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BUMBLEBEES AND MANDATORY DISCLOSURE

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The views expressed herein are those of Commissioner Treadway and do not necessarily represent those of the Commission, other Commissioners, or the staff.

BUMBLEBEES AND MANDATORY DISCLOSURE

Introduction

Ray Garrett, Jr., whose memory this conference honors, emphasized in 1974 in one of his many thoughtful addresses, that the Commission was an agency "dedicated to full disclosure." Voicing support for a system of mandatory disclosure, he observed that a significant portion of the Commission's effort "has been, and will continue to be, devoted to obtaining adequate information for the investor and his financial interpreter, so that rational economic decisions can be made." 1/

Since Ray spoke those words, mandatory disclosure has come under increased criticism. Some complain that the Commission requires too much meaningless disclosure, or simply too much disclosure in the aggregate; some charge that the Commission is insensitive to the costs imposed; some question the need for mandated disclosure at all. Others -- including some prominent spokesmen on Capitol Hill -- take a contrary view and think the Commission should require even more disclosure. To illustrate, witness the heated debate resulting from the Commission's recent amendments to our rules governing disclosure of executive compensation. 2/

In response to the critics of mandatory disclosure, in 1977 the Commission established an Advisory Committee to examine the functions, costs and benefits, and objectives of the disclosure system. The resulting Report has been most influential. 3/

1/ Ray Garrett, Jr., Improved Disclosure -- Opportunity and Responsibility for Financial Analysts, Address to the Financial Analysts Federation, Los Angeles, California, (April 29, 1974).

2/ Securities Act Rel. No. 33-6486 (Sept. 23, 1983); 28 SEC Docket 1406 (October 11, 1983). See also Spencer and Olson, Dissonant Chorus Greets SEC Proxy, Perk Rule Changes, Legal Times, Nov. 7, 1983, at 13, col. 1.

3/ Advisory Committee on Corporate Disclosure, A. A. Sommer, Jr., Chairman, Report of the Advisory Committee on Corporate Disclosure to the Securities and Exchange Commission, 95th Cong., 1st Sess. (Comm. Print 1977) (Committee on Interstate and Foreign Commerce of the U.S. House of Representatives).

The sixteen-member Committee endorsed a mandatory disclosure system and concluded:

> (1) The "efficient market hypothesis" -- which asserts that the current price of a security reflects all publicly available information -- even if valid, does not negate the necessity of a mandatory disclosure system. This theory is concerned with how the market reacts to disclosed information and is silent as to the optimum amount of information required or whether that optimum should be achieved on a mandatory or voluntary basis;
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> (2) Market forces alone are insufficient to cause all material information to be disclosed;
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> (3) Commission-filed documents often confirm information available from other sources. The Commission's filing requirements, while often not a source of new information to investors, assure that information disclosed by publicly held companies through many means is reliable and is broadly accessible by the public. 4/

On the matter of cost/benefit analysis, the Committee concluded:

> An effort to analyze costs and benefits was a part of the charge to the Committee. While reducing costs and benefits to objectively measurable terms would be highly desirable, the Committee was generally unable to do so. The Committee's staff successfully isolated only a few costs, principally legal and audit fees associated with registration statements and periodic reports. Efforts to go deeper were frustrated because methods of allocating internal costs are so varied that gathering comparable cost data from even a small sample of companies would have required far more time and resources than were available, and the data might still have been of doubtful reliability. Further, the Committee was unable to quantify such costs as competitive disadvantage and management disincentive to innovate and such benefits as confidence in the markets and efficient security pricing. The difficulties of evaluating costs and benefits, however, have not caused the Committee to reject the desirability of the Commission continuing its efforts to measure them more definitively. Further, inexact though they may be, perceptions about cost/benefit tradeoffs do underlie many of the recommendations found in this report. 5/

4/ Id. at D-6.

5/ Id.

Since then the Commission has continued to refine the mandatory disclosure system, sometimes adding and sometimes deleting requirements. Yet, the criticism continues, sometimes emerging from rather surprising places. All of you are undoubtedly familiar with the academic critics. But it was recently reported in the New York Times that a high-ranking official of the Office of Management and Budget wrote the President, stating that the federal securities laws should be fundamentally changed so that the Commission would be precluded from requiring disclosure of anything other than what he termed "basic financial information." I'm not completely certain what that means. But since this same official also told the President that insider trading should be legalized and all federal regulation of tender offers repealed, I have a good idea that he doesn't like our present mandatory disclosure system.

With that brief background, today, in memory of Ray and in the 50th year of the Commission, perhaps it's worth stepping back for a few minutes and reflecting upon our mandatory disclosure system and whether it continues to merit our support. But let me start by foreshadowing my conclusion: bumblebees and mandatory disclosure have much in common. More on that later.

Purpose of the Act

The two-fold purpose of the Securities Act of 1933 is well-known: to provide full and fair disclosure of the character of securities sold and to prevent fraud in the sale of securities. That objective is stated in the conjunctive -- a fact which sometimes appears to be ignored by those who argue that mandatory disclosure is a failure because fraud continues to occur. As was said in 1933: "All the Act pretends to do is to require the 'truth about securities' at the time of issue, and to impose a penalty for failure to tell the truth. Once it is told, the matter is left to the investor." 6/ That statement suggests that no one ever assumed that mandatory disclosure would eradicate all fraud.

Disclosure, however, was not a totally new development in 1933, for some quantum and quality of public disclosure already was required or urged. In addition to some state blue sky requirements, the New York Stock Exchange imposed disclosure obligations on listed companies. The Federal Reserve Board, some credit and trade associations, and public demand also influenced corporations to disclose some information. 7/ England's statutory requirement that certain corporate information be disclosed served at least as an example to American corporations and gave some impetus for disclosure.

6/ Douglas and Bates, The Federal Securities Act of 1933, 43 Yale L. J. 171 (1933).

7/ Twentieth Century Fund, Inc., The Security Markets 579 (1935).

In addition to a lesser quantity of pre-1933 disclosure, the quality was also spotty at best. For example, The Twentieth Century Fund's 1935 study, The Security Markets, determined that the content of pre-1933 prospectuses "ranged from relatively adequate disclosures to extravagant and unfounded promises to investors, poetic references to climatic conditions, questionable ethnology of the people the new issues were to serve, material omissions and outright misstatements." 8/ In 1937 the Columbia Law Review reexamined a 1929 holding company public offering in light of the disclosure requirements of the 1933 and 1934 Acts. They concluded: "A detailed comparison between disclosure in 1929 and that which would be required in 1937...immediately reveals that many more of the 'facts necessary to a sound investment judgment' will be presented" to the company's shareholders. 9/

The 1946 Commission Proposal and The Special Study

Abuses resulting from a lack of mandatory disclosure requirements were highlighted only a few years later by the Commission. In 1946 the Commission reported to Congress about disclosure practices, concluding that information about securities not listed on a national exchange -- therefore at the time not registered under the Exchange Act and not subject to mandatory periodic disclosure requirements -- was "at best inadequate and sometimes misleading." 10/ As a result, investors in such securities were vulnerable "to a far greater extent" to fraudulent schemes than investors in Exchange Act registered securities. A "preponderance" of the fraud cases investigated by the Commission involved securities not registered under the Exchange Act. In most of these situations the Commission found that mandatory disclosures "would plainly have rendered the fraudulent scheme difficult or impossible of execution." 11/ Although securities not registered under the Exchange Act were subject to the anti-fraud and anti-manipulative provisions of the securities laws, the Commission's experience was that "correction [by fraud prosecution after the fact] is not as effective as prevention." 12/

8/ Id. at 567.

9/ Note, High Finance in the 'Thirties: New Deal Legislation, 37 Colum. L. Rev. 1137, 1170 (1937).

10/ Securities and Exchange Commission, Proposal to Safeguard Investors in Unregistered Securities, H.R. Doc. No. 672, 79th Cong., 2d Sess. VI (1946).

11/ Id. at 5-6.

12/ Id. at VI.

The 1946 Proposal also examined the financial reporting and proxy practices of companies not registered under the 1934 Act. The results were no more encouraging. Financial reporting was erratic, material information concerning executive compensation and related party transactions was not disclosed, and proxy solicitations often failed to disclose even the names of the nominated directors. 13/

Some seventeen years later, the Commission's 1963 Special Study of the Securities Markets described a similar sad state of affairs. A survey of over 500 OTC companies found that "more than 25 percent of the issuers responding did not disseminate any financial information to shareholders at all," 14/ while those that did often failed to explain their accounting methods or provide meaningful explanatory notes. That is hardly a pretty picture of voluntary corporate disclosures.

The Attack on Mandatory Disclosure

Nothwithstanding the 1946 Proposal and The Special Study, mandatory disclosure continued to draw fire. George Stigler, in his seminal article, Public Regulation of the Securities Markets, 15/ compared the risk/return performance of new issues before the 1933 Act with those issued after the Act. He found that the Commission's registration requirements had no important impact on the quality of new securities sold to the public. Although Stigler's article was quickly challenged, 16/ others continued to advance Stigler's cause. By the early 1970's, this had escalated to a full-fledged attack, principally fueled by certain academicians. One charged that mandated disclosure was "close to being a fraud on the American investing public...." 17/ Another, with the aid of complex mathematical formulas, concluded that the disclosure requirements of the 1934 Act had no positive effect on prices of NYSE-traded securities,

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13/ Id. and Seligman, The Historical Need for a Mandatory Corporate Disclosure System, 9 J. Corp. L. 1, 37 (1983).

14/ 3 Report of Special Study of Security Markets of the Securities and Exchange Commission, H. Doc. No. 95, 88th Cong., 1st Sess. 11 (1963), and Seligman, supra, at 40.

15/ Stigler, "Public Regulation of the Securities Markets," 37 J. Bus. 117 (1964).

16/ Friend and Herman, "The SEC Through A Glass Darkly," 37 J. Bus. 382 (1964).

17/ Manne, "Economic Aspects of Required Disclosure under Federal Securities Laws," in Wall Street in Transition 66 (1974).

and that there was "little basis" for any federal legislation and "no evidence that it was needed or desirable." 18/

Briefly summarized, their arguments are:

(1) there is little evidence of fraudulent financial statements prior to the passage of the 1933 Act;

(2) corporations would, left to their own devices, disclose material information voluntarily (and did so prior to the federal disclosure statutes);

(3) in any event, disclosure has not been effective in eliminating fraudulent or misleading financial statements; and

(4) the costs of mandated disclosure greatly outweigh the benefits to investing public.

In short, the Commission's disclosure philosophy was based on a faulty premise, has been irrationally implemented, has failed to achieve its anticipated salutory purpose, and has done little but impose great costs. Unfortunately, the 1977 Advisory Committee, which reached a contrary conclusion, did not end the debate. It continues to swirl around, principally focusing on even more complex economic models, data, and theories.

Bumblebees Are Better Than Theories

That's a bit of a forced march through history, but I think it provides a useful backdrop for our reflections today. For I simply do not propose to enter the heavily economically oriented debate about mandatory disclosure, because the debate -- however interesting it may be -- is of limited utility. After all, for years other theorists -- physicists to be precise -- have told us that it is aerodynamically impossible for a bumblebee to fly, and they can prove it by applying the laws of physics. The bumblebee is too big and too heavy; its wings are too short; and its body is cumbersomely shaped. When you think about it, that's remarkably similar to the way the critics describe mandatory disclosure. But someone forgot to tell the bumblebee that it can't fly. The same, I submit, holds true for mandatory disclosure.

18/ Benston, Required Disclosure and the Stock Market: An Evaluation of the Securities Exchange Act of 1934, 63 Amer. Econ. Rev. 132, 153 (1973).

In short, one bumblebee is worth a thousand theories. Whatever its faults, the current disclosure system works -- because of down-to-earth, practical reasons. Let me suggest a few, drawing from my years of experience in private practice and almost two years as a Commissioner.

First Reason. Mandatory disclosure enjoys the widespread support of corporations, shareholders, financial analysts and intermediaries, and users, although each may support it to a different degree and for different reasons. By most it is perceived as a relatively neutral mechanism for forcing corporate information -- positive and negative -- into the marketplace on a regular basis. That widespread support alone, in my view, confers validity upon the system, because it means that society has embraced and supports it as a norm for conduct.

There is empirical evidence on this point. Former Commissioner Stephen Friedman once advocated that a limited number of actively followed large companies be allowed to opt out of the Commission's mandatory disclosure system. 19/ After all, they are the most sophisticated and widely followed and analyzed companies in the world, so what does our bureaucratic system add? Some dubbed this the "Nifty Fifty" approach, referring to the top 50 of the Fortune 500 companies. The National Association of Manufacturers was intrigued by this suggestion. They contacted several of these companies, offering advice and expressing interest in coordinating such a project in a constructive effort to free companies of bureaucratic burdens without diminishing investor protection. The unanimous response? An interesting idea -- like to see someone else try it -- but no thanks for us -- the current system works.

Second Reason. A mandatory disclosure system promotes consistency and comparability of disclosure. Clearly, not every piece of mandated information is useful to every reader, and some of the information will have been disclosed previously through press releases or meetings with analysts. Yet, disclosure of information prior to its being reflected in a Commission-filed document is due, at least in part, to the realization that at some point the information must be disclosed. Furthermore, our mandatory disclosure system results in regular disclosure in a comprehensive and organized form. That results in disclosure couched in a "common language" designed to be understood by a wide audience.

Third Reason. Much useful data simply will not be disclosed unless mandated. Consider the historical disclosure practices and attitudes of banks. The prevailing attitude has been "play it close to the vest." Banks historically have been secretive about

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19/ Friedman, Deregulation: An Approach and A Proposal, Remarks to the New York Chapter of Financial Executives Institute, New York, New York (March 24, 1981).

problem loans. Recently, news concerning foreign nations' problems in servicing their debt focused publicity on this problem anew. But Commission Staff Accounting Bulletins 49 and 49A, issued in 1983, led to bringing all of the detailed information into the marketplace, over the strong objections of banks.

An even more recent example occurred at yesterday's Commission meeting. The Commission issued for comment rules expanding the disclosure of management's involvement in legal proceedings. 20/ Commodities law violations would be added to the securities, banking, and insurance law violations already required about directors and executive officers. In addition, new registrants would have to disclose the same information about legal proceedings for promoters and control persons -- the people behind the scenes -- currently required for directors and executive officers. The proposal is a result of Senator D'Amato's recent hearings on abuses involving new issues, which found that this information was material but was not being voluntarily disclosed by issuers. Those are only two examples -- there are many others.

Fourth Reason. The mandatory disclosure system is efficient, because it promotes certainty. Uniform requirements make it easier for professionals and officers and directors to understand and use. And surely there is much value to the resulting certainty. Stated differently, a high cost indeed may be associated with uncertainty. Think about the small- or medium-sized company making its initial public offering, or a company which comes to the market rarely, relying upon its traditional attorneys who may not practice securities law extensively. Forms, guides, and express disclosure requirements are tremendously valuable educational tools which can guide all involved toward compliance with the law. After all, does it really make sense from a societal standpoint to say: "There's something called fraud out there. It can destroy you financially and maybe land you in prison. But we're not going to give you any guidance as to compliance, and we reserve the right to sue you after the fact." Faced with such uncertainty, I wonder how many companies would find themselves in costly or destructive litigation. And remember that 10,600 companies now file periodic reports with the Commission. That includes a lot of small, relatively unsophisticated companies who find valuable guidance from a mandatory disclosure system.

Fifth Reason. My next reason deals with the relationship between a mandatory disclosure system and fraud concepts. I acknowledge that mandatory disclosure has not eliminated fraud. 21/

20/ Securities Act Rel. No. 33-6530 (May 2, 1984).

21/ Even William Douglas recognized in 1933 that few of the financial scandals that brought the financial market into disrepute would be prevented by the passage of the 1933 Act. See Douglas & Bates, supra, at 171.

Yet, the Commission's position in litigation and administrative proceedings focusing upon express, mandated disclosures has been instrumental in developing the concepts and parameters of securities fraud. That further promotes certainty for all involved in the process.

Sixth Reason. A mandatory disclosure system has advanced the development of more uniform accounting standards and principles. We lawyers tend to think about mandatory disclosure as principally involving narrative disclosure. But one purpose of the Securities Act was to promote more standardized accounting principles and to eliminate abuses which occurred because of the availability of so many alternative accounting principles. The concept of a mandatory disclosure system, rather than a free-form, choose your alternative approach, has exerted pressure on the accounting profession -- as well as given support along the way -- to develop more uniform accounting principles and practices.

Seventh Reason. Bayless Manning, former dean of the Stanford Law School, has identified an additional benefit that transcends "fraud": mandatory disclosure has brought about an attitudinal change in the way corporate managers perceive their relationship with investors. "[M]ore members of corporate management are today alive to a perception of themselves as fiduciaries...." 22/ That was identified fifty years ago as an aim of the Act: "What we seek is a return to a clearer understanding of the ancient truth that those who manage banks, corporations, and other agencies handling or using other people's money are trustees acting for others." 23/

Eighth Reason. Any discussion about mandatory disclosure cannot ignore that fragile thing called public confidence. Improving public confidence in securities and finance was a primary theme of the legislation. 24/ Most believe mandatory disclosure

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22/ Manning, "Discussion and Comments on Papers by Professor Demsetz and Professor Benston," in Economic Policy and the Regulation of Corporate Securities 85 (H.G. Manne ed. 1969).

23/ Franklin D. Roosevelt, Message From the President of the United States Transmitting A Recommendation to Congress for Federal Supervision of Traffic in Investment Securities in Interstate Commerce, H.R. Doc. No. 12, 73d Cong., 1st Sess. 2 (March 29, 1933).

24/ "[L]et the seller beware," President Roosevelt said in his message to Congress recommending passage of the Securities Act. "It should give impetus to honest dealing in securities and thereby bring back public confidence." Franklin D. Roosevelt, supra, at 1.

has improved public confidence by ensuring that professionals and individual investors will have relatively equal access to important information.

Ninth Reason. Some critics of mandatory disclosure complain that the federal securities laws lack the support of any sound economic rationale. Using today's buzzword, they don't pass a cost/benefit analysis. But the legislators were not oblivious to "costs." After all, the goal was "giving maximum protection to investors with minimum interference to business...." 25/ Nor is it accurate to say that the Commission today ignores cost/benefit considerations. It is most difficult -- as the Advisory Committee said and as virtually every commentator has found -- to assign "costs" of the system -- issuer preparation, legal fees, printing, and accounting. But how much of these costs would be incurred by the company in any event? And how do you assign a measurable benefit to "investor protection" or "prevention of fraud" or "public confidence?" And if there were no guidelines to disclosure -- just general fraud exposure determined after the fact -- what cost would that system involve as issuers, executives, underwriters, and counsel all flailed about with no road map to compliance? I am unconvinced that voluntary disclosure passes a cost/benefit test any better than mandatory disclosure.

Tenth Reason. A related point is that a mandatory disclosure system gives individual officers and directors and their advisers a guide map to protect themselves from personal liability -- potentially ruinous in some cases. Such actors on the corporate stage have a reference source to consult which will carry them far in demonstrating that they have been diligent and reasonable in seeing that appropriate disclosures are made. That allows well-meaning and honest citizens to discharge their legal obligations with some degree of certainty, and that only seems fair and appropriate.

Eleventh Reason. Some critics of mandatory disclosure are beginning to acknowledge that our system may not be so bad after all. Professors Easterbrook and Fischel -- no great supporters of mandatory disclosure in the past -- have recently acknowledged that there may certain benefits from mandatory disclosure: (1) in a voluntary system, some companies won't disclose; (2) exclusive state securities enforcement is problematic; and (3) developing fraud standards by litigation would be necessary -- and inefficient. They refer to these as previously unadvanced arguments in favor of mandatory disclosure and conclude: "We cannot say that the existing securities laws are beneficial, but we also are not confident that

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25/ Douglas & Bates, supra, at 173.

their probable replacements would be better." 26/ I am delighted that Professors Easterbrook and Fischel are on the verge of conversion, although their characterization of those as "previously unadvanced benefits" is, I submit, incorrect. I have heard them advanced for a long time.

Some Concluding Thoughts

Those are my Eleven Pillars of Practicality. Mandatory disclosure not be the perfect regulatory response to every real or perceived problem on every occasion, and the Commission, with input from you, is obligated constantly to evaluate the disclosure system and seek improvement. It simply comes down to a question of common sense -- rules that will lend certainty and promote meaningful disclosure with a minimum of interference. I suggest that mandatory disclosure is here to stay and that -- as Ray Garrett said in 1974 -- the Commission "has been, and will continue, to be devoted to obtaining adequate information for the investor...."

In stating my case, I have referred to various scholarly studies -- The Twentieth Century Fund Study, the Special Study of the Securities Markets, and the Advisory Committee Report. But I want you to know that I have done some independent research on the quantity and quality of pre-1933 voluntary disclosure that heretofore has not been cited in learned treatises -- and perhaps never will be again. My source document is entitled The League of American Wheelman Bulletin and Good Roads, which calls itself the "Official Organ of the League of American Wheelmen." The August 27, 1897 edition of this publication -- paid circulation 93,141 -- carried advertisements for everything a cyclist could need -- laminated wooden rims, cyclometers, throat lozenges to keep the mouth moist while cycling, Electric Creamlac for polishing and renovating bicycles, and, most important of all, bicycle and horse riders abdominal supporters and jock straps designed to -- and I quote -"prevent the discomfort produced by jolting.... Write for catalogue and special circular describing Abdominal Supporters for Lady Riders." But this publication -- as unlikely as it may seem -- was also a journal of high finance and a place to tout and promote investment opportunities.

26/ Easterbrook and Fischel, Mandatory Disclosure and the Protection of Investors 51 (revised February 7, 1984) (to be published as part of a larger project in 1985).

Let's look at one example. 27/ It's set up like the present day "tombstone."

CAPTAIN JACK CRAWFORD
ALASKA PROSPECTING AND
MINING CORPORATION

No. 150 Nassau St.
New York...

Send for Prospectus.

I am responsible for this organization. It will be builded upon an honest foundation. The directors with whom I am associated are gentlemen of intelligence and established character who have held responsible positions. The practical miners who will accompany me will be steady, experienced and reliable men. We take our lives in our hands in this undertaking, and make sacrifices which you will fully appreciate.... If you have confidence in me and believe, as I do, that such a company of men cannot fail to find some of the hidden treasures of Alaska, I shall try in every way to be worthy of that confidence, and, with their aid, to make a showing that will be gratifying to all.

With sincere regards, believe me,

Yours in clouds or sunshine,

J. W. Crawford ("Cap't Jack")

27/ 26 L.A.W Bulletin and Good Roads 288 (August 27, 1897).

Captain Jack wasn't the only one selling clouds and sunshine. Another edition 28/ of the same magazine carries the following promotional:

...ALASKA GOLD...

The Philadelphia-Alaska Commercial and Gold Mining Syndicate
CAPITAL STOCK OF $500,000, PAR VALUE, $10 EACH.
Full paid-with no future liability.

>>>BOOKS NOW OPEN<<<

OBJECTS.- The objects of this Company are: (a). The exploration of gold fields of Alaska, and the Northwest Territory, and the development, operation and otherwise handling or disposing of such valuable discoveries and other properties as may from time to time be acquired by the Company.
(b). To operate in a general trading and transportation business; supplying tools, machinery, provisions and all necessaries for remote mining districts and communities.
(c): To operate in like manner wherever the opportunities for profit may warrant.

$10 Shares to be sold at $2.50 per Share. Do not delay.

Send for prospectus giving officers and directors.

Main Office, 315 Philadelphia Bourse, Philadelphia, Pa.

So much for clouds and sunshine, special discounts and voluntary disclosure. I rest my case for mandatory disclosure. After all, one bumblebee is worth a thousand theories.

Thank you.

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28/ 26 L.A.W. Bulletin and Good Roads 255 (August 20, 1897).