THE U.S. SECURITIES AND EXCHANGE COMMISSION DISCLOSURE STUDY

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The Report of the U.S. Securities and Exchange Commission ('SEC' or 'Commission') Advisory Committee on Corporate Disclosure, completed in November 1977, had its origins in a number of circumstances. In recent years there has developed significant research with respect to the manner in which securities markets operate. The thrust of many of these studies, particularly those concerned with the so-called 'efficient market hypothesis' and the 'random walk theory', suggests that so-called 'fundamental research', that is, the examination of data concerning issuers, movements in the market, macro-economic and industry information and the like, yields no better investment results than simple chance.¹ The purported reason for this is that, according to the efficient market hypothesis, information is so rapidly assimilated in the price of a security that there is no opportunity for anyone to profit from an examination of economic and corporate data.² This has led to the conviction among many that the only sensible investment policy is to assemble a diversified portfolio and then simply hold it.³ This theory, while certainly not universally accepted, nonetheless appears to be supported by a number of empirical studies.⁴

Also of importance were studies by economists which suggested that the system of investor protection enacted by the U.S. Congress in 1933 and 1934 has not provided any provable benefit to investors. Professor George J. Stigler of the University of Chicago, in 1964, on the basis of his researches, contended that the Securities Act of 1933, which required the registration of securities prior to distribution and the use of a prospectus with extensive and mandated contents, had really not reduced the level of fraud upon the public.⁵ Professor George J. Benston of the University of Rochester concluded that the requirements of the Securities Exchange Act of 1934 did not provide new information and hence such filings were simply superfluous.⁶

In addition to these scholarly criticisms, there has risen in the U.S. in recent years significant criticism of the SEC-administered disclosure system by users of the information,⁷ the providers of it (issuers)⁸ and others involved in the disclosure process. User criticisms have been varied. Individual investors contend that the

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information which is disclosed is often too complex for their comprehension. Professional investors and institutional investors have been critical because in their estimation much useful information has been denied them by Commission policies, for instance, forward-looking information such as projections, estimates, and the like. Issuers have complained about the steadily increasing burdens upon them; probably this criticism reached its highest point as the result of the Commission’s requirement that there be disclosed in a footnote to financial statements information concerning the impact of inflation upon fixed assets and inventories.

Finally, there has been rising in the U.S. in the last half-decade increasing frustration with the complexity and the burden of governmental regulation. This has become a bipartisan issue, with Republicans and Democrats vying to identify themselves as the true patrons of deregulation.

As a consequence of all these forces, as well as others, in January 1976 the Commission established an Advisory Committee on Corporate Disclosure. Advisory committees are fairly common in the U.S. and are specifically authorized by statute. This Committee consisted initially of 17 members, none of whom, except the Chairman — the writer — for a period of three months before his resignation from the Commission, were then associated with the Commission. Before completion of the work of the Committee, one member became Chairman of the Commission. A full-time staff of eight to ten people worked on the study throughout its course, preparing materials for the Committee, interviewing various participants in the disclosure system, and drafting the final Report for consideration by the Committee.

The Commission’s charge to the Committee was

"... (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 study was conducted through several means. Extensive questionnaires were prepared for issuers, institutional investors, financial analysts, individual investors, information disseminators and others involved in the process. These were supplemented by extensive face-to-face interviews. The data secured through these techniques is summarized in the Report of the Committee.

In addition to this original research, the staff reviewed the extensive literature which has developed concerning disclosure and markets. In addition to that, large amounts of this literature were distributed to members of the Committee, and the
meetings provided clear evidence that much of it had been carefully considered by
the Committee members. The Committee members themselves were a rich resource
of experience and information. On the Committee were attorneys, accountants,
financial analysts, academics, economists, businessmen and investors.

It is fair to say that the Report of the Committee received mixed reviews. Many
had hoped that it would recommend a substantial dismantling of the disclosure
system which had been developed since 1933 by the Commission. Others were
disappointed that it did not draw tighter disclosure requirements in certain areas,
such as management forecasts of operating results. However, there was widespread
satisfaction with the Report and a considerable measure of agreement with its con-
clusions.

The basic conclusions of the Committee were these.

First, the Committee recognized that in any society needs and demands will
exceed available resources. When that is the case, as it universally is, it is necessary
that the scarce resources be allocated. It is axiomatic that such allocation will be
best achieved if those involved in allocation decisions have the benefit of reliable,
timely and sufficient information. Thus, in making investment decisions, investors
are likeliest to make efficient allocations of resources if they have available
information with those characteristics. The Committee therefore concluded that it
is essential to a well-ordered society and to the efficient allocation of resources that
there be a system by which sufficient and reliable information reaches investors in
as timely a fashion as is practicable. 15

The Committee concluded that the interplay between companies and analysts —
the demands of analysts for information, and the acquiescence by the corporations
in those demands in an effort to gain popular acceptance for their securities — is
not a sufficient force to assure the timely dissemination of reliable and sufficient
information. That being the case, it was concluded that there had to be as a part of
the system a mandatory force which would make determinations with regard to
standards of reliability and sufficiency and with respect to appropriate timeliness of
dissemination, which would structure a mechanism within which such standards
would be achieved, and which would enforce the standards. Looking at the
experience and the expertise of the Commission, the Committee concluded that it
was the most appropriate agency to carry out those functions. 16

Underlying this series of propositions, of course, was the conviction of the
Committee, based upon staff research and upon the experience of members of the
Committee, that there is value in fundamental research and that superior invest-
ment results can be accomplished by the utilization of issuer-originated and other
information. 17 While it is true that in a society like that of the U.S., large amounts
of information concerning many issuers are quickly disseminated among decision-
makers, still it was concluded there is room for superior judgment, and superior
results, based upon such information. Further, while rapid dissemination of infor-
mation is characteristic of companies whose securities have large markets and wide
acceptance, it is not necessarily true of companies less followed by the investment
community. Beyond that, of course, the efficient market hypothesis assumes the availability of information, but it makes no statement with regard to the characteristics that information should have. The market for a security will be efficient even if all of the information available about the issuer is false. Thus, in order to have efficient allocation of resources, it is necessary that there be qualities in the marketplace in addition to simple efficiency.

The Committee concluded—again, this is axiomatic—that experienced investment decision-makers do not expect to, and do not, make their decisions solely on the basis of the information which is provided as a consequence of SEC mandates. Investment decision-makers, in making portfolio decisions, take into account much information that is not contained in SEC documents, e.g., the state of markets in general, information concerning the economy, forecasts concerning economic trends, data with regard to the world economy, information concerning the industry in which the portfolio candidate operates, and a host of other information. It has sometimes been charged that the Commission administers the securities laws as if the information contained in its mandated documents constituted all that was necessary for sound investment decision-making. The Committee repudiated such a notion. Having done so, it then considered whether it would be appropriate to expand the universe of information which should be included in SEC filings and prospectuses to embrace such information. It was determined this was not practicable, that such information was now available through many sources and that incorporating it in SEC documents would further lengthen and complicate documents already frequently criticized because of their size and complexity.

The Committee addressed the question whether the Commission's requirements should be designed in a manner that would serve the needs of a broad spectrum of investors. The Committee in this respect concluded:

The proposed statement [to be issued by the SEC concerning its objectives] 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.

Thus, the Committee did not believe that the Commission should design a variety of formats and degrees of summarization to serve the diverse needs of various investors. It is evident that the sophistication and knowledge of investors varies broadly, from the small, occasional, 100-share purchaser (or even the odd-lotter) through the sophisticated portfolio managers. The Committee believed that by having the Commission concentrate on the needs of sophisticated investors, the needs of other types of investors would be adequately served through the many private services which collect, synthesize, summarize and comment upon data concerning issuers. Among these are financial newspapers, investor services, and brokerage firm reports. It is possible for virtually any investor to secure an abun-
dance of information which has been formatted in a way that is usable by him. Beyond that, our survey indicated considerable reliance by small investors upon their brokers to provide them with information and to assist them in making investment decisions. Thus, the Committee believed that the best situation for all investors is the one which combines the efforts of the Commission to make sure that there is a sizable pool of reliable, timely information with those of private enterprises which draw on such a pool in rendering their services to the broad spectrum of investor sophistication. This is not a new notion; it can be found in the legislative history of the Securities Acts and was remarked upon shortly after their enactment by then Professor, later Chairman of the SEC, later Supreme Court Justice, William O. Douglas.

While it was concluded that often the information contained in SEC filings with regard to publicly-held companies had been disclosed and disseminated earlier, still it was felt that those filings served significant purposes and had considerable value. First, they assure an equality of access to all investors. Second, in some cases SEC requirements elicit information which is not routinely disseminated outside the SEC system but which is of importance to knowledgeable investors. Finally, the requirement of filing with the SEC, with such filings potentially subject to harsh liabilities if false, has the effect of disciplining the entire disclosure process, not only the filings themselves, but all disclosure by corporations. For instance, a corporation knowing that its earnings will have to be disclosed in a formal filing will, when it announces such earnings earlier, be quite cautious to be sure that it is not embarrassed and exposed to liability by an inconsistent filing.

The Committee also concluded that the Commission should administer the system primarily for the purpose of providing useful information to investors and potential investors in companies. Thus it should not try to use its powers to compel disclosure concerning, for instance, social or environmental matters, hiring practices, and the like, unless it could be shown that such matters were material to investors. There has been in the U.S. considerable pressure and litigation seeking to cause the Commission to use its powers to satisfy the desires of those with intense social concerns for information concerning corporate conduct to facilitate enforcement actions and to pressure corporations into conformity with commendable social policies. Furthermore, often the Commission is urged to require disclosure as an indirect means of law enforcement or compelling progress toward social objectives. While the Committee recognized that often a collateral result of a disclosure which has clear investor relevance will be a modification of corporate conduct, still the Committee felt that should not be a primary objective of the Commission’s activities.

In that regard, the Committee sought to define with more specificity than had been done previously by the Commission and the courts what is ‘material’ to investors. In this area, the Committee failed: it came no closer to certainty or simplicity than had others who went before it. Materiality is a remarkably difficult concept to express with precision, and yet, even with its hazy boundaries, it is ob-
viously a necessary standard for sorting out truly important information from that in which even the most sophisticated investor would not have an interest.

These were the major conceptual conclusions reached by the Committee. Based upon them, the Committee made a number of specific recommendations. The Commission, in an unusual move, perhaps to some extent attributable to the circumstance that its present Chairman, Harold M. Williams, served for over a year as a member of the Committee before his appointment, officially reacted to the Report of the Committee. This reaction was largely affirmative and supportive, and already the Commission has undertaken a number of actions to implement the specific recommendations of the Committee.

Briefly, these are the principal recommendations and what the Commission has done in response to them.

(1) The Committee recommended that the Commission should adopt a statement of its objectives in administering the system, placing emphasis, as indicated, on investor needs. The Commission determined not to adopt such a statement, principally because it was fearful that the existence of such a statement would complicate its enforcement program and litigation work since the statement could provide a procedural weapon that might impede the Commission's work.

(2) The Committee felt that the Commission should revamp its rulemaking procedures. First, it felt that there had been too much reliance upon enforcement and other ad hoc procedures to develop disclosure policy and that the Commission should move more quickly into a rulemaking posture when a disclosure problem appeared, such as the improper payments problem. Secondly, the Committee felt that the Commission should, instead of initially putting out the text of a proposed rule, rather elicit comment at first on the basis of an analysis of the problem, its conception of alternative solutions, and a discussion of the benefits expected to be derived from the rule. The Commission stated its support for this position, at least with respect to major proposals. Third, the Committee recommended that the Commission should as a part of rulemaking, particularly with respect to major rules, establish in each case a means of monitoring the functioning, effectiveness and cost of compliance with the rule and then, two or three years after adoption, determine whether the rule should be abandoned or modified; again, the Commission confirmed that it will follow this policy. Fourth, the Committee recommended that periodically the Commission should review existing rules and determine their adequacy and relevance; the Commission confirmed its similar belief and has already done that with respect to at least one major rule.

(3) Recognizing that there are disclosures that are unique to various industries and that not all industries can be fitted into a single Procrustean bed, the Committee recommended that the Commission should do more of what it already has done with regard to real estate and oil and gas offerings, namely, develop in collaboration with issuers in an industry and with analysts who follow it specific disclosure
requirements for the particular industry; again the Commission has already undertaken this with regard to two industries.

(4) The Committee believed that so-called ‘soft information’ (that is, management’s estimates of future performance, appraisals of its properties, statements of management’s objectives and capital spending plans, all of which represent the kind of information which historically the Commission has banned from prospectuses and SEC filings) is important to investors. The Committee was not ready, however—and in this there is something of an anomaly—to say that such information should now be mandated. There still exists in the corporate community considerable opposition to such a mandate, and the Committee felt that before imposing it upon companies which historically have been reluctant to expose themselves to legal risks associated with incorrect forecasts, an effort should be made to accomplish the result by persuasion. As a means of doing this, the Committee recommended that the Commission should adopt a rule which might reduce the fear of unwarranted liability, thus perhaps encouraging companies to avail themselves of the opportunity to make projections in SEC filings and prospectuses. Related to the problem of forward-looking information was the Committee’s recommendation that the present requirement for analysis by management of financial information in several Commission filings and in the annual report to shareholders be strengthened. Many commentators have felt this requirement, first required by the Commission in 1974, was one of the most far-reaching advances in disclosure policy in many years, but have complained of shortcomings in compliance with the spirit of it. The Commission has indicated that it intends to implement these recommendations.

(5) The Committee affirmed its support for Statement of Financial Accounting Standards No. 14 with respect to segmented reporting, and recommended that such reporting should be required not only on an annual basis but quarterly as well. Furthermore, it recommended that as a part of the development of industry guidelines, uniform standards for reporting with respect to product line sales within an industry should be developed. Finally, the Committee recommended that in the narrative parts of disclosure documents there should be similarly segmented reporting, as, for instance, in reporting on backlog, plant facilities, and the like. The Commission has indicated its concurrence with these recommendations, with the exception that, consistent with the action taken by the Financial Accounting Standards Board, it has deferred action with regard to quarterly reporting pending completion of the FASB’s study of interim reporting.

(6) The Committee recommended that the Commission should, with respect to disclosures in proxy statements to existing shareholders, develop additional disclosures which will “... taken as a whole, ... strengthen the ability of boards of directors to operate as independent, effective monitors of management perfor-
mance and that will provide investors with a reasonable understanding of the organization and role of the board". 41 The Commission has recently completed extensive hearings addressing the problem of corporate governance 42 and it appears that out of those hearings will come rule recommendations that may reflect the recommendations of the Committee.

In addition to the foregoing, the Committee made a number of technical recommendations which it hopes will result in simplification of certain filings with the Commission through such techniques as incorporation by reference. 43 It also recommended that the Commission have a public proceeding to determine whether the disclosure burden on small companies might somehow or other be reduced. 44 The Commission has now held such hearings. 45 The Committee approached even such mundane matters as the way in which the Commission maintains its files, and recommended changes there. 46

There were areas in which the Committee had hoped to accomplish more than it did. One of its objectives had been to identify the costs and the benefits of the disclosure system. 47 The Committee sought earnestly to do this and to the disappointment of some members of the Committee 48 had to confess that it simply did not have the resources or imagination to accomplish that. About the only hard figures the Committee was able to develop with regard to the costs of SEC compliance were auditors' fees and lawyers' fees, and even there imbedded in those figures was such a variety of services that it was difficult to separate out those directly attributable to SEC compliance. 49 When the endeavor turned to internal costs, it was apparent that no useful or reliable data could be developed. Obviously the difficulties of determining the benefits of the disclosure system were even more complex: how does one measure the value of integrity of markets, protection of investors, prevention of improvident investments and so on? It is hoped that this effort will not be abandoned and that scholars will continue the effort to develop techniques that might permit a better resolution of this problem.

The Committee did in its recommendations with respect to rule-making exhort the Commission to, at least with respect to major new rules, establish a monitoring method to ascertain costs and benefits of a new rule. 50 The Committee felt that such prospective cost-benefit analysis might be feasible, as contrasted with an effort to evaluate present costs and benefits of the entire system.

In another area this writer also felt that the Committee fell short of its mission. He would have liked to have seen the Committee develop further its concepts with regard to the role of proxy disclosure. A tremendous amount of effort is expended in making disclosures to shareholders, theoretically to permit them to make informed voting decisions. The simple, unassailable fact is that, in the absence of a proxy contest — and those are extremely rare — management is almost invariably overwhelmingly reelected by the shareholders. However, the information that is disseminated as a consequence of the proxy requirements serves an extremely important purpose. It is disclosure to the general public of important information con-
cerning the company. Furthermore, it is of assistance to present shareholders and potential shareholders in assessing the desirability of an investment in the corporation. Thus, proxy disclosure may well have as its true value and justification assisting the investment process. If the Commission addressed that function more explicitly, it might be able to develop a more meaningful and useful set of disclosures to be disseminated through the proxy-soliciting mechanism.

While all members of the Committee, save one, signed the Report, a total of six expressed reservations in one degree or another with its conclusions or analysis. Interestingly, with one exception, each of the six commented on different aspects of the study; thus, there was no dissenting 'bloc' united in dissent to the substance of the report. The dissents varied: one member faulted the study for insufficient attention to cost-benefit analysis; another for failing to lighten disclosure requirements; another for drawing too tightly the restriction on the Commission's disclosure rule-making process; another because of the particulars of the Committee's recommendations with respect to projections; another for a variety of finite reasons.

The most encouraging consequence of the Committee's efforts has been the recognition by the Commission of the merit of the proposals. As indicated, the formal response by the Commission to the Report is unique and represents a commitment that the Report, unlike so many others, will not be permitted to gather dust on a shelf.
Notes

4 These studies are summarized in Lorie and Hamilton, *supra* n. 2, at 18.
9 Epstein, The Usefulness of Annual Reports to Corporate Shareholders, ch. III (1975).
12 The books and articles on this theme are now legion. Representative of them is Wallis, *An Overburdened Society* (1976).
15 Id. at XIIIff.
16 Id. at XVIIff.
17 Id. at XXXVIIIff.
18 Id. at XXXVff.
20 Report, XV.
21 This conclusion does not appear to be expressly stated in the Report, but it was the clear conclusion of the Advisory Committee members.
23 Id. at 312ff.
27 Report, XVI.
28 Id. at ch. VII.
31 See Blumberg, *op. cit. supra* n. 29.
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