IMPROVING DISCLOSURE FOR INVESTORS

An Address By
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I presume that most of you have, at best, a limited interest in the administrative, personnel and budgetary aspects of the Securities and Exchange Commission. Certainly many businessmen and professional people think of these things rarely, and then, in a time of trouble, think of them only to wish they would all go away, and, with them, the whole damn SEC. You can understand, however, why I might have a different attitude toward these matters. Let me spend a moment in this neighborhood.

The SEC is an independent agency, created by the Congress, with Commissioners appointed by the President, with the advice and consent of the Senate, and having no direct ties with the rest of the Executive Branch of the Government. The Act that created us, the Securities Exchange Act of 1934, contemplates a staff, but it doesn't specify the table of organization -- that's up to the Commission. Nor does it specify the number of staff members -- that depends on the annual appropriations made by Congress, with some control by the Civil Service Commission over grades and job descriptions.

As to the size of our staff, we have varied, in the past from slightly under 2,000 to as low as 666. In recent years, we hit a plateau of about 1,400 in the early 60's and stayed at approximately that level until fiscal 1974, when our appropriation was raised to enable us to increase the staff to 1,912. Our appropriation for the current fiscal year supports a staff increase of 225. The result is that in a two-year period, we will have been able to increase our total personnel by about 30 percent. We hope you will see the difference, as the new people become trained and integrated into our operations, in better service. You will also see it in more active inspection and enforcement work.

From our earliest days, our staff has been divided into a headquarters office in Washington and several regional offices. The proportions have varied over the years. Today, sixty percent of our staff is in the headquarters office, and forty percent in the regions. I have never looked into how the regions were determined, but we are not required to conform-to the standard regional groupings used for most other Federal purposes. The Denver Regional Office, for example, is responsible for Colorado, New Mexico, Wyoming, Utah, Nebraska and the Dakotas. Because of a peculiar concentration of activity requiring enforcement attention, the Denver Office has a branch in Salt Lake City, and it has been busy. Out of it recently came an interesting episode.

Enforcement work is hard work. Investigations are frequently frustrating and time-consuming, especially, as is so often the case with us, when the evidence of illegal activity is buried in voluminous files and books

of account. For the people engaged in this work, the feeling of being undermanned and overworked is chronic. This sensation, to a degree, probably goes with the job, but with us it also has been based on fact. The Denver Regional Office, for example, has only 22 persons, including 5 in the Salt Lake City Office, to deploy, on a regular basis, to investigative work, including work in court. It can, when necessary, get help from our Division of Enforcement in Washington and other regional offices, but they really have no one to spare, so this isn't done often.

But, as I started to say, sometimes this hard work produces moments of special satisfaction and even amusement. Recently, the Salt Lake City's investigative efforts were coordinated with those of the local United States Attorney, who had a grand jury to work with. After many weeks of investigation and grand jury hearings, five indictments naming fifteen persons were handed down last May. News of the indictments was widely reported almost immediately, but the names of those indicted were withheld, pending their arrest. In the intervening period, however, nine people called the U.S. Attorney's Office and said "I know you're looking for me, but please don't send the Marshal to my house -- I'll turn myself in." But, only one of the nine callers had, in fact, been indicted! Perhaps this is a tactic that should be used more often in our law enforcement work.

Our enforcement efforts have been peculiarly affected by the decline in our stock markets and the diversion of the individual investor's interest toward other places for his money. Much of this money has gone into fixed interest

investments of one sort or another that cause us no special concern but much of it also has been attracted to various types of exotic devices, mostly sold as magic means of beating inflation and/or the tax collector. We have had to struggle to match with our ingenuity the amazing inventiveness of those who want to separate our citizens from their money without giving the sucker an even break. Our task is not made more easy by the equally amazing gullibility and greed of so many people -- but that is a problem as old as mankind. We all remember the observation of that dean of confidence men, Yellow Kid Weil, when he said, "I have never cheated an honest man." A proper victim in a con game must have larceny in his heart. Like most memorable statements, this is an exaggeration. We find many truly innocent victims. Yet we continue to be surprised and depressed at the number of people who will even seriously consider giving their cash to a complete stranger who promises, for example, a 20 percent return in three months through a joint venture to import Portuguese "industrial wine", a non-existent commodity.

This general development has led us to look closely at programs to invest in interests in Scotch whisky, rare coins, pre-1965 silver coins, and other methods of getting suddenly rich on precious metals. The pace of all this is sure to quicken in 1975 when direct investment in gold becomes legal. There are, of course, quite legitimate dealers in these commodities, and they are being sorely damaged by the swarm of illegitimate promoters that have moved into the territory. Last Monday, representatives of several Federal agencies concerned in one way or another with gold investments held a press

conference and, among other things, issued a list of 14 "golden rules" for investing in gold, which we helped to prepare.

Of course, our jurisdiction is limited. We have no jurisdiction over direct purchases of commodities or any other property. There must be involved something that we can bring under the definition of a "security", usually by way of an "investment contract" -- with such features as a pooling or buy-back arrangement, or other services. Legal purists may deplore what we have done and tried to do with the legal meaning of "security," but, when we see something wrong going on in the investment area that no one else is doing anything about, we are not inclined to be shy. At any rate, an important part of this general area will, on April 21, come under the new Commodity Futures Trading Commission. We rejoice in its establishment.

But let me get back to the Denver Regional Office. The office is now staffed by 45 persons, including 19 lawyers, 7 securities compliance examiners, 3 accountants.. 2 securities investigators, and 1 mining engineer. Its responsibilities include the inspection of broker-dealer firms, investment advisers and investment companies headquartered in its region. It processes small offering filings under Regulation A. It consults with and advises people who come to it with questions under our laws. And it investigates violations of our laws and handles court and administrative proceedings related thereto, when the evidence warrants. For an administrator in Washington, our Denver office has long been a joy.

Donald Stocking, who retired last May 24, after nearly 13 years as Denver Regional Administrator, and 36 years of service on the staff of the Commission, was a person of peculiarly fine judgment and wisdom and abiding dedication to the Commission and its mission. Among other things, Don was a splendid trainer and inspirer of younger men. His "boys" are something of a modern legend at the Commission. People that grew up, professionally, under Don now head our regional offices in Los Angeles, Fort Worth and Seattle; one is an Associate Regional Administrator in New York City; and one, of course, now has succeeded to Don's position here in Denver, for Bob Davenport worked under Don for 12 years. Bob has all the qualities necessary to be a worthy successor to Don, and, to us at the Commission, that is high praise indeed. Bob, of course, doesn't work alone. He has a fine staff headed by Joseph Krys. It seems in the best interests of the Commission, and of Joe, that he be stationed in Denver rather than Washington, but we think so highly of Joe, and his legal ability and experience that he is also an Assistant General Counsel to the Commission, along with his Denver duties.

Now let me turn to some matters of more direct professional concern to all of you. Not long ago I ran into a friend -- perhaps I should say ex-friend -- at a gathering of analysts, who slapped me warmly on the back and said, "Ray, you are about to achieve the bureaucrat's ideal in investor protection -- an annual report to shareholders and a 10-K so long and complicated that not even a CFA can understand them, and so expensive of preparation, production and distribution as to bankrupt the issuer. And you've done all this in less

than two years!" I naturally replied, "Aw, shucks, Judas. You exaggerate. I couldn't have done it all alone. The staff deserves most of the credit."

While I appreciated his praise, I pondered the thought on the way home, and at our next meeting with the staff we agreed that we would watch carefully the size of 10-K's, at least. When the average size, net of exhibits, reaches 100 printed pages, thereafter anyone who proposes that something more be added must accompany his proposal with something that can be taken out.

Pending the achievement of that equilibrium, we do receive complaints, in varying degrees of stridency, that we are imposing burdens on issuers that are not matched by any benefits to investors. Indeed, some urge that we are making things worse for investors by flooding them with too much information. We would be greatly disturbed if this were true. Whether it is true is not susceptible of simple measurement. One might put a price tag on compliance, although that is not really easy, but how do you assign any number to the benefits? Cost-benefit analysis is fashionable today, and ought always to be fashionable, and one critical observation is that the Commission is dominated by legal and accounting theorists whose only concern is with some sort of conceptual fairness without regard to the practicalities. There is, in fact, a fair amount of practical experience among our ranks, but that isn't really the point. Whether I have drafted more S-1's than my critic isn't going to determine the wisdom of my decisions. What does?

We are engaged in a continuous effort to make the disclosure process really work. How do we know when it really works? That depends on what it is supposed to do. In my conception, and I think this is the traditional view, it is first of all supposed to generate a sense of fairness among investors. Fairness not in the sense that every investment they make will be a good one -- that cannot happen in our economy -- nor even in the sense that they are being offered a fair shake, as some blue sky laws try to do, but fairness in the sense that they have access to all of the information that a reasonable person would want in order to make an investment decision. The Federal government has refused to take the paternalistic view that it knows better than the investor where he should put his money, provided only that the investor has the facts insofar as they are available, material and relevant. As a corollary to fairness in the initial sense, we also know the practical wisdom in Brandeis's dictum that sunshine is the best disinfectant -- that many shady transactions are deterred by the need to disclose them.

In addition to fairness, however, the disclosure philosophy assumes a theory as to capital allocation. It assumes that, on the whole and over the long run, the aggregate capital resources of our economy will best be employed if the allocation is left to the individual decisions of all actual and potential investors. But this can only be true, if it is true at all, when these investors know what they are choosing and rejecting. Of course, they cannot know all they would like to know. Most of all they cannot know the future. As to that, they must make their own guess, or accept someone else's guess. But they should know, or have access to, all that can reasonably be made available.

To the degree that capital formation relies upon, and is influenced by, the secondary trading market, it is as important that investors in outstanding securities be as well informed as those being offered new securities. And, at least since Milton Cohen's famous article in 1966, it has been well recognized that the Federal securities regulatory process did a reasonably good job of getting information to persons being offered new securities, but a pretty lousy job of keeping information available to persons considering buying or selling outstanding securities. In a sense, what is going on is an effort to redress this discrepancy -- to establish a continuous disclosure process that takes the emphasis off the occasional registered public offering and places it on a steady flow of information unrelated to whether new securities are being offered.

The SEC's disclosure study of 1969, headed by then Commissioner Wheat, developed both the theory of continuous disclosure and the practical steps to bring it about in a comprehensive program of rule and form revisions. The proposed Federal Securities Code being prepared by Louis Loss and his advisers under the auspices of the American Law Institute is, of course, completely devoted to the achievement of continuous disclosure as the basic system.

Working within the present statutory framework, the Commission has not adopted the Wheat Report proposals in detail, but it has in substance. The first task was to change the rules and forms to upgrade the Form 10-K, and

quarterly and current reports so that the 10-K now resembles an annual prospectus. But, achieving at least annual disclosures equivalent to an S-1 involves more difficult problems than merely changing the form. There is the problem of the quality of the substance of the report, in addition to its format.

It was observed years ago that there is much more to the quality of a well-prepared S-1 than appears in the items of the form, and this derives from the circumstances under which it is prepared, especially where able underwriters are involved, and the degree of concern devoted to the task -- born in part, no doubt, of the fears inspired by Section 11, but also today of well-settled tradition -- plus the prompt and concentrated attention traditionally accorded such filings by the Commission's staff. The old 10-K did not get anything like the same attention on either side. Some wise men have seriously doubted whether it is possible to make it much different with the new 10-K.

Alan Levenson and his Division of Corporation Finance are confident that it can be done on the Commission's side. Aided, in part, by the relative dearth of ‘33 Act filings these days, staff members are becoming current in their review, and issuers are being surprised with letters of comment on 10-K's -- a very rare event in the past. I wonder how it is on the issuer's side. I used to advise corporate clients that it would be wise for their officers, directors and counsel to treat the new 10-K like an S-1, but I had only limited success. That, however, is clearly what should be done.

It especially should be done if the company wants to be in a position to take advantage of the short Form S-16 for secondary offerings. Since the 10-K is roughly the equivalent of an S-1,the Commission has felt able to adopt notification-type '33 Act registration, at least for the types of transactions to which S-16 is applicable. We plan future use of this device in other areas. But remember that S-16 incorporates by reference the 10-K, which makes the 10-K subject to Section 11 liabilities.

The improved continuous disclosures also provided a foundation for some other moves which the Commission had previously found difficult. One was the adoption of Rule 146 relating to sales of restricted securities.

One abiding problem, however, with continuous disclosure has been getting the information out to investors at large, for whose presumptive benefit the whole system exists. Everyone recognizes that a 10-K reposing in our public reference room in Washington, while available to the public, is of limited value to most investors. Copies are available by mail at a reasonable charge. There is a microfiche service available. Nevertheless, dissemination is far short of what it should be.

The temptingly obvious solution is to require that a copy of the Form 10-K, without exhibits, obviously, be mailed to each securityholder of record. Some companies are in fact doing this, by attaching a copy to their annual report to shareholders. Presumably they think this good for shareholder relations and also of some legal protective value. A few more adventuresome

companies have combined the two documents by filing their annual report to shareholders as their Form 10-K. It looks like an annual report. They worked out with the staff a cross-reference sheet, similar to that filed with an S-1, and serving the same purpose.

While we have not been so bold as to require as much, we have intruded a bit further into the annual report to shareholders, by requiring it to include some additional information taken from the 10-K. This additional information includes fuller financial statements, a summary of operations with management analysis of significant developments, a brief description of the business, line-of-business information, management information and market and dividend information. The annual report also must include an undertaking by the company to mail any shareholder a free copy of its latest report on Form 10-K, plus the exhibits thereto, for a reasonable fee. We've taken pains to emphasize that these requirements do not make the annual report to shareholders a filed document or one subject to staff review prior to use, and that they should not inhibit management in its use of imagination in the form of the report. In fact, we expressly encourage the use of charts and graphs to present financial information in understandable form.

All of this has caused some grumbling, and will surely cause more as you get into the work of preparing the document this winter. But we think this is a desirable program that justifies the effort. If we think it important to have an effective disclosure system, we must continue to search for ways to get the information around where it is needed.

Arguments that investors don't read prospectuses, certainly won't read 10-K's, and don't even read much of annual reports have been with us almost from the beginning. We know there some truth to the arguments, and some recent surveys regarding annual reports are disappointing, especially considering how handsome and readable so many of them are. As for prospectuses and 10-K's, there is more evidence that analysts use them. We all know that the most careful readers will be plaintiffs' lawyers.

Sometimes these arguments of non-readership are urged to support the proposition that the documents are essentially useless, and, therefore, we should be much less demanding as to what goes in them. But other times they are urged to support the proposition that a disclosure system will not work. To some economists a disclosure system won't work because fundamental information about issuers and their securities is essentially irrelevant. The random walk or the dart board work as well, so all this disclosure is expansive nonsense. To others, however, non-readership means that it is unrealistic to rely on the fully-informed investor either to protect himself or to participate in decisions allocating capital.

Without attempting to justify our reliance on fundamental analysis and fairness through full disclosure, it is obvious that we remain committed to that philosophy and that approach. And, rather than backing off we are adding on. We are striving to come closer to the ideal that the system can produce the material information necessary for investment decisions, insofar as this can be

conveyed on paper and insofar as it relates to the issuer and its securities. And in re-examining the process, it has seemed that there is significant information, much of it of a financial nature, that has not been generally available.

This has led to our recent releases on the subjects of leases, compensating balances, short-term borrowing arrangements, income tax expense, and defense and other long-term contract activities. If a person is to get a full picture, we think he needs more information on these matters than he has been getting.

All of the developments that I have discussed thus far relate primarily to disclosure of financial information and not to accounting measurement or quantification, for which the accounting profession has primary responsibility. But, the line between disclosure and accounting standards is very fuzzy, and some commentators have suggested that we have gone over the line and preempted the standards-setting function of the accounting profession, particularly in light of the large number of Accounting Series Releases that the Commission has issued in the last two years. As a result, some persons have questioned whether the Commission will continue to support and cooperate with the Financial Accounting Standards Board, in the establishment of -accounting standards, as we have in the past with the Accounting Principles Board of the American Institute of Certified Public Accountants.

I can assure you that the Commission wholeheartedly supports the Financial Accounting Standards Board. We announced our official position in this regard in Accounting Series Release No. 150, where we stated that the FASB's statements and interpretations would be considered substantial authoritative support for accounting practices or procedure followed in filings with the Commission. We have established a close liaison between the Board and the Commission, which is buttressed by a close working relationship between our Chief Accountant and his staff, and the Board and its staff.

Our support for the FASB is evidenced further by the proposal we issued last month to conform the accounting requirements in our Regulation S-X, pertaining to .research and development costs, to the standards established by the FASB in its recently adopted standard "Accounting for Research and Development Costs."

In a number of cases where we have identified emerging accounting problems, we have called them to the attention of the public and the FASB in an exhortatory release. In some cases, where we were concerned that alternative accounting practices might grow up through selective adoption to suit the purposes of management, rather than as a result of careful study by an authoritative body, we have deemed it necessary to place a moratorium on changes in certain accounting practices until such time as the FASB is able to act. In each of these cases, however, we have not prejudged the ultimate solution to the accounting problem in question, but have left the development of an appropriate result to the Board.

As we indicated in Accounting Series Release No. 150, however, the Commission is charged with primary responsibility, under the federal securities laws, for ensuring that investors are provided with adequate information on which to base investment decisions. The Commission has discharged its statutory mandate in this regard by acting promptly to require better disclosures and more timely reporting of important financial information whenever the need has arisen. In the few cases where there has been the possibility of a conflict between Commission disclosure requirements and future FASB Statements, we have indicated that our requirements will be reconsidered when the FASB acts on the matter.

At present, we have some proposals outstanding on disclosure matters which we hope to finalize within the next few months. One such proposal would require a more detailed statement of the accounting policies followed by a company and would provide for disclosure of more information regarding depreciation, inventories, and finding costs for mineral resource companies. We originally had proposed additional disclosures regarding research and development expenses, but these will be dropped inasmuch as they were made unnecessary by the Statement on such costs issued by the FASB, subsequent to our proposal.

In another proposal dealing with the relationships between publicly-held corporations and their independent public accountants, we are attempting to strengthen our present disclosure requirements regarding disagreements

between companies and their accountants on matters of accounting principles or practices, financial statement disclosures, or auditing procedures. We propose to require that additional information on the relationships between the two parties be disclosed in filings with the Commission, and we believe that our proposal, if adopted, will help to strengthen the independence of auditors.

While management has "front-line" responsibility for financial statements, we believe that both management and independent public accountants must recognize that they have a joint responsibility. In most cases, management and independent accountants can work together effectively to improve corporate financial reporting.

I am also pleased to note that the AICPA recently appointed a committee to study the general question of what should be expected of independent auditors. This committee, which is comprised of three public accountants, a financial executive, a financial analyst, an accounting professor and a lawyer (Manuel F. Cohen, a former Chairman of the SEC), will bring a broad range of thought and opinion to bear on these questions.

In summary, the Commission, financial executives and the public accounting profession all have a high stake in our cooperative efforts to improve financial reporting and disclosure. Financial reporting and disclosure are central to any effective system of continuous, fair and complete

disclosure. All of which, as I said earlier, we believe to be essential to our capital markets and the economy as a whole, and to our society.