusual competitive conditions in the industry, cyclicality of the industry and anticipated raw material or energy shortages to the extent management may not be able to secure a continuing source of supply.

INSTRUCTION:

This paragraph is intended to provide the investor with background information about the industry and company environment in which he or she has invested to the extent that information is distinctive or unique to either the industry or the company.

PART III

ITEM 9. MANAGEMENT ANALYSIS OF THE FINANCIAL STATEMENTS AND FORWARD-LOOKING INFORMATION

Provide an analysis for each business segment of the reported financial statements which (1) will enable investors to understand and evaluate material periodic changes in the various items of the reported financial statements; and (2) will enable investors to relate the reported financial statements to assessments of the amounts, timing and uncertainties of future cash flows for the reporting entity.

INSTRUCTIONS:

1. The analysis of material periodic changes (a) should explain material increases or decreases in discretionary items such as research and development costs, advertising expenses, and maintenance and repair expenses, and (b) should break down variances into components, such as the amounts by which changes in prices and changes in volume resulted in a material change in sales.

2. The analysis should focus on facts and contingencies known to management which would cause reported financial statements to be not indicative of future operating results or of future financial condition. This would include description of and amounts of (a) matters which will have an impact on future operations or financial condition and have not had an impact in the past, and (b) matters which have had an impact on reported financial statements and are not expected to have an impact upon future operations or financial condition.

The form and content of disclosures pursuant to this item will necessarily vary among registrants and will change from period to period for the same registrant as circumstances change. In general, the disclosures should be similar to that which the chief executive officer might prepare for the board of directors of a company. Both quantitative analysis and narrative discussions are important.

3. Voluntary disclosures of projections of future economic performance and of future financial condition, and voluntary disclosure of management's plans and objectives may be included as part of this analysis. Since management's projections, and plans and objectives will inevitably reflect some amount of management's biases, it would be desirable to disclose the major assumptions which were made in developing such projections, and plans and objectives; however, disclosure of assumptions is not required in conjunction with voluntary disclosures of projections or of management's plans and objectives.

4. Registrants are encouraged, but not required, to furnish for each business segment a description of planned capital expenditures and financing for (1) the current fiscal year and (2) the succeeding four year period. If this information is furnished, it would be desirable to disclose the amounts related to environmental control facilities and the expected effects upon production capacity, and to furnish an analysis of differences for the most recent fiscal year between previously-disclosed budgets and actual capital expenditures.

PART IV: Part II of Current Form 10-K*

PART V: Financial Statements*

* Parts IV and V will remain substantially the same as in the current Form 10-K; but see recommendations regarding proxy statement disclosure (Chapter XIII) and financial statements (Chapter XVI).

DISSENTING STATEMENT OF HOMER KRIPKE

I strongly support the recommendations of the Advisory Committee with respect to projections and other soft information and with respect to monitoring.

I dissent from the remainder of the Report. I had intended to sign the Report and express some reservations. But after a majority of the Advisory Committee adopted the Introduction as its own, as described below, my views must be classified as a dissent.

Early in the Advisory Committee's history, at the October 1976 meeting, the Committee determined that it believed that a mandatory system of disclosure run by government is necessary. The minutes state that these determinations were to be enlarged upon in the Final Report, but the manner of enlargement was not indicated. I consider these determinations to be trivial, as explained below.

In a series of memos to Chairman Sommer and to the Committee before and after the October meeting, I tried to indicate that a black-or-white, all-or-none approach to the evaluation of mandated disclosure was inadequate.* After its May, 1977 meeting, which was supposed to be its last meeting at which substantive matters were to be considered,** the minutes repeated the same determinations

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* See also my article, An Opportunity for Fundamental Thinking--The SEC's Advisory Committee on Corporate Disclosure, N.Y.L.J. Dec. 13, 1976, reprinted in SEC 1977 (N.Y. Law Journal Press, 1977).

** It was to be followed only by a final meeting to consider the draft of the Committee's Report.

plus an approval of the SEC as the governmental agent, in explanation of the Committee's refusal at the meeting of my request to discuss the subject further.

Taking everyone's good faith and good will for granted, I have tried to understand the contrast between the above sparsely expressed attitudes of the Committee and its sudden loquaciousness on the subject in the Introduction to the Report. I conjecture that the original attitude was due to a confusion of the efficient market hypothesis and other new insights of economics, which would leave room for a sensitive appraisal of the costs and the benefits or usefulness of the Commission's mandated disclosure system, with the Stigler and Benston theses, which are stated on an all-or-none basis and require merely a corresponding response.* Thus the Committee never went beyond the conclusion that some mandatory disclosure was needed, to the question "How much?".

The determinations recited in October, 1976 and repeated in May, 1977 are in my opinion trivial, because they merely reject Stigler-Benston. They do not address the real issue of analysis of costs and benefits.

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* Chairman Sommer of the Advisory Committee seemed to be particularly concerned about the Stigler and Benston writings while he was a Commissioner. See Sommer, Required Disclosure in the Stock Market: The Other Side, Address before the Conference Board, New York, Sept. 27, 1973, at 5. He alluded to them again in explaining the purposes of the Advisory Committee, Sommer, The Disclosure Study: What Is It? Address before the Midwest Securities Administrators, February 17, 1976.

The Committee's sudden willingness to discuss the subject at length in the Introduction has the following background:

During the summer of 1977 I drafted, to accompany my signature to the Report, some reservations which expressed some cost/benefit hypotheses. During the same period a member of the Advisory Committee was drafting the Introduction, which developed into an advance rebuttal of my views. His first draft was transmitted to Committee members on August 31, 1977. At the final meeting of the Advisory Committee on September 6, it was understood that the Chapter would be redrafted. It was resubmitted on October 13. It was made the subject of a mail and telephone vote in the last two weeks before filing of the Committee's Report. It received the concurrence of a majority but not all of those voting.

The unsoundness of this procedure does not necessarily mean that the substance of the Introduction is unsound. The Introduction is stated to be a statement of reasons for propositions essentially similar to the determinations of October 1976 and May 1977, but prefatory remarks to the Introduction state these propositions somewhat differently, and add to them a rejection of the reliability of market forces. These remarks were added this last weekend.

Most readers will accept the Introduction's opposition to "dismantling" or "elimination of" the disclosure system, which is an absolutist rejection of the absolutism of Stigler

and Benston.

The reader will find cause to marvel at the Committee's fervid rejection of the possibilities of voluntary disclosure in the issuer's self interest, in view of the opposite views attributed to the Commission by Commissioner Sommer in explaining the purposes of the creation of the Committee: "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." Sommer, The Disclosure Study: What Is It?, Feb. 17, 1976. The reader may also wonder why the Committee rejects the remarks of its staff, who conducted extensive field interviews and in its Chapter X uses language supportive of the Commission's, not the Committee's, views. But the Committee claims that its conclusion rests on its own research.

On the paramount issue of costs and benefits, the Introduction (and the remainder of the Report) remain essentially silent.* They reject the possibility of

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* The Digest of the Report in draft form supplemented its brief discussion by asserting: ". . . subjective conclusions about cost/benefit tradeoffs underlie the recommendations found in this report." The word "conclusions" was changed to "perceptions" because one member of the Committee wrote the staff: "We really didn't have any discussion of cost/benefit tradeoffs for most of our recommendations."

a useful cost/benefit analysis by this Committee,* although the Committee's charter adopted by the Commission (including the Committee's Chairman, Mr. Sommer, who was then a Commissioner) includes the following:

> ". . . (B) The Committee's objectives are as follows:
>
> * * *
>
> 2. To assess the costs of the present system of corporate disclosure and to weigh those costs against the benefits it produces; . . ."

An underlying attitude like this must have been responsible for the frustrating history described above. I reject this defeatism. I do not, however, use this forum to set forth my own views, because they are still individual hypotheses untested by Committee discussion.

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* The spirit of the times should have precluded this kind of evasion of this question. See three articles on Regulation in the quarterly, The Public Interest, Fall, 1977. In one of these, Nichols and Zeckhauser, Government Comes to the Workplace: An Assessment of OSHA, Id. 39 at 58, it is said:

> "OSHA has steadfastly refused to subject its standards to any kind of benefit-cost analysis, repeatedly observing that there is no widely accepted method for assigning dollar values to improvements in health or longevity. While the observation is correct, OSHA's attempt to use it as a justification for failing to integrate considerations of both costs and benefits into its policy decisions is not. The rationale for government intervention in the area of workplace safety and health is not that costs should be divorced from benefits, but rather that some costs and benefits may be misperceived by, or are not borne by, private decision makers."

I hope to address the subject at a future time.

As to the remainder of the Report:

Of course, I do not dissent from the Chapters written by the staff and containing the results of its field study. I do note, however, how little the Committee's conclusions rest on the field study. Indeed, examination of the Committee's minutes will show that all of the Committee's important conclusions except the Introduction were reached before the results of the field study were available.

I have long expressed my reservations as to the Commission's delegation of its authority over accounting principles to accountants' agencies, and I dissent from the proposed enlargement of this delegation by subordinating the Commission's requirements on accounting disclosure to those of the FASB. Until recently the Commission's spokesmen had claimed that it was retaining this jurisdiction for itself.

I dissent from the portions of the Report dealing with new additional disclosures and with revision of the forms. It is not so much the detail of these recommendations which concerns me. On questions of detail I am willing to submerge my own views in deference to majority views. Many of the proposals of the Committee's dedicated and able staff to whom I am grateful, are meritorious. Rather, my objection concerns the priorities pursuant to which the Committee devoted so much of its time and energy to these matters. The

regular staff of the Commission is capable and energetic and has been engaged in producing new disclosure requirements and revising the forms on a continuous basis for over 40 years. The regular staff is presently in the midst of a period of great productivity, proposing new requirements and revision of the forms at an astounding rate, at least supplying all of the demands of the market. What the Commission did not need was a second shift of special staff and an Advisory Committee of volunteer supervisors increasing this productive activity over normal levels, while the Committee was failing and refusing to discuss the fundamental problems.

What the Commission did need at this time--and what I thought was called for by the the Advisory Committee's charter--was a broad-gauged consideration, with an adequate perspective, of the usefulness of continuous maintenance and enlargement of the detail of the mandated disclosure system, especially for established companies. In my opinion this would have involved a sensitive consideration of (a) the present system of costs of disclosure taxed by the Commission* on issuers for the

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* And its delegate, the FASB. The heavy tax on issuers for the cost of segmented accounting disclosure was levied by the FASB, a private agency, and enforced by the Commission without any initiative or independent consideration of its own.

benefit of security analysts and the public (like transfer payments taxes to fund welfare); and (b) the limited apparent benefit of the system in the light of the fact that it is past-oriented and necessarily firm-oriented, while it becomes increasingly apparent that the macro-economic events bombarding our times overwhelm the detailed disclosures of the individual company in their impact on securities selection considerations and on securities prices.

The Report shows that the Committee never accomplished or even attempted this task, and the Introduction shows that the Committee remained fixated to the end on an all-or-none approach to mandated disclosure.

Homer Kripke
November 2, 1977

SEPARATE STATEMENT OF ROBERT A. MALIN

Perhaps owing to the composition of the Committee's membership,[1] President Ford's and SEC Chairman Hills' challenges to seek practical methods to deregulate have gone largely unanswered. Instead, many on the Committee have proposed increased regulation, notwithstanding clear evidence that the costs of the current mandatory disclosure system outweigh its benefits.

The varied economic forces operating in the investment markets act to produce information flows so broad and rapid that the SEC's system of corporate disclosure is now largely supplementary (although arguably crucially supportive). After over four decades of increasingly detailed regulatory requirements the point of diminishing returns in terms of value to investors has long since been passed. It is time to attempt modest deregulation. A few examples may suggest some practical approaches:

Automatic "sunset": Most of the SEC's present and future disclosure rules could be made subject to an automatic phase-down or phase-out process; thus time alone could rid the system of outdated and/or unproductive disclosure requirements. This gradual process would allow for necessary adjustment and experimentation.

1/ The Committee has many distinguished representatives of the legal, accounting and academic professions; however, neither corporations nor investors are sufficiently represented.

Filing reviews: SEC staff reviews of registration documents generally add importantly to the cost, but contribute very little of investor value. It is clear that most corporate registrants (including their counsel, accountants, investment bankers, etc.) exercise sufficient care in registration document preparation to justify investor reliance without SEC line-by-line scrutiny.[2/]

Economic justification: The SEC could adopt rigorous cost/benefit "hurdle" tests to prevent the adoption or continuance of all but the most basic disclosure requirements, unless demonstrable economic value to investors exceeded associated costs. This would cause the focus of mandatory disclosure to shift towards clearly evident investor needs and help slow apparently irreversible regulatory momentum.

Accounting disclosure: The FASB has already proven itself both capable and willing to deal with accounting problems of both principle and disclosure. Furthermore, it is amply sensitive to investor needs. The SEC, without shirking its statutory obligation, could largely remove itself as an accounting rule-setter and enforcement agent.

Certain proposals for increased mandatory disclosure merit brief dissenting comment:

2/ It is worth noting that court decisions against corporations for material omissions or misstatements are extremely rare.

Segment reporting: To increase the extent and complexity of already burdensome and sometimes artificial segment reporting cannot be justified in terms of investor need or use; if investors require further segment information their market power can produce it. That sell-side analysts must continually press for increased SEC requirements in this area offers proof that the market won't voluntarily pay for it.

Industry guides: The beguiling arguments for the development of specialized industry disclosure guides [elimination of irrelevancies, uniformity of requirements, user participation, etc.] are only a mildly deceiving veil for what are obvious proposals for increasingly complex and detailed regulation. For decades, registrants have successfully applied the SEC's disclosure rules to their specific circumstances; an additional overlay of specialized guidelines will only make that task more difficult and introduce superficial and misleading "standardization".

Corporate "suffrage": This concept, however appealing to those seeking various social objectives, is usually meaningless to investors seeking to obtain economic return. Some social issues may involve major economic consequences, but the corporate ballot box is an awkward and inefficient means of dealing with them. The solid improvement in the performance of corporate

directors throughout American industry is continuing; the extent to which proxy statement disclosures proposed by the Committee can contribute to this manifest progress is uncertain at best.

Forecast data. In response to investor demand, corporations often voluntarily disclose various types of forecast data that managements are presently precluded from doing so under the SEC's mandatory disclosure system works a clear disservice upon investors. But to permit and encourage registrants to provide forecast data only within a set of tightly administered mandatory "guidelines" would defeat the purpose. The data sought is inherently difficult to generate and disseminate; maximum flexibility ought to be allowed for experimentation. The "safe harbor" rule will offer managements and underwriters scant comfort until fully tested in the courts.

Companies and investors generally agree that the philosophy and practice of mandated full disclosure have facilitated capital raising and investment decision-making. But there are practical economic considerations involved in (a) complying with detailed and complex requirements and (b) making use of information so reported. The SEC's well-earned reputation for professionalism and fairness notwithstanding, the mandatory disclosure system it administers needs rigorous pruning, not new growth.

Robert A. Malin
October 5, 1977

SEPARATE STATEMENT OF DAVID NORR
(Roger Murray Concurs as Noted Below)

In view of the great importance of the subject and the limited occasions on which Disclosure is given a thorough review I wish to set forth certain observations:

The SEC should require a compulsory educational program for all analysts.

In preparing financial statements for sophisticated investors there is an assumption that there is a large class of well informed users. Responses from certain investors and registered representatives indicated a hunger for education. In order to assure an even-handed approach to disclosure, efforts should be made to assure corporations, accountants, registered representatives and individual investors, that the user is well equipped to benefit from the intense level of disclosure beamed at him.

There is in existence a voluntary testing and certification program, Chartered Financial Analysts. Response over many years has not been overwhelming. The program should be reexamined; if found satisfactory it should be compulsory. If not satisfactory a substitute program should be designed for analysts.

This is designed to assure that the sophisticated user has been exposed to substantial details of the latest accounting theory, economics and portfolio policy.

2. Proxy Statements should be stapled into annual reports.

Proxy statements are all too often ignored by investors. One way to put the "disinfectant of sunlight" on proxy statements and give them greater visibility would be to include them in the annual report. As of now too few analysts are familiar with proxy statements of the companies they follow. Greater dissemination of proxy statements would not, it seems, unduly burden reporting companies.

3. Information in 10-Ks should also be found in annual reports.

There is no excuse for excluding, as is the current practice, important investment information from the annual report. The annual report is the basic investment document. To put added information in the 10-K serves no purpose other than creating a class of proofreaders searching for new tidbits. All the data of concern should be in one handy place. Mr. Murray concurs.

4. Segment Reporting.

No subject is more important to investors than segment reporting. But 10 years after the SEC first issued a call for this method of disclosure conspicuous gaps persist in the information available to investors. The Advisory Committee recommends that the SEC require interim reports to include segment profit data. This would result in significant improvement.

Several other reforms are necessary, however. First, where significant variations in tax rates exist, segment profit data on an after tax basis and after all allocations should be reported. This is the only meaningful way to disclose operating results and would remedy a significant omission in SFAS No. 14.

Second, SFAS No. 14 provides an exemption to integrated companies. Where there are separate markets and different rates of profit and risks in these markets, failure to require segment reporting ignores investment realities. Segment disclosure in the annual reports should be monitored by the SEC. If SFAS No. 14 fails to result in meaningful disclosure in the chemical, paper, mining, oil and other integrated industries, the SEC should remove the exemption granted integrated companies. It should be noted that President Carter has called for significant segment reporting in the oil industry.

Finally, it remains to be seen how management and accountants will interpret the foreign segment reporting requirements of SFAS No. 14. These disclosures should be monitored in the annual reports for 1977. If found inadequate, the SEC should study disclosures already made anywhere in the world, with a view to incorporating that profit data in a summary table in the annual report, on the basis of GAAP.

Thus, if a local affiliate has an annual report available in German, another has a report available in Italian, if a loss is reported in Sweden, if there is a filing with a government agency in Japan, if there is a response to a Fortune 500 International request, if French bondholders receive a prospectus with French results, if there is a filing in the UK under the Companies Act, -- then all those items should be recapitulated in the annual report.

Note that this data is now publicly available. The results should be adjusted to GAAP in preparing the consolidated U.S. report. The FASB failed to consider this. The SEC should not ignore the vast information publicly filed around the world.

5. Cutting through the detail.

Wallace Olson of the AICPA raised this point in a speech a year ago. What can be done to simplify the proliferation of footnotes to tell the essential story? Forecasting is certainly a step in the right direction. Are there other moves that can be made?

The problem is readily evident if one contrasts an investment analysis with an annual report. One is historical, and the other analytical and future oriented. Regrettably, the Committee did not address this issue adequately.

David Norr
November 3, 1977

SEPARATE STATEMENT OF ELLIOTT J. WEISS

I express my concern about the second sentence of the Committee's recommendation pertaining to the objectives of the disclosure system, which states that the Commission should not require disclosure where its "principal" objective is to influence corporate conduct. The Committee, in explaining that statement, makes clear that its intent is only to bar disclosure where the information sought is immaterial. However, I believe the language of the recommendation itself is ambiguous and could be misinterpreted as suggesting that the Commission should not require disclosure of information it believes to be material where its principal objective in requiring disclosure is to influence corporate conduct. Consequently, the sentence in question should have been deleted or changed to conform more closely with the language explaining its purpose. I note that the Committee explicitly acknowledged that there have been situations where the Commission believed information to be material but where it required disclosure primarily to influence corporate conduct, and that the Committee decided not to question the propriety of those actions. ASR 165 is an example of such a situation; there the Commission required disclosure relating to changes of auditors for the stated purpose of strengthening auditors' independence.

I also believe that in situations where the

Commission's principal objective is to influence corporate conduct, the Commission should state both the reasons why it wishes to influence corporate conduct and the reasons why it believes the information it is requiring be disclosed is material. By following that procedure, the Commission would make clear the purpose of its actions and would facilitate judicial and legislative evaluations of its actions.

Elliott Weiss
November 3, 1977

SEPARATE STATEMENT OF FRANK T. WESTON

(Roger Murray Concurs As Noted Below)

I am disappointed that the Committee has taken a narrow view of a portion of its charge--"to articulate the objectives of a system of corporate disclosure"--and has limited its consideration to the objectives of the Securities and Exchange Commission in its administration of the present disclosure system. A broader approach would have developed information as to the current environment which would have been useful in assessing the appropriateness of the present corporate disclosure system.

I believe that the recommendation regarding the voluntary disclosure of projections should provide that, when a projection is disclosed, disclosure of the major assumptions is mandatory. In my view, a projection which does not disclose its major underlying assumptions is of very little value and may be misleading, particularly if the assumptions differ significantly from those anticipated by the reader. Such disclosure also helps to communicate to users that there are significant uncertainties involved in the projection process and thereby cautions users as to the limitations of projections of operating results. Mr. Murray concurs.

I also believe that the report should make clear that there is, in effect, a mandatory requirement that a published projection be revised whenever it differs significantly from

management's current projection for the specified period and thus could be considered currently misleading. The treatment of this matter in the report is far from clear. Mr. Murray concurs.

With respect to the recommendations as to management's analysis and the revised Form 10-K, I believe that the requirement that management disclose "facts and contingencies known to it which would cause reported financial statements to be not indicative of future operating results or of future financial condition" is equivalent to requiring a forecast or projection of future operating results. I believe that this should be made clear in the report. This mandatory forecast requirement is inconsistent with the Committee's view expressed elsewhere in the report--with which I agree--that the disclosure of projections should be on a voluntary basis for the foreseeable future in order to encourage such disclosure.

With respect to social and environmental information, I believe that the Committee has failed to take a sufficiently broad and objective view of the increasing importance of the measurement and disclosure of corporate social performance. Disclosure of the social consequences of business actions is becoming an integral part of modern accountability and the corporate suffrage process. The Committee has failed to explore this important area and to take a responsible position to encourage the expansion

of this type of disclosure. Mr. Murray concurs.

The recommendations as to financial statements include a requirement that financial statements for certain industries disclose "information that will enable investors to evaluate the potential impact upon income from operations resulting from changes in those economic assumptions [underlying asset and liability valuations subject to greatest uncertainties], and the likelihood of such changes." I object to this requirement since it introduces into the historical financial statements forecasts of the impact of future events on future results of operations and also requires management to indicate the probability [likelihood that such changes will occur. While I favor the publication of forecasts of operating results, I believe that the results of this process should be displayed separately from the historical financial statements. The introduction of this type of information in financial statements--particularly when limited to certain items--is bound to confuse users and reduce the credibility of financial statements.

Frank T. Weston
October 5, 1977

Introduction

The most fundamental questions which the Committee addressed, and the answers to which are basic to its entire work, including the recommendations contained in this Report, are relative to whether there is under present conditions sufficient reason to continue essentially in its present form the SEC-administered system of mandatory company-originated information. This most fundamental question has been raised by economic studies, such as the efficient market hypothesis; by eminent scholars, such as Professors George J. Stigler and George J. Benston, who have questioned the benefits of the system; by renewed interest in the reduction of the scope and quantity of regulation; by the dissatisfactions with the present system

voiced by many of the participants in the system, especially issuers which bear most heavily the costs of the system. If the answer to this fundamental question is negative, of course, the recommendations contained in this report are without logical or practical foundation.

The answer to this question depends upon the validity of four basic propositions. These are:

1. Reliable and timely information sufficient to the needs of those who have the responsibility for the allocation of investment (capital) resources is essential to the efficient allocation of resources in any economy;

2. Market forces and self-interest cannot be relied upon to assure a sufficient flow of timely and reliable information;

3. Such being the case, there must be present in the system an effective mandate to assure that sufficient, timely and reliable information is available to investment decision-makers; and

4. In view of its experience, expertise and record, the federal government, and more particularly, the Securities and Exchange Commission, is the appropriate agency to provide such assurance.

All members of the Committee who are signatories to this Report concur in these statements. Committee member

Beaver's qualifications are set forth in the Chapter written by him.

The following statement, prepared by a member of the Committee, is intended to provide economic and non-economic justifications for these conclusions; these are not exhaustive or definitive. This statement is concurred in by a majority of the members of the Committee.

The Disclosure Study had its origins in many circumstances and considerations. Among "participants" in the process -- issuers, analysts, auditors and others -- there had developed considerable criticism of the process. Some, notably issuers, complained that they were being subjected to increasingly heavy burdens of disclosure without clear evidence that the information was either useful or used by investors. Disclosure documents had become increasingly complex and the recurrent complaint was that few, if any, read them. Even among experienced securities analysts, there were complaints that, for instance, the footnotes to financial statements had expanded to such a point that truly useful information was obscured. Many users of documents filed with the Securities and Exchange Commission complained that long standing, now antiquated, Commission policy prevented issuers from including in such documents information of types which had been demonstrated to have utility, particularly so-called "forward-looking information": earnings forecasts, estimates, appraisals, management projections and the like. Also, federal agencies increasingly were urged to concern themselves with cost-benefit analyses; critics of the SEC administered disclosure system suggested that the benefits from expansions of disclosure bore little relationship to the costs that were

imposed upon issuers and others in complying with these new requirements.

These sources of the Study are dealt with in other parts of this Report. This chapter is concerned with a more fundamental consideration, namely, whether there are presently economic and public policy justifications for the existence of a disclosure system that, at least with respect to company-originated information, is characterized by a strong mandatory dimension regulated by a federal agency.

The Committee carefully considered, in the course of its study and deliberations, the various economic theories which have been propounded in recent years with respect to securities and securities markets. The staff, as well as Committee members, reviewed extensively the literature which has developed concerning these matters in the last two decades. While recognizing that the work that has been done with respect to securities markets disclosure and related topics is fully deserving of the most careful scrutiny and attention by regulatory agencies and others as well, the Committee cannot conclude at this time that the research so far justifies a dismantling of the present disclosure system or a radical reorganization of its structure. However, the Committee does encourage the Securities and Exchange Commission to monitor constantly the development of economic

thinking with regard to securities markets and the economics of disclosure and as this research continues, to modify its policies when such studies result in sufficiently certain conclusions, including conceivably at some point in the future a conclusion that, at least with regard to a portion of the universe of securities traded, forces other than direct regulation of disclosure are sufficient to safeguard the interests of investors.

The Committee believes that at the present time there continues to be a need in this society and in this economy for a disclosure system with respect to company-originated information that is characterized by a substantial mandatory element administered by a federal governmental agency; the Committee further concluded that, given its expertise, experience and proven record of competence, the Securities and Exchange Commission is clearly the most logical agency to administer the system. The reasons for these conclusions constitute the remainder of this chapter.

The Origins of Federal Regulation of Disclosure

The adoptions of the Securities Act of 1933 and the Securities Exchange Act of 1934 were preceded by very little theoretical economic discussion before Congressional committees or in Congress. This is not surprising. Congress, like the rest of the nation, in 1933 and 1934 confronted a

severe economic crisis in the country and the world. As Congressional investigations sought out the causes of the national catastrophe, it quickly appeared that there had existed during the 20's serious abuses in the public markets for securities. There had been sordid manipulations on the exchanges, so-called "bear raids", grave misuses of options and other speculative techniques, and a host of other abuses. It appeared that singular among those abuses was the failure by issuers and those in control of them to provide the public with important information about the securities being sold during distributions and traded on exchanges. It was these shortcomings in the distribution process that Congress first attacked through the Securities Act of 1933. Later, in 1934 it expanded the disclosure philosophy to include periodic reporting by listed companies and also attacked other manipulative practices as well.

It is not surprising that Congress gave little attention to economics. Prior to 1933 there had been little research done with respect to securities markets. Furthermore, at the time when Congress was formulating these statutes, economists were frantically trying to understand the national trauma which was then continuing and develop mechanisms and techinques which might abate or reverse the disastrous deflation which had afflicted the country.

Non-disclosure and false statements having been identified as widely present during the distribution of securities in the 1920's, Congress attacked that evil in a direct and, in the estimation of many, relatively unsophisticated fashion. The actions it undertook had some foundation in the common law. The applicability of deceit, fraud, and other common law actions to securities transactions was well established. However, it was often virtually impossible for investors to utilize the remedies provided by common law or by state statutes, because of difficulties in proving the necessary elements of the offense and in hounding down the miscreants in a country as large as the United States. Thus, an investor defrauded in, say California, might be confronted with the necessity of bringing suit in New York if he could find there the one who had harmed him. Furthermore, many who ostensibly bore responsibility to the public were, because of common law doctrines such as privity, reliance and the like, able to escape liability even when they could be found and sued. Thus Congress, perhaps somewhat simplistically, having seen evil done on "Main Street" by conduct often indistinguishable from outright fraud, opted for a system bearing elements of the common law, strongly influenced by the British experience under the Companies Acts, and plainly inspired by the

Brandeisian axiom concerning the efficacy of sunshine and the electric light as policing instruments. The legislative history of the 1933 and 1934 Acts contains little effort to determine whether had there been more candid disclosure in the 20's, the financial catastrophe might have been avoided or mitigated; experience during recent speculative orgies casts doubt on the easy assumption that it would have.

Changes in Securities Markets

Since the enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934 there have been profound changes throughout society; industry and the securities markets have been among those most dramatically changed. Increasing amounts of investable wealth have been concentrated in the hands of so-called "institutional investors". It has been estimated that approximately 70% of the dollar volume of trading on the New York Stock Exchange is institutional. Concurrently with this, and somewhat anomalously, the number of individual investors has, at least until recently, steadily increased, reaching a peak in 1970 of over 30 million. The causes of the decrease in numbers since that time are uncertain: An apparent decline in profit opportunities in equity securities has been suggested as the possible reason. During this period, a virtually new profession emerged, that of financial analyst. At the time

Congress enacted the 1933 and the 1934 Acts, Messrs. Graham and Dodd were in the final stages of preparing their monumental work on security analysis. This enormously influential book was in the eyes of many responsible for the development of a profession devoted to the collection and analysis of corporate, industry and economic data and the drawing of conclusions with respect to investment decision-making from that analysis. Because of the increasing presence at the edges of the marketplace of skilled, well-trained analysts, there arose a greater demand for larger and larger amounts of complicated information concerning issuers, information of a volume and complexity little suited to the needs of individual investors. That the disclosure system enacted by Congress might yield an information system of only limited direct utility to unsophisticated investors was not surprising. This was recognized in the course of Congressional deliberations and was also discussed by Professor (later Chairman of the SEC, later, Justice) William O. Douglas. In an article which appeared in the Yale Review (N. S.), Professor Douglas suggested that the disclosures mandated by Congress and the SEC were too complex for the understanding of the ordinary investor and stated that any benefit accruing to him would be the consequence of intermediation by brokers and others able to assimilate, condense and communicate the information.

Since 1934, there has also developed a sophisticated, extensive, variegated dissemination network through which information concerning issuers, industries, and the domestic and world economy flows in various formats to many audiences of differing skills and needs. Thus, many brokerage houses supply extensive research, not only to institutional investors, but to individuals as well. In addition, a multitude of advisory services and information services have developed; so that it may be fairly said that there is available to investors a vast variety of sources of information, advice, format, condensation and analysis so that they are not dependent for information on mastering the SEC-filed documents. The extent to which these services supplement, and depend on, the SEC information system is discussed later in this chapter.

Along with these forces, there has, of course developed an increased complexity in industrial and commercial organization. "Multinationals" and "conglomerates" are essentially terms of the current generation. While in the 1930's, many American companies had export activity, relatively few had extensive overseas operations. Furthermore, while there were in the 1930's some businesses engaged in activity in more than one industry, these were scarce. During the 1960's particularly, American companies expanded their

activities dramatically abroad and diversified them through acquisitions as well as by internal development. The communication of information about such companies in a meaningful and useful way became a challenge to management, but dealing with it and interpreting it was also a challenge to analysts who were increasingly troubled by the absence of segmented data and to the Securities and Exchange Commission confronted with increasing evidence of serious deficiencies in disclosure policy.

During this time there developed new legal theories which to a large extent had the effect of restricting the opportunity of "insiders" to use information not publicly known in making investment decisions. These legal theories appeared to have as their predicate the belief that there should be created in the market as large a measure of equality in access to information as practicable, i.e., investors, large and small, should be brought to as close a position of parity as possible.

Concomitantly with all this there developed strong pressures for change in the procedures and institutions of the accounting profession. The history of the 1960's and early 1970's suggests that the accounting profession, as well as the business community, experienced tremendous difficulty in adapting accounting principles and auditing

standards to the new necessities of disclosure posed by multi-national and multi-industry companies. The development of new means of conducting business, new kinds of enterprises, and new techniques for the inflation of profit placed considerable pressure upon conventional standards and often the inadequacy of those standards become painfully apparent when some companies displayed drastic financial reverses.

Finally, in the early 1970's there developed a considerable interest in, and considerable political pressure to achieve, "deregulation", with a substitution of market forces for direct intervention of the government. The system of securities regulation was not immune from these pressures.

The Problem of Allocating Resources

As long as resources are less than demands for them, a society, whether it be socialistic, capitalistic, communistic or a mixture, must allocate its resources among the competing demands. In an authoritarian society, this function is in large measure performed by centralized, bureaucratic authority, although even in such societies there is frequently present a limited amount of allocation by operation of market forces.

In the United States the allocation function is largely performed by market forces and is accomplished through a

multitude of individual decisions. Each family, each person, is constantly making allocation decisions as between consumption and savings. With respect to the portion of resources allocated to saving, there is then the necessity of dividing that allocation among numerous opportunities for investment. Not only are individuals and families confronted with that kind of decision, but this kind of decision is constantly presented for business enterprises and governments.

It is a fundamental desideratum of all persons having the responsibility for the allocation of resources that the allocation be made in a manner that maximizes benefits flowing from the allocation; in the case of consumption allocations, these are varied for they may be pleasures of the senses or the mind, a sense of well-being, and so on. When the allocation decision relates to investment the benefit is usually defined in terms of "return", that is, either income or increases in value of the amount allocated to the investment. Essential to investment decisions are perceptions with respect not only to return but to risk as well; investment portfolio theory has made significant contributions to the development of these concepts and the nature of their relationship.

Ideally, resources saved, that is, investment resources, would be allocated in the most efficient manner possible so

that the marginal return of each allocation is equal to the marginal return on every other allocation with similar risk characteristics. That is generally accepted as the objective of those having responsibility for the allocation of resources.

It would appear to be self-evident that the quality of any investment allocation decision, that is, the extent to which it maximizes return, will in large measure be determined by the quantity and quality of the information that is available concerning the potential investments which may be made. Thus, if among the investment options available are the securities of corporations, then information concerning those corporations is essential in any allocation decision. This is not to suggest that the only information pertinent to an investment decision is information concerning the issuers whose securities may be under consideration for the portfolio; given the nature of the investment universe, obviously information concerning industries as a whole, information concerning corporations other than the one under consideration, information concerning the economy of the country and the economy of the world and much besides may be important to an allocation decision maker; this is evident from the Study's analyses of security analysts' decision-making processes.

The best proof of these rather elementary propositions lies perhaps in trying to conceive an economy in which no information whatsoever was permitted to be disseminated concerning corporations. Except for "bootlegged" information, there would be no way for an investor to assess risk and return as between General Motors and American Motors, as between General Electric and any other company.

If, then, information is essential concerning investment opportunities, it would follow that the most efficient allocation of resources will occur when the information is sufficient for the purposes of those making decisions, when it is reliable, and when it is disseminated in a timely manner. To the extent that any of these elements is lacking, there is posed the danger of an inefficient allocation of resources, that is, an allocation that does not yield the best utilization of the resources of the society in terms of marginal returns. If the information is not sufficient, or if it is not reliable, then resources may be committed to an enterprise having characteristics different from those perceived by the decisionmaker, thus resulting in a loss of efficiency; similarly, if information is not timely disseminated, then at least during the interim until the information is disseminated, there is posed the prospect of an inefficient allocation of resources.

In our society allocation decisions are made by a vast multitude of people. The evidences are that increasingly these decisions are being made, or at least strongly influenced, by persons who are professionally trained to make such decisions and have the ability to assimilate and utilize a vast and complex variety of information. However, the capacities, the abilities, the educability and the resources of allocation decisionmakers stretch across a seemingly infinitely varied spectrum. At one end are relatively unsophisticated, inexperienced individuals possessing investable resources but having little ability to utilize information in making decisions; for the most part these people appear to rely upon others having higher skills to assist in their decisionmaking. At the other end of the spectrum are highly sophisticated financial analysts, portfolio managers, research specialists and others, who do have significant skills and training. It is impossible to design a single set of disclosures that will by legislative or regulatory fiat serve directly the needs of this entire spectrum of users; the reasons for this and the manner in which the present system serves this variety of investors are discussed later.

In discussing the necessity of information to the operation of our resource allocation system, the influence

and value of judgment should not be overlooked. Facts are not pristine, clearly defined, unequivocal, or susceptible of a single interpretation. As the complexities of industrial enterprise have grown the opportunities for diverse judgments concerning the importance of individual facts or complex configurations of facts have multiplied, with the result that investors frequently perceive the same new information in sharply different lights: to one, it may have a bullish connotation, to another, it may seem equally bearish. This is seen in the Griffin paper which appears as Chapter XXII of the Study.

Market Forces and Disclosure

If, then, sufficient, reliable, timely information is essential to the most efficient allocation of resources, how can it be assured that information having those characteristics is available and disseminated?

It has been suggested that this can be assured through market forces. Essentially the argument is this. At the present time, securities markets are characterized by the presence of a large number of professionals who are constantly seeking out information from corporations, especially large ones (the researches of the Committee indicated that less than 1,000 corporations out of the more than 10,000 which file periodic reports with the SEC are followed by one

or more analysts at any time). These analysts have an interest in securing reliable information on a timely basis and, it is agreed, it is often in the interest of issuers to provide that information to them. The latter's interest derives, it is said, from a desire to have a good market for the company's securities, the necessities of tapping the public market for financing, the benefits of a corporate image that reflects integrity and honesty in dealing with the public, and the awareness that a failure of disclosure or misrepresentations would have an adverse affect upon all of these desired benefits. It is suggested then, that at least with respect to large companies followed by analysts, sufficient timely information would be available even without any governmental mandate. It is suggested that as analysts procure this information they, or their clients, make buy or sell judgments based upon it, thus causing new information discovered to be quickly reflected in the prices of securities. It is this consequence of the efficient operation of the market that assures investors in general that they are paying an essentially "appropriate" price (the word is that of Professor J. Lorie and M. Hamilton, authors of The Stock Market: Theories and Evidence (1973)), one which reflects all information available to the market, thus putting them on an equal footing with all other investors, including professionals.

A further extension of this argument is that, with respect to offerings, the potential liabilities of underwriters and others associated with the underwriting process -- attorneys, auditors, directors and so on -- will be a sufficient assurance that there will be full disclosure in the offering literature without the necessity of preparing the cumbersome documents filed with the SEC and the review process that attends public offerings. Essentially, the self interest of underwriters and other participants in the process and their desire to avoid legal liabilities will be sufficient to assure that sufficient information will be disseminated in connection with the offering.

These arguments were not unappealing; it would be preferable if market forces could be substituted for regulatory forces whenever the benefits of the latter can be adequately secured through the former. However, many members of the Committee believe that the researches conducted by it and by others previously and their own experiences as participants in or students of the disclosure process and securities markets indicate that, at least at the present time, market forces may not safely be relied upon to secure for investors the benefits presently flowing to them from the regulatory mechanism that has been established.

In the course of interviews with them, many analysts indicated to staff members that, in the absence of the requirements imposed by federal law, they believed that they would be seriously handicapped in securing information that was sufficient, reliable and timely. They frequently cited as an example their difficulties prior to 1969, when the Commission first mandated segmented disclosure, in securing useful information with respect to the various constituent parts of a conglomerate business. They state that even since the inception of such requirements they have still been unable in many instances to secure more than the bare minimum required, even though there appears to be a widespread belief among analysts that such is insufficient for adequate analysis. They cite too the difficulties that they have experienced in many cases in securing from management estimates with respect to earnings, information concerning management's plans (especially capital spending plans) and objectives, and similar types of information which are regarded by virtually all classes of investors as useful to their decisionmaking.

Furthermore, even if it were true that over the long run the market would penalize issuers which withheld useful information or engaged in misrepresentations, frequently

the "run" is indeed a long one. In the meantime, many investors would make improvident investments and there would thus be inefficient allocations of resources. There have been many instances known to members of the Committee which demonstrate that falsified financial statements and other abuses of the disclosure process have endured for a long time without market forces in any way bringing about sufficient, reliable or timely disclosure; in these cases, the remedy usually lay not in the market but in intervention by the Securities and Exchange Commission.

A recent demonstration that market forces are insufficient to produce adequate disclosure is in the area of municipal financing. Until the New York City crisis focused attention upon disclosure practices with respect to those securities, notwithstanding the perception by many analysts that the information available was incomplete and unreliable, very few municipalities or other governmental units had adopted disclosure policies that would satisfy the analysts.

Even if the assertions of those who would substitute market for regulatory forces are correct with respect to securities followed by analysts, the fact is that many millions of dollars are invested in companies which are not followed by analysts; analysts have virtually no interest in a company with a market capitalization of less than $50 million and less than one in ten reporting companies are

monitored by one or more analysts. Thus, with respect to the overwhelming number of publicly-held companies there would be no analysts having a sufficient interest to systematically seek out and utilize in investment decision-making information secured from issuers. Among the thousand-odd companies followed by analysts, many of them are followed only sporadically by analysts and often at most by a single individual.

Analysts typically seek information for proprietary purposes, that is, for the purpose of realizing some private gain, either by selling the information to clients who are willing to pay whatever their fees may be, by communicating it to the investment decision-makers who employ them, or by investing themselves on the basis of the information secured. They do not regard themselves as surrogates for the universe of investors and hence do not feel under obligation to disseminate widely information which they secure (the present state of the law, of course, under Rule 10b-5 does oblige them to refrain from trading on the basis of, or communicating, material information received from a corporate source which has not been publicly disclosed). Thus in a system where reliance was placed upon analysts to secure information (obviously reliance upon the analysts to procure information and cause it by their buying and selling activity to be reflected in market price

would require that there be no restraints on the use of material "inside" information, could result in both a substantial delay in the dissemination of information and the unfair use of inside information by some professional group. Another potential problem could result if the information were available initially to investors without sufficient resources to fully translate it into market price. As an example, if an analyst managing a portfolio with an aggregate value of $10,000 and no capacity to borrow learned that General Motors had developed and placed in production a device that would double the mileage of its automobiles, this information would obviously not become fully expressed in the market prices of General Motors stock if the analyst used his total resources to buy General Motors stock -- namely, $10,000. A far larger amount of money would be necessary to translate this information into a fully adjusted market price; until that was done the price would not be "appropriate" and the market would not be efficient. In the meantime, those who came into possession of the information before it was fully reflected in the market price would have the opportunity to realize what economists call "abnormal profits" at the expense of those denied the information.

Of course, the foregoing discussion is confined to essentially economic considerations. In discussing disclosure, its uses, the effect of disclosure upon markets, and

similar subjects it is not sufficient to confine the discussion to market efficiencies. There is a notion of fairness and equity which has become so deeply ingrained in the expectations of American investors that any modification of the system of disclosure that appeared to jeopardize fairness to the extent it now exists in the market would be politically unrealistic and publicly unacceptable.

Reliance upon market forces -- the energies of analysts and the self interest of issuers -- to bring forth into the marketplace sufficient reliable timely information to serve the purposes of investors would result in a high degree of likelihood that unacceptable inequities would be created among investors. As mentioned above, analysts regard information that they procure otherwise than through public sources as proprietary -- information which they can (to the extent permitted under Rule 10b-5) and do use for the private benefit of their clients, their employers or themselves. Under a system which principally relied on the activity of analysts to secure new material information and cause it to be imputed in the prices of securities, either they would be allowed to continue in that posture, or they would be required to become the instrumentality for accomplishing public disclosure, in which case there would be no economic incentive for them to perform the function. Since they would not be able to purvey to any limited universe

of clients anything of value, inasmuch as they would be under an obligation to make the same information publicly available. Assuming the latter role of the analyst would be economically untenable, i.e. that is there would be no one to pay them, then they would be left in the same position they are at present -- namely, purveyors of a proprietary product, but in the hypothesis discussed this "product" would be material undisclosed information. Obviously their clients would be the beneficiaries of information that would permit them to realize profits not realizable by others who were not clients of the analyst in possession of the information. Thus, at least for some period of time, and conceivably for a substantial period of time, others in the market would be severely disadvantaged, at least until the information had been sufficiently widely disseminated that enough resources would be committed on the basis of the information to cause the information to be totally reflected in the price.

A market-motivated system would significantly undermine well-developed and historically established notions of fairness in the marketplace and more importantly, would likely result in benefits being realized by some investors at the expense of others. The opportunities for abuse by insiders and for collusion between analysts and insiders, the temptation to chicanery are all too reminiscent of the events of the 1920's which resulted in passage of the 1933 and 1934 Acts. It appears beyond reasonable doubt at the present time that

the dismantling of the disclosure system, even with respect to a relatively narrow spectrum of large companies, might very well result in a serious and lasting impairment of public confidence in the fairness of the securities markets, a confidence that is already seriously lacking. If this were to occur, the present difficulties of corporations in securing equity financing would undoubtedly be further exacerbated, resulting conceivably in the necessity of public intervention in the capital allocation process, a result totally at variance with the hopes of those who urge the substitution of market forces for regulatory forces in effecting disclosure.

The arguments of those who would rely upon market forces to perform the role of a regulatory agency in the dissemination of company-originated information are based upon the assumption that those responsible for disclosure policies of issuers would recognize the perils in the marketplace of misrepresentation, undue delays and other distortions in the dissemination process and adopt policies that would cause dissemination to be made fully, accurately and promptly. Again, discussions with analysts in the course of the Committee's research indicated that good news concerning a corporation is generally much more quickly and willingly forthcoming than bad news. The experience

of some Committee members confirms this. Very often there are significant motives for at least temporary concealment of adverse information on the part of corporate executives. Often a sizable part of management's total compensation, such as benefits from stock options or stock bonus plans, depends upon the price level of the company's securities. Frequently, their direct compensation -- salary and bonuses -- will depend upon the earnings of the company, thereby providing strong motivation to enlarge artificially the Company's earnings. In addition, there is often simply the hope that bad news will be temporary and thus need not be disclosed.

The Securities and Exchange Commission's enforcement cases demonstrate that even in a regulatory environment such as exists and even with the potentially severe penalties that attend misrepresentation and non-disclosure, some corporate executives take the risk of suppressing adverse information or tilting disclosure to a favorable bias. A review of the quality of disclosure contained in Form 10-Ks filed with the Commission with the corresponding annual reports to shareholders shows that even with the discipline of required filing of the Form 10-K, annual reports habitually present a more favorable picture than the Form 10-Ks. While there is some evidence that such

disparity is less noticable with regard to large publicly-held companies, nonetheless, even among them it is sufficiently frequent to give pause before assuming that market forces would be a sufficient substitute for regulatory forces.

The same conclusion must be drawn with regard to disclosure in the course of underwritten public offerings. Again, the evidence suggests that even the heavy burdens undertaken by underwriters in the course of a public offering have not always been sufficient deterrents, as evidenced by experience in the new issue market during the periods when new issues were common. Notwithstanding the vigilance and diligence of the Securities and Exchange Commission, some underwriters have engaged in questionable practices, have been indifferent to the demands of due diligence, preferred to take the risk of liability, rather than incur the expenses of proper diligence. If these deficiencies occur in a closely regulated securities distribution process, it may be safely assumed that they would be multiplied if the regulatory mechanism were less pervasive or vigilant. It may be stated almost as a principle of human nature that short-term considerations, particularly when they entail substantial profits, are often able to override judgments with regard to long-term negative consequences and dangers.

The foregoing discussion of the need for a mandatory element with respect to company-originated information is not to deny the fact that much of the dissemination of such information is accomplished as a result of market forces. As is noted later, information filed with the SEC is often in a format and detail and of such limited accessibility that is is often unusable directly by most investors. Their needs are satisfied by various kinds of disseminators who, responding to their perceptions of the market for information presented in different ways, take the information filed with the SEC, as well as other information, and summarize, reformat, condense, simplify and analyze it in ways they think will appeal to the markets they pursue and try to serve. The integrity and competence of these disseminators--matters not considered in this report--are of course of considerable importance to the quality of investment decisions and the efficient allocation of resources.

These conclusions about the desirability of a disclosure system including mandatory requirements for company-originated information, of course, make no statement with respect to the optimum amount of information that a mandated system should require; the determination of that involves careful examination of the investment process, the needs

of investors, the fashioning of concepts of "materiality", all of which are elsewhere discussed in this report.

Fundamental Research and the Efficient Market Hypothesis

Fundamental to consideration of the corporate disclosure system is the question whether fundamental research -- that is, the study of company-originated and other financial and other information -- can yield for investors superior investment results. This question has been the focus of extensive academic discussion for many years, with, as might be expected, those engaged in security and financial analysis asserting that, indeed, superior results can be obtained, with others, predominantly economists, asserting that empirical evidence suggests that over the long term, whatever that span may be, results average out.

One of the early theories was the "random walk theory." While, as Professors James H. Lorie and Mary T. Hamilton have pointed out, the "random walk" had been of interest to statisticians since the early part of the century, it was not until 1959 that it attracted the attention of scholars concerned with the functioning of the securities markets. Professor Burton G. Malkiel has stated the theory in this fashion:

> The history of stock price movements contains no useful information that will enable an investor consistently to outperform a buy-and-hold strategy in managing a portfolio.

In effect, this says that the "technicians", the "chartists" and similar market watchers cannot outperform the market.

A direct outgrowth of this work has been the "efficient market hypothesis". Since the 1950's there has emerged a considerable economic literature addressed to the functioning of securities markets and theories based upon these analyses.

The availability of information is, of course, intrinsic and essential to the efficient market hypothesis, since the heart of the hypothesis is that the market price is an accurate reflector of information that is available. One writer has said, "Black, Fama, Francis, Gorie and others have set forth various requirements for an efficient market. They include: 1. Effective Information Flow. This means that news is disseminated quickly and freely across the entire spectrum of actual and potential investors ..." (Kuehner, "Efficient Markets and Random Walk," in Financial Analysts' Handbook, Vol. I, p. 1227). This hypothesis, which was extensively considered by the Committee and by the staff, has been stated in various ways. Essentially it appears to say two things: one, at any given moment the price of a security in the market reflects all of the information which is publicly available about the company

and the security (this is the so-called "semi-strong" version of the hypothesis); and two, any new information which becomes publicly available is quickly, almost immediately, assimilated into the price. One member of the Committee, a noted academician and portfolio manager, has suggested this articulation of the efficient market hypothesis: "Market prices so quickly reflect the prevailing interpretation of widely available information that superior returns cannot be earned from analytical effort unless it produces a more accurate interpretation of the information." This statement takes the efficient market hypothesis beyond simple factual assimilation and introduces an element of judgment and suggests that superior judgment may, notwithstanding the efficient market hypothesis, yield "abnormal" profits, that is, profits in excess of those realizable by investing in the market as a whole.

The efficient market hypothesis, as commonly articulated, is indifferent to the quantity and quality of information that is available to investors. The market price of a security reflects true information and false information with equal efficiency, as long as the quality of the information is not itself a part of the information in the market place. Thus, a fraudulent income statement,

not known to be false, will be reflected in the market price of the security to the some extent as a true one. Furthermore, the market is efficient in terms of whatever information is available: if there is one "bit" of information available, the market price will reflect that, theoretically, and be efficient; if there are a million "bits" of information available, the market will reflect those and be efficient.

Thus the efficient market hypothesis, as is readily admitted by its proponents, makes no statement with respect to the optimum amount of information which should be made available or the desirable accuracy of it. Thus conclusions concerning the desirable quality or quantity of information must have their foundation elsewhere than in the efficient market hypothesis.

Some scholars, notably Professors George J. Stigler and George J. Benston, assert that their empirical research has established that there is no evidence whatsoever that the disclosures mandated under the 1933 and the 1934 Acts have provided protections to investors or been the occasion for the introduction of new, useful information in the marketplace. Their conclusions, which have been sharply disputed by equally eminent scholars, such as Irwin Friend, would appear to be consistent with the efficient market

hypothesis, although there does not appear to be any necessary conceptual link between their studies and the hypothesis.

The disputes concerning the meaning of the efficient market hypothesis, the researches of Messrs. Stigler and Benston, portfolio theory and the beta coefficient continue vigorously.

In considering the efficient market hypothesis and fundamental research, it should be recognized that few, if any, believe that satisfactory investment decisions, assuming the validity of fundamental research, can be made solely on the basis of information that is contained in documents filed by issuers with the SEC, or for that matter, can be made on the basis only of company-originated information. Experienced analysts universally equip themselves not only with company-originated information, but with extensive information as well concerning other components of the industry, the state of the United States and world economy, trends in the economy, expectations with respect to interest rates and a host of other data. To the extent that the criticism of the Commission is justified that it has administered the securities laws as if filed information were sufficient for investment decision-making, the Committee strongly urges the Commission to take steps to

clarify the limitations of information filed with it. One member of the Committee has suggested that perhaps Commission filed and required documents should bear a legend informing users of the need for seeking out and using data in addition to that contained in the document in making investment decisions.

Those who assert that fundamental research cannot yield "abnormal" results support their contentions with significant empirical data. A number of studies have been published indicating that, for instance, investment companies over specified periods of time have under-performed popular stock averages by amounts at least equal to transaction and management costs; similar studies with respect to bank portfolios and other managed assets appear to confirm these indications. The theoretical justification for this is that the market operates with a high degree of efficiency in assimilating new information, so that there is virtually no opportunity for any investor to gain advantage from the utilization of information before it is impacted in the security price. Recent studies by efficient market devotees have suggested that there may be a very short period during which the market is assimilating information and that during this relatively short period there may be an opportunity for investors to realize "abnormal" profits,

although it must be emphasized that the period suggested before assimilation is quite brief.

If these contentions are correct, then we confront a confusing anomaly which Professors Lorie and Hamilton have described:

> In order for the hypothesis to be true, it is necessary for many investors to disbelieve it. That is, market prices will promptly and fully reflect what is knowable about the companies whose shares are traded only if investors seek to earn superior return, make conscientious and competent efforts to learn about the companies whose securities are traded, and analyze relevant information promptly and perceptively. If that effort were abandoned, the efficiency of the market would diminish rapidly." [The Stock Market: Theories and Evidence, p. 98 [1973]].

If analysts cannot over the long run realize "abnormal" profits for their clients, or their portfolios, then there is no economic benefit to be derived from employing them; on the other hand, however, if their employers all acted on this apparent phenomenon, then a major factor in the formation of securities prices would be removed from the marketplace and prices would presumably no longer be efficiently established. It is suggested that the justification for the activity of analysts is the performance by them of what is essentially a public good by being the mechanism through which the efficient market operates. It may be suggested that such would be

scant consolation to those bearing the costs of financial analysts and it would not be inappropriate for them to suggest that the cost of performing a public good should be borne by the public. It has been suggested by one member of the Committee that as soon as departures of analysts from the market reached proportions that impaired the efficiency of the market, then analysts would perceive opportunities for "abnormal" profits and would return to activity in the market until such time as the market reached a level of efficiency again. Obviously there might be significant time lags while analysts moved in and out of their professional endeavors.

The Committee believes that notwithstanding the interesting and clearly significant work done by economists and others in developing the efficient-market hypothesis, the evidences that fundamental research is essentially useless are not yet, and may never be, sufficiently telling to justify the elimination of a disclosure system premised on the proposition that such research is useful and necessary.

Many of the Committee members have known of extremely successful investors who have relied upon fundamental research; and for that matter, there are members of the Committee who have themselves achieved significant success in this manner. Furthermore, there are other studies

that appear to contradict the statistical researches and seem to indicate that some portfolios organized on the basis of fundamental research have exceeded, sometimes in a significant degree, the "index" portfolios. It should also be remarked that virtually all of the research done with respect to the efficient market thus far has been focussed upon New York Stock Exchange-listed companies which, as a group, are contestedly the most liquid and which have the highest measure of analyst and professional following.

It is difficult to reject the evidence afforded simply by the existence of a substantial analyst profession for whose services literally millions of investors are willing to pay often substantial fees for the benefits of information and advice based upon fundamental research. This does not deny that frequently the public is the victim of widespread myths and commits substantial resources in pursuit of them. However, given the facility of communication, economic studies, and personal experience of investors it is difficult to believe that this elaborate industry and profession would be perpetuated and financed by sophisticated, knowledgable, expert investors when there is no value whatsoever to be secured from it.

Even those who have been clearly identified with espousal of the efficient market hypothesis are reluctant to deny totally the possibilities of superior profits from analysis. For instance, Professors Lorie and Hamilton have said:

> A belief in an efficient market is not exactly equivalent to a disbelief in the possibility of superior security analysts. There can be individuals in the world who have a quicker or more profound understanding of the economic consequences for individual firms of changes in the economic environment or changes within the firm itself. (Lorie and Hamilton, The Stock Market: Theories and Evidence, p. 104 [1973]).

Again, Professor Burton G. Malkiel has said, after discussing favorably the random walk theory (progenitor of the efficient market hypothesis),

> I walk a middle road. While I believe that investors must reconsider their faith in Super Analyst, I am not as ready as many of my academic colleagues to damn the entire field." (A Random Walk Down Wall Street, p. 120 [1973]).

And he then lays down some investment rules clearly inconsistent with random walk and efficient market notions.

Portfolio Management Theory and Disclosure

Also emerging during this time were various theories with regard to portfolio organization and the so-called "capital asset pricing model". Increasingly portfolio managers were attentive to the so-called "beta coefficient" which was a measure of risk. Emerging portfolio theory

suggested that sensible investment policy entailed a judgment with respect to the degree of risk desired in the portfolio and the investment of the portfolio resources in securities having beta coefficients which would average out to the desired degree of risk. These theories do not militate against a mandatory disclosure system. If anything they suggest a maximization of the quantity and quality of disclosure through a mandatory component in order that the beta of securities may more accurately reflect the degree of risk.

The Means of Achieving A Mandated Disclosure System

Having reached the conclusion that a corporate disclosure system needs, at least in part, especially with respect to company-originated information, to have a mandatory dimension, the question of the means by which mandates should be established and enforced must be addressed. There are a number of approaches available; these may be roughly broken down between non-governmental and governmental.

It is theoretically conceivable that there might be developed some sort of a compact between issuers and analysts and other users of company-originated information with respect to the contents, timeliness and other characteristics of disclosure by corporations. Apart from possible problems under the antitrust laws, such an approach appears at a

minimum to be impractical in an economy as large as the United States' because of the very substantial number of issuers which are publicly-held and the very substantial number of analysts and others who use information. Furthermore, it would seem difficult to develop a system of enforcement and penalties which would be satisfactory.

A second non-governmental approach might be to rely, either in part or in whole, upon the exchanges. Prior to the enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934, the New York Stock Exchange, at least, had been moving in the direction of, and for that matter, had been the principal force in developing, mandates and standards for disclosure by listed companies. Thus, the Exchange had required that all listed companies publish audited financial statements and certain other information. This continues to be the pattern in the United Kingdom and in his study comparing American and United Kingdom financial disclosure Professor Benston has concluded that the British system is functioning satisfactorily. There is some reason to believe that a large part of the success of the British system derives from the unique nature of the financial community in Great Britain where it would appear that peer pressures, the geographical concentration of the financial community in London, the influence of the Bank of England, the merchant banks and the London Stock Exchange, together with a long history, have been significantly effective in enforcing integrity among various elements of the financial community.

Notwithstanding this, there have been a number of financial scandals in Great Britain which have led to strong pressures for the supplementation of the present system by governmentally imposed requirements.

A governmentally ordained and operated mandatory disclosure system may take several forms. One form would consist simply of antifraud rules that might be enforced by criminal prosecution and civil litigation by injured parties. Obviously, the effectiveness of such a system would in this country be substantially greater than, for instance, in Great Britain, because of the relatively permissive attitude of federal courts with respect to class actions. As a variation of this system conceivably a governmental agency might be empowered to seek civil remedies; this mode of enforcement of antifraud prohibition is, of course, a significant part of the federal securities regulatory scheme at the present time and appears to work satisfactorily. The agency could, like the Commodities Futures Trading Commission, provide investors a forum for seeking reparations for rules' violations. Another variation of an essentially antifraud approach would entail the establishment of detailed rules by the governmental instrumentality with regard to disclosure, much like the content of the various forms adopted by the Commission, with departures from those rules enforced through civil or criminal proceedings, but without requirements of filing and review.

- Whether any configuration consisting essentially of antifraud rules, either stated generally or with particularity, would provide satisfactory protection to investors is uncertain. In general, it appears that the experience in other countries with other modes of regulation has not proved satisfactory since there has been a significant increase in the number of countries opting for what may be called essentially the SEC approach. Furthermore, the interaction between issuers, users and the SEC through the filing and review process is helpful to the Commission in developing meaningful disclosure standards; without those elements of the system it would not be expected that standards would be as responsive to the public interest as they now are.

Members of the investment community who had experience with disclosure prior to the 1933 and 1934 enactments are often strong in their averment that the securities acts have been extremely effective in raising the levels of disclosure, and certainly in significant measure this is attributable to the system of filing and review mandated under them and extended by the Commission through its rulemaking authority. It seems doubtful that any other available system would be as effective in developing the sensitivities of issuers and those who control them to the needs of the financial market.

The Committee believes that an essential component of a satisfactory system of corporate disclosure is the significant involvement of the federal government in establishing the rules of disclosure and in the enforcement of them. The functioning of the securities markets is heavily freighted with considerations of public good; the confidence of the public in the integrity of those markets is essential if private capital is to be committed to private corporations, and particularly to the equity securities of those corporations. Notwithstanding the strong belief of members of the Committee that in many areas of government it is desirable that there be a reduction in the scope and extent of regulation, most of the Committee members believe that a significant retreat of the federal government from regulation of the disclosure process as presently constituted would have unfortunate impact upon securities markets and the ability of private corporations to raise capital in them. In addition, they believe that there are strong arguments to be made for the belief that the most efficient method of regulating the securities markets is through a system of filing, review, rulemaking, and governmental enforcement, coupled with extensive opportunities for private enforcement.

The Committee also addressed the question whether

filings made with the Commission add to the information that is available to the market. Many have suggested that the filings are redundant or at most only confirmatory of information that had been absorbed and used in the marketplace long before it appeared in a Commission filing. The Committee believes that in large measure this is true. However, it believes also that there are other benefits that accrue as a consequence of the filing process with the SEC. First, issuer knowledge that information otherwise made publicly available will, when it is incorporated in a filing with the Commission, become potentially the subject of serious liabilities under the securities acts will cause the information when initially released to be more credible and reliable. Thus the subsequent filing has what might be regarded as a disciplining effect in assuring that the earlier release is accurate. Furthermore, the information contained in the filings is usually much more extensive than that released earlier. Thus, it provides to analysts and others a means by which the more abbreviated information released may be qualitatively reviewed, parsed, and assessed. To some extent, the detail itself may constitute additional necessary information which would not be available but for the requirements contained in the various filing forms.

The Committee recognizes that the portion of the corporate disclosure system administered by the Securities

and Exchange Commission satisfies directly the needs of only a small proportion of the users of company-originated information in investment decision-making. Most investors, particularly those customarily referred to as individual investors, secure their information from a host of sources that present, format, summarize and simplify in varying degrees and ways in an effort to secure the favor and patronage of various classes of users. These privately operated sources of information are extremely important parts of the total disclosure system, for they provide accessability, both from the dissemination standpoint and the understandability standpoint.

These sources of information are the beneficiaries of the Commission disclosure system and without that system their activities would be severely hampered. Much of the information that they disseminate they secure from Commission filings. Further, the mandatory disclosure system, with its possible penalties not only for misstatements and omissions in filed material but in other corporate disclosure as well, provides a high degree of assurance that all information furnished by corporations, privately and publicly outside filings as well as in them, will be responsible and accurate.

The important role of the private disseminators of information is enhanced significantly by the presence of a mandatory dimension to the system.

Summary

The Committee has concluded that, notwithstanding the arguments of economists and others that the efficient market hypothesis, the random-walk theory and the strength of market forces, have rendered obsolete or unnecessary such or all of the mandatory disclosure system administered by the Securities and Exchange Commission, these arguments are not sufficiently compelling to justify dismantling the existing system at this time. Some of these theories, while having gained widespread academic acceptance, appear to be contradicted by some evidence and have not been fully explored in their application to all markets for publicly-held securities. Others, while useful to professional portfolio managers, do not reflect the actual manner in which innumerable investment decisions are being made.

Beyond these considerations, the disclosure system has worked well during the four-plus decades of its existence; American securities markets are recognized world-wide for their integrity and the quality and quantity of information available about American corporations. Anomalously, it has been suggested that the ease and small expense with which money can be raised in the Eurobond market, where no formal disclosure requirements exist, is because the companies seeking funds there have been compelled to make full disclosure in the United States, thus permitting underwriters and purchasers

in that market to invest with assurance concerning the quality of their investments.

In concluding that radical change is not now desirable, the Committee would reiterate its belief that the Commission should observe closely developments in economic theory and should modify its policies to reflect such developments when they have achieved a tenability sufficient to sustain policy.

To conclude the foundations of a structure are sound is not to conclude that refurbishing, repairs and remodeling are not desirable. The recommendations of the Committee which follow are intended to be of that nature.