

CHAPTER XII.

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REPORTING REQUIREMENTS

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CHAPTER XII.

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REPORTING REQUIREMENTSA. Introduction

In preceding chapters, the Study has recommended increased coordination between the disclosure requirements of the '33 and '34 Acts and has suggested that still greater coordination may evolve as experience is gained with improved '34 Act reporting. The success of any such coordination depends heavily on improving procedures for and increasing emphasis on administration and enforcement of '34 Act reporting requirements. Commenting on this need, Milton Cohen observed:

The most important measure of all, I believe, would be a combination of (1) SEC staff review of all 1934 Act filings resembling as far as practicable, in thoroughness and promptness, its review of 1933 Act filings, and (2) prompt and decisive action by the Commission--in the form of deficiency letters, publicity, suspension of trading, injunction proceedings, or other legal proceedings, as circumstances may warrant--to correct a false or misleading record.^{1/}

Section B of this chapter concludes that the existing enforcement tools are adequate for this purpose, if they are properly used, together with imaginative employment of the Commission's EDP facilities, as suggested in Section C of this chapter. A critical need is for allocation of additional staff to the administration of '34 Act registration and reporting requirements. Should the Study's

^{1/} Cohen, "Truth in Securities" Revisited, 79 Harv. L. Rev. 1340, 1371-72 (1966).

recommendations in Chapter X be adopted, important new information will be called for in '34 Act reports. If other aspects of disclosure policy are to rely more heavily on the existence of this information, assurance that reasonable standards of disclosure are being met is essential. These considerations, set against a background of rapid growth in the trading markets and their importance to increasing numbers of investors, may well justify an addition to the Commission's professional staff.

B. Presently available procedures are adequate to deal with enforcement of reporting requirements if effectively used.

The Study gave careful consideration to several as yet untried methods of dealing with reporting delinquency which were suggested to it. These included (1) the preparation and publication of a delinquent list, together with establishment of an obligation on the part of broker-dealers to advise any purchaser of securities of an issuer on the delinquent list of that fact, and (2) rules against purchases or sales by insiders during a period of delinquency. Because of certain practical problems encountered with each of these novel procedures, it was decided not to recommend them; instead, the Study urges fuller and more effective use of presently available enforcement tools.

1. Informal procedures for handling delinquent reports.

The Division of Corporation Finance makes extensive use of informal procedures for dealing with deficiencies and delinquencies in '34 Act reports. It usually contacts a delinquent issuer by letter in an effort to ascertain the reason for the delinquency. Should informal procedures fail, the delinquency will normally be referred to the Office of the General Counsel for appropriate action.

As more fully described in Part E of this chapter, the Division also informally reviews requests for extensions of time to file reports under Rule 12b-25. Until recently, only the Commission could deny such a request. In January, 1969, the Commission delegated that authority to the director of the Division, a move which the Study considers highly desirable. A registrant can always ask review by the Commission of the director's determination.

Although these informal procedures are useful and necessary first steps in the enforcement of '34 Act reporting requirements, they have been pursued far too haphazardly in the past. In some cases, many months have elapsed before serious enforcement effort was considered. Delinquency in filing should not be tolerated for long periods of time when the issuer's securities are publicly traded.

2. Formal procedures.

(a) Administrative compliance proceedings under Section 15(c)(4) of the Act.

Section 15(c)(4) of the '34 Act, adopted as part of the '64 amendments, permits the Commission, after notice and opportunity for hearing, to issue an order requiring a delinquent issuer to comply with Sections 12, 13 or 15(d) of that Act. Should the issuer thereafter fail to comply, the Commission's order is enforceable in court.

This procedure, which has been employed only five or six times, can be highly useful, in the Study's judgment, as a means of bringing substantive violations of reporting requirements to the attention of investors and their advisers. As an example, the facts developed in a recent proceeding under Section 15(c)(4) indicated that a number of '34 Act reports of two reporting companies under common control were materially deficient, false and misleading. In substance, those reports failed to disclose that a controlling person of the two companies had secured ownership of a controlling block of stock in one company through concealed utilization of the assets of both companies. The proceedings against both companies were discontinued after the companies filed appropriate amendments to their reports and supplied the missing information. In view of the misleading information previously given investors, the Commission ordered both companies to send copies of its findings and opinion to

all shareholders. In its opinion, the Commission observed that the controlling person's "personal ends were pursued without regard to the interest of other stockholders" and that "in the course of the transactions, material amounts of assets were subjected to risk without any apparent compensatory benefit to those shareholders."^{2/}

The Study believes that the Division should consider ways by which Section 15(c)(4) procedures could be streamlined and thereby made more useful in delinquency situations.

(b) Injunctive proceedings to compel compliance with reporting requirements.

This remedy is sometimes sought when informal procedures to remedy delinquency in reporting do not achieve results. It is most often pursued in situations where there appear to be violations of other provisions of the securities laws as well as of the reporting provisions of the '34 Act. In such situations, compliance proceedings under Section 15(c)(4) of the '34 Act would not provide complete relief.

(c) Criminal reference.

The Commission may transmit evidence of violations of the '34 Act reporting requirements to the Attorney General who may, in turn, institute criminal proceedings under the Act.^{3/} There have

^{2/} Securities Exchange Act Release No. 8200, pp. 7-8 (December 4, 1967)

^{3/} Securities Exchange Act of 1934, Section 21(e).

been several recent and successful prosecutions based on allegations of filing or conspiring to file false reports under the '34 Act.

For example, in 1966 several indictments were returned charging certain individuals connected with a reporting company with conspiring to violate the reporting provisions of the '34 Act. More specifically, the indictments charged the defendants with conspiring to file a false report on Form 10-K in order to conceal the effect of transactions where the company's funds were funneled [sic] through a subsidiary to certain of the defendants and others and used for their benefit. The government obtained convictions in the resulting trials.

In another case, certain officers and directors of a reporting company and others were indicted in 1968 for mail fraud and violation of the reporting and filing provisions of the '34 Act. The indictments charged that the defendants misappropriated company funds in transactions dressed up as loans from the company and concealed their alleged misappropriation by fictitious payments of those loans. The sham repayments were timed to coincide with the end of the company's fiscal year to avoid reflecting the loans on the company's balance sheets filed with the 10-K reports. The trial of these cases has not been completed.

3. Suspension of trading.

Perhaps the most immediately effective remedy available to the Commission where there has been serious failure to comply

with the reporting requirements under the '34 Act is the power summarily to suspend trading under Sections 15(c)(5) and 19(a)(4) of that Act.

In one recent case, the Commission's staff reported that market quotations for a company's common stock had risen from 1¢ bid in June 1967 to \$1.50 bid in February, 1968. There was no current information available concerning the company's financial condition. Although the company had been permanently enjoined in 1965 from failing to file timely and complete reports under the '34 Act, the last annual report on Form 10-K for the fiscal year ended May 31, 1966 had been filed approximately three months late on December 20, 1966. That report stated that the company had no income and no employees. Such statements were repeated in a 9-K report for the 6 months ended November 30, 1966, likewise filed many months late in June, 1967. No annual report had been filed for the 1967 fiscal year and no interim reports subsequent to the end of that year.

The Commission suspended trading pending investigation of the market activity and filing of the overdue reports. The reports were filed prior to termination of the trading suspension. They showed that, in addition to the absence of income or employees, the company had no assets and a large deficit.

The Study asked for reactions from many of the groups with which it conferred as to the Commission's use of its power to

suspend trading. The reaction was uniformly favorable. No person indicated a belief that there had been too many suspensions. A number of comments were made concerning the value and significance of the information about certain companies pried loose by suspension of trading. Greater use of the power was suggested.

It is of interest to note that the major exchanges have made liberal use of their powers to halt trading or to delay openings in order to implement their own timely disclosure policies. In 1967, the New York Stock Exchange ordered 218 trading halts and 88 delayed openings to permit information which that exchange considered necessary to informed trading to be prepared and disseminated by listed companies. During the same year, there were 67 trading halts and 84 delayed openings on the Amex for the same purpose. No comparable mechanism exists for the over-the-counter market. As mentioned in a previous chapter (at pp. 332), the Study considers it important that such a mechanism be perfected by the NASD when its NASDAQ system goes into operation.

A suspension of trading by Commission order is, of course, a more formal and serious matter than an exchange trading halt. Most of the occasions calling for such a halt would not justify a Commission order suspending trading. A Commission order should be reserved for serious cases, and every effort should be made to lift the suspension as soon as possible in light of its effect

on existing public stockholders. Where, however, there has been continued or reckless disregard of a company's obligation to file reports required in the interest of an informed trading market, careful consideration should be given, in the Study's opinion, to a suspension of trading until either (a) the required reports are filed, or (b) the Commission can itself release to the public such information as it has been able to obtain through investigation.^{4/} As the Commission observed early in its history in a case involving a temporary suspension of registration on a national securities exchange:

The statute contemplates that trading in securities on a national securities exchange should be permitted only where there is a public file of accurate and current information regarding the affairs of the issuer of such securities, and we do not believe that the statute authorizes us to permit the continuance of listing where the issuer has failed to keep current the information required by the statute.^{5/}

- C. New EDP programs should be developed to permit rapid discovery of reporting delinquencies and disclosure deficiencies and to aid in determining appropriate remedies.

The Commission's EDP equipment is now capable of producing as often as desirable a list of issuers delinquent in filing the revised Form 10-K and quarterly reports which would be required

^{4/} Where fraud is not involved in a trading suspension, the Division of Trading and Markets has been developing procedures under which as much information concerning the issuer as can be elicited in a relatively short period is embodied in a public Commission release, after which trading is permitted to resume.

^{5/} Austin Silver Mining Company, 8 S.E.C. 234-236 (1940).

should the Study's proposals be adopted. The computer could also assist in identifying those issuers which have not furnished shareholders with proxy or information statements and are therefore obliged to include in their Form 10-K reports information equivalent to that required in such statements. New computer programs would have to be written but those who would be responsible have assured the Study that such programs can easily be prepared. The information made available to the staff could include a history of past delinquencies and other violations of the securities laws by each issuer on the delinquent list. This information would assist the staff in determining quickly the appropriate enforcement procedure to be used.

The study recommends that these programs be authorized.

D. Increased staff effort should be directed toward prompt review of '34 Act reports and registration statements.

Improvement in '34 Act reporting requires a more effective procedure for review of '34 Act reports, identification of disclosure problems, and correction of less serious problems through contact between staff and registrant.

An analysis was made by the Study of information gathered by the Division of Corporation Finance relating to the review given to registration statements and periodic reports filed under the '34

Act from 1964 through 1967. In addition, the Study conducted its own survey (1) of the processing of registration statements on Form 10, including a careful review of the statements of a dozen Section 12(g) companies selected at random; and (2) of the processing of all documents filed with the Commission over a period of three or more years by ten additional companies.

The review process for Form 10 registration statements resembles in form, but not in emphasis, that for '33 Act registration statements. Letters of comment are prepared and amendments are requested and made in response to those comments. Under Section 12(g), however, registration automatically becomes effective 60 days after the filing of the registration statement. In only 3 of the 12 cases examined was the review process completed before the statement became effective. Letters of comment for the other 7 statements were sent from 66 days to 371 days after filing. The review process for these registrants, including appropriate amendments, was ultimately completed in periods ranging from 3 to 16 months. The average time to complete the review for all 12 registrants was approximately 7 months.

Form 10 registration statements represent the first full disclosure available to the trading markets concerning a Section 12(g) company. It is therefore important that they be given appropriate priority for review.

Periodic reports filed under the '34 Act have generally received even less attention than registration statements on Form 10. Early in 1967, the Division indicated to the Commission that it would be unable to review all periodic reports filed under the '34 Act. The Commission approved several suggestions made by the Division at that time to curtail the review of these reports and invited issuers filing 10-K reports to assist the staff by indicating by letter whether financial statements in the report reflect any change in the accounting principles or practices followed in the prior year.^{6/} A screening policy has been adopted by the Division to identify those Form 10-K reports which should be reviewed on a priority basis. Unfortunately, the gap between the number of '34 Act reports filed and the manpower resources of the Division available for their review has continued to widen.

It is extremely doubtful that a greater degree of effort can be allocated to '34 Act reports through shifting the assignments of existing Division personnel. Workload in the area of '33 Act filings has greatly increased, and a substantial reduction in the review given to those filings was recently announced.^{7/} The Study can only express its hope that the additional resources necessary to provide adequate review of augmented '34 Act filings can somehow be found. It is believed that a prompt review of '34 Act filings

^{6/} Securities Exchange Act Release 8040 (February 23, 1967).

^{7/} Securities Act Release No. 4944 (January 15, 1969).

would reduce the scope of review needed for '33 Act registration statements filed by reporting companies.

E. Rule 12b-25 dealing with extension of time to file reports should be tightened

Under Rule 12b-25, an issuer may by application request an extension of not more than 60 days following the due date in which to file a report. The application is deemed granted unless denied by Commission order issued within 10 days of receipt of the application. (The Division director was recently given delegated authority to deny such requests.) About 500 Rule 12b-25 applications were filed from February through about May 15, 1968. Only 13 were denied.

The Study noted a number of instances in which a clear abuse of Rule 12b-25 was shown. For example, a company whose securities were registered on the now defunct San Francisco Mining Exchange (and are now listed on the Salt Lake Stock Exchange) applied for two 30-day extensions of time to file its annual report on Form 10-K for the year ended December 31, 1967. The application for the second extension was denied by the Commission, the first request having been granted by operation of Rule 12b-25. The background indicated a continuing disregard by the company of the disclosure requirements of the '34 Act. With the exception of 1960 (when a request for extension of time was denied) the company was either

delinquent in reporting or received an extension of time in every year subsequent to 1957.

Moreover, an extension request can be an attempt to mask a fraud. In 1963, a company with securities listed on a national securities exchange requested an extension of time to file its annual report on Form 10-K for the fiscal year ended September 30, 1962, due January 28, 1963. On the company's representation that it had made substantial acquisitions of service routes during the previous quarter and that its auditors had not had sufficient time to review these transactions, the Commission granted a 30-day extension. The company later applied for a further 30-day extension. The Commission was informed by the company's auditors, however, that the reason for the delay in completion of the financial statement arose from the fact that the accounting firm could not issue an unqualified opinion because of doubt as to the collectibility of a large receivable. The Commission thereupon rejected the second extension request and ordered suspension of trading in the company's securities and an investigation. Based on the results of the investigation, a court order was obtained in April, 1963, appointing a conservator who was directed to prepare and file the reports required by the '34 Act. The company was ultimately placed in reorganization under Chapter X of the Bankruptcy Act. The underlying fraud which was concealed during the period of delay is filing the report on Form 10-K resulted in a number of criminal indictments and convictions.

The Study believes that Rule 12b-25 should be revised to prevent abuses and to facilitate its administration. The proposed revision, set forth in Appendix XII-1, incorporates some of the suggestions developed by the Division of Corporation Finance several years ago but never submitted to the Commission.

The Study suggests that the rule be prefaced by a note referring to the importance of prompt filing and that only serious and unexpected situations will justify delay. The reasons for any request should be required to be stated in detail. Each extension should be limited to 30 rather than 60 days. (The Division has informed the Study that many companies request the full sixty days regardless of their needs.) A signed statement from the company's auditors should be required in appropriate cases. The present procedure for automatic extension if the issuer has not been notified of denial of its request within 10 days should be retained. Finally, the rule should codify the practice of requiring timely filing of any material portion of a report available when an extension request as to the balance of the report is submitted.