CHAPTER II.

BACKGROUND FOR A RE-EXAMINATION OF DISCLOSURE POLICY

A. Introduction

B. The philosophy of disclosure.

    1. Basic aims.

    2. Indirect benefits.

    3. Disclosure for whom?

C. Criticisms of current disclosure policy.

D. Comparison of the new issue and trading markets; implications for disclosure policy.

E. Recent developments relevant to the future course of disclosure policy.

    1. The opportunity presented by the '64 amendments.

    2. Technological developments and their implications.

CHAPTER II.

BACKGROUND FOR RE-EXAMINATION OF DISCLOSURE POLICY

A. Introduction

The notion that the law can and should require business enterprises to disclose pertinent information about their affairs to public investors, both present and prospective, has become part of the prevailing wisdom of the American private enterprise system. No longer is the subject a burning issue. More than a generation has elapsed since the federal statutes which codified this concept were enacted. The financial community, the accounting profession, the bar and industry generally have come not only to accept but to support the principle that those who make use of the public's money must supply the information essential to the formulation of intelligent investment decisions, and that it is a proper responsibility of government to keep an eye on the accuracy and adequacy of such information.[1/]

1/ The President of the Investment Bankers Association of America is quoted by Professor Loss as observing in 1954:

> I assure you that as long as I am mixed up in the Investment Bankers Association--I have been mixed up in it for 40 years--the investment banking business--that I and others for whom I speak would never come before you and suggest anything that would weaken in any way the Securities Act.
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> We stormed and ranted about it when it first came along, we had to get used to it and so forth, but the spirit of full disclosure means as much to us as the small investor, or anyone else.
> (Hearings on S. 2846 before a Subcommittee of the Senate Committee on Banking and Currency, 83rd Cong. 1st Sess. 81 (1954).)

1 Loss, Securities Regulation 128, n. 17 (2d. Ed. 1961).

Lately, a few economists have challenged this principle (see, for example, Stigler, Public Regulation of the Securities Markets, 37 Journal of Business 177 (1964)) but their views do not appear to be representative of the economic profession as a whole or to find a strong echo in the general business community.

Why, then, is a broad re-examination of disclosure policy needed? At least five reasons could be briefly noted:

First, the American shareholder population has been swiftly increasing in recent years. Studies by the New York Stock Exchange give the following estimates of the number of Americans with direct interests in equity securities.[2/]

1952	6,490,000
1959	8,630,000
1962	17,010,000
1965	20,120,000
1967	25,000,000
1968	26,400,000

This growth in numbers has led to a vast increase in the number of investment decisions based, directly or indirectly, on information supplied by corporations.

Second, the spread of higher standards of knowledge, skill and craftsmanship in the investment business has brought about a more insistent demand for careful and up-to-date disclosure by publicly held corporations.

Third, The [sic] amendments to the '34 Act adopted in 1964, which greatly expanded the coverage of the reporting and proxy provisions

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2/ These estimates include shareholders of investment companies but exclude persons with indirect interests in equity securities through such intermediaries as pension and profit-sharing plans.

of that Act, have made is practicable, in the formulation of disclosure policy, to minimize discrimination between securities markets.

Fourth, technological advances have made possible new applications for disclosure and faster, less expensive methods for its transmission from repositories such as the Commission's files to those who can make use of it.

Fifth, there has been growing criticism of certain long-established practices associated with disclosure policy. This criticism comes mainly from sources sympathetic to the general principle of disclosure. Its constructive value should be recognized and utilized.

As Harry Holler has observed:

> The swiftness of industrial and economic change in free societies such as the United States and the countries of Western Europe makes reappraisal of the effects of securities legislation a recurring necessity.[3/]

The Study does not wish to overemphasize the importance of disclosure policy in securities regulation. Disclosure is not a cure-all. More difficult and significant problems of policy formation may well lie ahead in other areas. Some of those areas.

3/ Heller, "Integration" of the Dissemination of Information Under the Securities Act of 1933 and the Securities Exchange Act of 1934, 29 Law and Cont. Prob. 749 (1964).

are to be examined by the Commission's pending Study of Institutional Investors.

B. The philosophy of disclosure.

1. Basic aims.

A brief word concerning the basic philosophy of the disclosure provisions in the '33 and '34 Acts is in order.

The fundamental aim of the prospectus requirement was to provide information, and not to shield the public from ventures deemed to be of dubious merit. "The purpose of these sections," said the House Committee, "is to secure to potential buyers the means of understanding the intricacies of the transaction into which they are invited."[4/]

But the '33 Act made no provision for informing the trading markets. The mechanism for this purpose was developed by degrees. First, the '34 Act permitted the Commission to require periodic reports by companies with a class of securities listed on a national securities exchange. Next, by amendment of the '34 Act adopted in 1936, the Commission was given authority to require the filing of such reports by issuers which had effectively registered securities under the '33 Act. Finally, in 1964, over-the-counter companies meeting specified asset and shareholder tests were

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4/ H.R. Rep. No. 85, 73d Cong., 1st Sess. 8 (1933).

required to register under Section 12(g) of the '34 Act and were made subject to the reporting and proxy requirements of that Act.

A classic statement of the purposes of provisions designed to inform the trading markets is found in the report of the House Committee on the '34 Act:

> No investor, no speculator can safely buy and sell securities . . . without having an intelligent basis for forming his judgment as to the value of the securities he buys or sells. The idea of a free and open public market is built upon the theory that competing judgments of buyers or sellers as to the fair price of the security brings about a situation where the market price reflects as nearly as possible a just price. Just as artificial manipulation tends to upset the true function of an open market, so the hiding and secreting of important information obstructs the operations of the markets as indices of real value. There cannot be honest markets without honest publicity. [5/]

2. Indirect benefits.

Although basically intended to inform, the disclosure provisions of the early Acts were expected to accomplish more. Their principal architects were disciples of Justice Brandeis who, in 1913, made the famous observation in Other People's Money that:

> Publicity is justly commended as a remedy for social and industrial diseases. Sunlight is said to be the best of disinfectants. . .[6/]

5/ H. Rep. No. 1383, 73d Cong., 2nd Sess. 2 (1934).

6/ p. 92.

The fact that there is a significant degree of truth in such observations is attested by all who have worked with the disclosure provisions of the '33 and '34 Acts. The registration process has sometimes been referred to as a housecleaning: one of its most valuable consequences is the elimination of conflicts of interest and questionable business practices which, exposed to public view, have what Justice Frankfurter once termed "a shrinking quality."[7/] Many illustrations could be given; one representative example is provided by a paragraph from a recent '33 Act registration statement:

> From time to time during the past three years, certain officers, directors, and stockholders received loan accommodation from [name of company], without interest, all of which loans were repaid by September 30, 1968. This practice has been discontinued and such loans will not be made in the future.

3. Disclosure for whom?

At what audience should disclosure be aimed? Is the literature elicited by the Commission's requirements intended primarily to aid the unsophisticated? Is it, on the contrary, designed to assist the assiduous student of finance who searches for every clue to the intrinsic value of securities? Or should the Commission strive to meet the needs of a hypothetical "reasonable" investor of "reasonable" sophistication?

7/ Frankfurter, The Securities Act: Social Consequences, Fortune, August 1933.

Throughout its history, the Commission has struggled with these questions. They may well be unanswerable. A balance must be struck which reflects, to the extent possible, the needs of all who have a stake in the securities markets.

By and large, the Commission has responded to the various needs for disclosure in pragmatic fashion. Thus, where an issue of securities possessed unusually speculative elements, it was felt that special efforts should be made to call these factors to the attention of the ordinary investor--hence the development of the "introductory statement" to the prospectus.[8/] By contrast, the detailed financial information required by the schedules to the Form 10-K report could be intended only for the skillful analyst. Indeed, it was recognized from the beginning that a fully effective disclosure policy would require the reporting of complicated business facts that would have little meaning for the average investor. Such disclosures reach average investors through a process of filtration in which intermediaries (brokers, bankers, investment advisers, publishers of investment advisory literature, and occasionally lawyers) play a vital role.

The values of the filtration process are also pertinent, albeit to a lesser degree, to the '33 Act registration process.

8/ See Securities Act Release No. 4936, pp. 7-8, (December 9, 1968); Doman Helicopters, Inc., 41 S.E.C. 431 (1963); Universal Camera Corporation, 19 S.E.C. 648 (1945) and cases cited therein. Similar considerations apply to offerings of issuers engaged in enterprises of a type that has never been publicly held and with respect to which professionals in the securities business have no special expertise. See The Wolf Corporation, Securities Act Release No. 4830, p. 8, n. 21 (May 4, 1966).

The prospectus is designed to help the investor to make an informed decision. It is also intended to assist those to whom investors look for professional advice. The Congress that passed the '33 Act was concerned that methods of distribution then in vogue

> . . . practically compelled minor distributors, dealers, and even salesmen, as the price of participation in future issues of the underwriting house involved, to make commitments blindly.[9/]

Shortly after the '33 Act went into effect, a commentator who was later to be the Chairman of the Commission observed:

> The truth about securities having been told, the matter is left to the investor. The Act presupposes that the glaring light of publicity will give the investors needed protection. But those needing investment guidance will receive small comfort from the balance sheets, contracts, or compilation of other data revealed in the registration statement. They either lack the training or intelligence to assimilate them and find them useful, or are so concerned with a speculative profit as to consider them irrelevant. And wise and conservative investors will find the Securities Act useful but not necessary and from it will gain but little real protection against an occasional Kreuger or Insull. This means that the results of the Act so far as investors are concerned are primarily two-fold: (1) the requirement that the truth about securities be told will in and of itself prevent some fraudulent transactions which cannot stand the scrutiny of publicity: (2) even though an investor has neither the time, money, nor intelligence to assimilate the mass of information in the registration statement, there will be those who can and who will do so, whenever there is a broad market. The judgment of those experts will be reflected in the market price. Through them investors who seek advice will be able to obtain it.[10/]

9/ H. R. Rep. No. 85, 73d Cong. 1st Sess. 8 (1933).

10/ Douglas, Protecting the Investor, 23 Yale Rev. (N.S.) 508, 523-524 (1933).

In more concrete terms, those with experience in the preparation of registration statements will be able to recall instances in which, following the careful investigation of the registrant's affairs necessary for the preparation of the draft prospectus, the proposed public offering price was substantially reduced. That investigation may on occasion reveal a situation which will lead the prospective underwriters to decide that a public offering is unsuitable.

The significance of disclosures which have an initial impact at the professional level has been heightened by recent changes in the securities business. Most important of these is the enormous growth of intermediation in investment. The relative importance of such professional money managers as bank trust departments, pension fund managers, investment counseling firms and investment advisers to mutual funds and other investment companies is greater than ever before. To a degree, at least, there have been parallel changes in the brokerage firms. Research and analysis have become progressively more important as merchandising tools. These changes are reflected in dramatic fashion in the membership figures of the Financial Analysts Federation. At the end of 1950, there were 2,422 individual members. By the end of 1967, that figure had grown to 11,752.

C. Criticisms of current disclosure policy.

Over the years, the existence of problems of interpretation in determining when the registration requirements of the '33 Act are applicable has been the source of much critical comment and analysis. Among the articles which might be cited in this connection are:

> Loss, Contemporary Problems in Securities Regulation, 45 Va. L. Rev. 787 (1959).
>
> Knauss, A Reappraisal of the Role of Disclosure, 62 Mich. L. Rev. 607 (1963).
>
> Flanagin, The Federal Securities Act and the Locked-In Stockholder, 63 Mich. L. Rev. 1139 (1964).
>
> Wood, The Investment-Intent Dilemma in Secondary Transactions, 39 N.Y.U. L. Rev. 1043 (1964).

Practical aspects of such problems of interpretation were extensively dealt with in two books published under the auspices of the Practicing Law Institute: SEC problems of Controlling Stockholders and in Underwritings (1962) edited by Carlos L. Israels and When Corporations Go Public (1962) edited by Mr. Israels and George M. Duff, Jr., of the New York Bar. Experienced lawyers and members of the Commission's staff made important contributions to each of these publications.

In the sprint of 1966, a scholarly examination of criteria for a coordinated disclosure system was published in the Harvard Law Review.[11/] Its author, Milton H. Cohen, was director of the Commission's Special Study of the Securities Markets.

11/ Cohen, "Truth in Securities" Revisited, 79 Harv. L. Rev. 1340 (1966).

In the fall of 1966, a conference was held under the auspices of the American Bar Association Section of Corporation, Banking and Business Law on "Codification of the Federal Securities Laws." Distinguished lawyers from all parts of the country participated in the conference. Their widely-shared view was expressed by the principal speaker, Professor Louis Loss, who observed: "There simply is not enough predictability in this field."[12/]

Subsequent to the codification conference, suggestions for reform by administrative action were published (Schneider, Reform of the Federal Securities Laws, 115 U. Pa. L. Rev. 1023 (1967) and Acquisitions Under the Federal Securities Acts -- A program for Reform, 116 U. Pa. L. Rev. 1323 (1968)) and humor lightened the weight of criticism (Kennedy, The Case of the Scarlet Letter, 23 Bus. Law. 23 (1967)).

Another aspect of the current interest in disclosure policy centers around the problem of prospectus distribution. In a wide ranging series of articles appearing in the Dallas Morning News in the summer of 1968, Business Editor Al Altweg asserted that it is often impossible for an interested investor to get a red herring prospectus on a new issue of securities and recommended that prospectuses be made more readily available. Recommendations of a

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12/ Proceedings of the Conference on Codification of the Federal Securities Laws, 22 Bus. Law. 793, 805 (1967).

related nature were received by the Commission in 1967 from the North American Securities Administrators, who specifically urged the requirement of a summary prospectus in addition to the final, full prospectus as a means of informing investors.[13/]

Aware of the value of constructive criticism, the Study has reviewed the comments cited above (and many others) with care and interest. In addition, in a series of conferences held during the period February-June, 1968, the Study asked for critical comments from representatives of the securities industry, the securities bar, state administrators, financial analysts, accountants, corporate officers, financial reporting services and various individuals, all of which have been taken into account in this report.

D. Comparison of the new issue and trading markets; implications for disclosure policy.

In absolute terms, the amounts of money raised by new offerings of securities (the principal subject matter of the '33 Act) are substantial. Although no statistics are available on the number of people who buy securities in such offerings, that figure, too, can be assumed to be substantial. However, when viewed in relation to the amounts of money changing hands in the trading markets and to the number of investors who buy or sell securities in those markets, the new issues phase of the securities business pales into

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13/ These recommendations are outlined in more detail and the Study's response thereto is contained in Chapters III and IV.

relative insignificance. This pattern is not new. Nevertheless, it is a factor of importance in any assessment of disclosure policy.

A review of available data pertaining to offerings of new equity securities for cash, as compared with exchange trading volume in equity securities, was made by the Study, covering the period 1920-1967. The results are contained in a table in Appendix II-1. Before summarizing those results, a few preliminary remarks are necessary. First, the data presented relates only to equity securities. Most trading in debt securities--even when listed--takes place on the over-the-counter market. Because of the absence of statistical data, it is not possible to compare new bond flotations with the volume of trading in outstanding bonds. Second, the lack of statistical information on over-the-counter volume necessitates recourse to exchange volume as the sole measure of trading market activity. This regrettable necessity results, of course, in an understatement of trading volume. Third, information on secondary offerings by control persons and so-called "statutory underwriters" which are required to be registered under the '33 Act is lacking for years prior to 1933. To avoid distorted comparisons, figures on new offerings refer only to primary equity financing by or for the account of issuers.

The review showed:

1. Over the entire period covered (1920-1967, inclusive) the aggregate volume of new equity securities offered for cash

was approximately 3.15% of aggregate exchange trading volume. Thus, during that period of almost half a century, investors spent approximately $31.70 on the purchase of already outstanding equities for every dollar they spent on new equities.

2. During the 1920’s, new equity offerings as a percentage of exchange trading volume varied from 0.95% in 1927 to 3.60% in 1920. The low point was reached in the 1930’s, with new equity securities offerings amounting to only 0.01% of exchange trading volume in 1931 and 1932. Trading volume dropped to its lowest point in the years 1941 and 1942, but new equity securities offerings did not exceed 4.42% of exchange trading volume in those years.

3. The largest ratio between the two figures (12.52%) appears in the year 1947. During the 1950’s, the ratio was generally high, with new equity securities offerings recovering more rapidly than exchange trading volume. Since 1961, however, the growth of exchange trading volume has generally outstripped that of new equity securities offerings, and the ratio between them declined from 5.3% in 1961 to 1.63% in 1967.

It would appear that, quantitatively speaking, the trading markets are an area of far greater significance than the area of new offerings for the application of disclosure policy. Statistical quantities alone, however, are not an adequate basis for the formulation of policy. There are two principal qualitative reasons for placing particular stress on the disclosures required by the '33 Act.

First, the buyer of securities in an initial distribution is in a somewhat different position from the buyer in the trading markets. Not only the '33 Act but much of the legislation previously passed by the states in the securities field rests on this premise. The compensation that dealers and salesmen receive when they participate in a '33 Act offering is almost always appreciably more generous than that customarily received in exchange or over-the-counter trading. New securities have to be distributed in short order. Special efforts are necessary if disclosure is to serve as a useful shield against the dangers inherent in such a situation.

Second, new public offerings, especially those for the accounts of issuers, have a special economic significance. The transaction in which one investor purchases from another a security originally issued many years ago has less impact on the economy than one in which the investor's dollars go directly into the treasury of a corporation in order to help it to develop a mine, construct a new plant, or exploit a new technological development. A special disclosure effort may well be justified when allocation of capital in a free society is affected. The thrust of the report of the House Committee on Banking and Currency in 1933 was to this point. After commenting on the losses sustained by investors in new issues, the Report observes:

> Equally significant with these countless individual tragedies is the wastage that this irresponsible selling of securities has caused to industry . . . [I]nvestment bankers with no regard for the efficient functioning of industry forced corporations to accept new capital for expansion purposes in order that new securities might be issued for public consumption. Similarly, real estate developments would be undertaken, not on the basis of caring for calculated needs but merely as an excuse for the issuance of more securities to satisfy an artifically [sic] created market. Such conduct has resulted both in the imposition of unnecessary fixed charges upon industry and in the creation of false and unbalanced values for properties whose earnings cannot conceivably support them. Whatever may be the full catalogue of the forces that brought to pass the present depression, not least among these has been the wanton misdirection of the capital resources of the Nation.[14/]

For these reasons, among others, quantitative differences between the new issue and trading markets must be regarded with caution. Nevertheless, in the Study's judgment, the statistics demonstrate the need to achieve a better balance in disclosure policy, with greater emphasis on continuing disclosures for the trading markets.

14/ House Report No. 85, 73d. Cong., 1st Sess. 2-3 (1933).

In the past, such a balance was difficult for the Commission to achieve. The reason: until 1964, the coverage of '34 Act reporting requirements was only partial. When that Act was adopted the primary focus was on the securities exchanges. In consequence, only those corporations whose securities were listed on exchanges were covered.[15/] Improvement in continuing disclosure might have provided an incentive for corporations to delist their securities and could thus have been self-defeating. It is therefore not surprising that the Commission focused its primary attention on the prospectus. Although prospectus disclosure came only on the fortuitous [sic] occasion of a new public offering or a registered secondary, it was clearly the Commission's most valuable disclosure tool.

E. Recent developments relevant to the future course of disclosure policy.

1. The opportunity presented by the '64 amendments.

The '64 amendments gave recognition to the importance of the trading markets by requiring that reports furnishing information for the benefit of those who trade in those markets should be filed both by listed and unlisted companies. By ending the privileged

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15/ No provision was made in the original '34 Act for the filing of reports by any unlisted company. Coverage of the reporting requirements was extended in 1936 by addition to the '34 Act of the original version of Section 15(d), which covered those unlisted companies which had filed '33 Act registration statements. Such companies were required to file reports only if the aggregate value of the class of securities covered by the '33 Act registration statement amounted to at least $2 million following the offering 49 Stat. 1377 (1936).

position of many unlisted companies, the amendments made it possible for the Commission to move forward with the development of disclosure policy, free of concern that by doing so it might create an unwise or unacceptable discrimination between the two markets.

2. Technological developments and their implications.

Until very recently the utility of ’34 Act reports was limited by their relative inaccessibility. Readership of the reports was confined in the main to: (1) a small number of financial men who had been led by experience to regard the reports as valuable in spite of gaps and imperfections; (2) a somewhat larger group that made intermittent use of the ’34 Act files for occasional intensive study; and (3) members of the Commission’s own staff, who consulted the reports in order to keep track of developments in the companies to which they were assigned.

Contemporary technology shows promise of breaking the circle of high cost and consequent neglect of the reports as disclosure tools for the trading markets. All ’34 Act reports are now being photographed promptly after filing and the photographs assembled on microfiche which can easily be mailed to subscribers. Other aspects and potentials of this new service are described in Chapter IX.

In addition to enhancing the Commission's ability to supply continuing disclosures quickly and inexpensively, technological progress may have heightened the financial community's demand for such material. Computer-based techniques are being used more and more extensively in the study of investments. The potential of data processing enhances the value of original sources of information such as '34 Act reports.

Technology has still a third implication for disclosure. It is now feasible for the Commission to keep continuous track of the performance of thousands of companies in meeting disclosure obligations under the '34 Act. Thus, for an appropriate purpose the Commission can know at any time, and can make known to the world, the roster of those issuers which are up-to-date in reporting on their affairs.

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The time is ripe for a re-examination of disclosure policy, for a careful evaluation of present disclosure tools, and for an inquiry into the practicability of achieving greater coordination between the '33 and '34 Acts.