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**News
Release**

**WHEN CORPORATE AMERICA TALKS:
THE DIFFERING USES OF CORPORATE DISCLOSURE**

Remarks to

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Current Financial Issues

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

American corporations are schizophrenic. Anyone who's reviewed detailed financial or business information knows that. Anyone who's compared the bulky, unromantic Form 10-K filed at the SEC with the skillfully marketed annual report to shareholders knows that. Why, even the Securities and Exchange Commission knows that American corporations are schizophrenic. I use this term loosely, of course. Schizophrenia is a psychotic disorder characterized by, among other things, a disintegration of personality. Now I don't mean to suggest that there are psychotic disorders abounding in America's corporate boardrooms -- although some may dispute that point -- but I would posit to you that American corporations do indeed suffer from a disintegration of personality.

A major cause of "personality disintegration" on the part of the American corporation is that most corporations attempt to be all things to all people when communicating with the outside world. Or at least, they attempt to be many different things to many different people. There are distinct audiences who listen when corporate America talks. The major question is: should all these audiences be given the same speech when they really want to hear different things?

This is the question I would like to examine with you today. In this discussion, I will consider three different "audiences" listening when corporate America speaks:

- the corporation's shareholders;
- securities analysts, advisers, rating agencies, and institutions; and
- the Securities and Exchange Commission.

Each of these "audiences" is listening for very different things in the speeches given by corporate America; we should look at various ways to accommodate all of their wants.

You may have noticed that the "market" was missing from this list -- that is, I didn't include potential shareholders, only the current ones. I believe that the "market" would include "listeners" in each of the above categories, for the universe of potential investors in any given security includes the unsophisticated, the professional, the institution, the insider, the defrauder, the hunch-player, and any number of additional characters. If we look at the wants of the three groups which I just specified, we will probably take into account most of the "market" wants as well.

In examining what these three different "audiences" are listening for when corporate America talks, I want to consider four current developments in the area of financial reporting and corporate disclosure:

- ° A further look at a proposal near to the heart of this Institute -- the "Summary Annual Report";
- ° Management's Discussion and Analysis, or "MD&A" segment of current disclosure documents;
- ° Interim Segment Reporting, a proposal released for comment by the Commission in early 1984; and
- ° Proxy and Shareholder Communication initiatives, as set forth in recent proposed and final rules by the Commission in 1985.

Obviously, not all of these areas will be equally important to each audience. But let's begin looking at these audiences, and get a better feel for corporate America's schizophrenia.

When Corporate America Talks...Shareholders Listen

First, let's look at the audience composed of the corporation's current shareholders. Even if the company is a large public company with atomistically dispersed ownership, the view of the individual shareholder is important. The "gloss" in the "glossies," as Annual Reports to Shareholders are nicknamed, is no accident. Obviously, companies treat their annual report as a marketing and image tool as well as a financial and business summary.

In discussing how corporate America relates to its current shareholders, obviously proxies and periodic reports are a paramount issue. A proxy is the one item that separates a current shareholder from the rest of the world.

In July of this year, the Commission released for comment rule revisions resulting from its comprehensive proxy review. 1/ The highlights of this proposal include clearer treatment of management compensation, disclosure about the company's independent accountant, and increased reliance on "incorporation by reference," or reference to other disclosure documents already filed with the Commission. 2/ There were 47 comment letters filed in response to this proposal, including one by the FEI's Committee on Corporate Reporting. Most commentators were concerned, as was the FEI, with the disclosure relating to the company's independent public accountants and their standing in a self-regulatory organization. 3/

1/ Securities Act Release No. 6592, 50 Fed. Reg. 29,409 (1985).

2/ See id. at 29,409-11.

3/ The comment letters are available for public inspection and copying in the Commission's Public Reference Room (see File No. S7-31-85).

However, I do want to note that the FEI noted in its letter that it generally supports the Commission's efforts to simplify and streamline proxy rules. Final action on these rules may be before the Commission in early 1986.

Just last month, the Commission adopted final rules which may change the way that much of corporate America reaches its audience of current shareholders. 4/ The Shareholder Communications rules established procedures for mailing annual reports and proxy statements to shareholders. In adopting these rules, the Commission noted the importance of using an intermediary between the brokers and the issuer so that lists of beneficial owners can be efficiently compiled, 5/ and the Commission also recognized that issuers can save substantial costs in some cases if they are allowed to mail the Annual Report themselves. 6/ The Commission permitted companies to send the Annual Report and the proxy separately, so long as the company makes reasonable efforts to ensure that the Annual Report arrives with or before the proxy.

The Commission's Office of Disclosure Policy also plans to undertake a comprehensive review of proxy contests -- an important area of company-shareholder communications. This review will include consideration of amendments to Schedule 14B, the information filed by proxy contestants.

Of the current issues that I listed at the outset, which are important to current shareholders, I believe that proxies and shareholder communications top the list. However, when we're considering this "audience," I believe that Management's Discussion and Analysis, or "MD&A," is also important.

The Commission has indicated that the main focus of the MD&A should be on the company's operational and financial condition. The MD&A relies primarily on past results, although the Commission encourages innovation in the use of forecasts. The MD&A can be a fertile ground for effective communication with shareholders. The management is freed from the strictures of the financial statements, and permitted to discuss any aspect of the business -- or its financing -- which it believes to be important. 7/

4/ See Securities Exchange Act Release No. 22533, 50 Fed. Reg. 42,672 (1985).

5/ Id. at 42,674-75.

6/ Id. at 42,676.

7/ See Securities Act Release No. 6349, 23 SEC Docket 962 (Sept. 28, 1981), discussing the Commission's early experience with MD&A. The Commission noted in that release that "[i]n order to allow registrants to discuss their business in the manner most appropriate to individual circumstances and to encourage flexibility, the provisions were intentionally general and offered a minimum of specific requirements." Id. at 963.

However, freedom brings responsibility. Management today is finding that the MD&A is a fertile ground for litigation and SEC enforcement as well. 8/ Given the obligation to discuss all relevant aspects of operations, companies may find that it's more important what they choose not to discuss in the MD&A.

Beyond the issue of extended or abbreviated disclosure in the MD&A is the question of whether the Annual Report should be a different type of document altogether. I hesitate at this point, lest I slip into the decades-old battle about who really uses or needs the SEC's bulky, formal disclosure. It's often viewed as an assault on the citadel -- that being the stodgy, recalcitrant SEC -- by corporate America, seeking liberty from current disclosure strictures which require them to overload investors with information. Suffice it to say that even the harshest critics of our full disclosure program believe that the information required to be disclosed is useful to a great extent in promoting an efficient market. 9/

But to whom need all this information be disclosed? A significant effort in this area was sponsored by your organization under the Financial Executives Research Foundation, in its study of Summary Annual Reports in 1983. 10/ This is an extremely informative view of what companies believe their shareholders should be told. In reviewing the results of that research, I was impressed by the amount of detail which remained in these "summary" reports. It is apparent that at least the large corporations in America would feel compelled to include much of the information already required by the Commission.

A partial response to this "information overload" on the average shareholder is the Commission's decision to rely on incorporation by reference in its proxy materials. The theory of incorporation by reference is that information need not be disclosed because it has been provided elsewhere and is either readily available to the shareholder, or it has already been digested by the marketplace and properly impounded into security prices. Thus, according to this theory, shareholders can be spared information which they either already have or do not need. 11/ Indeed, the so-called

8/ See infra notes 18-21, discussing recent Commission enforcement cases based on allegedly inadequate MD&A.

9/ See, for example, the statement of Professor Homer Kripke infra text accompanying note 12.

10/ Deloitte Haskins & Sells, Summary Reporting of Financial Information: Moving Toward More Readable Annual Reports (1983).

11/ See supra Securities Act Release No. 6592, 50 Fed. Reg. at 29,409-10.

"differential disclosure" idea is really part and parcel of the Commission's integrated disclosure program. For example, I mentioned at the outset the distinction between the Annual Report to Shareholders and the Form 10-K filed with the Commission. This represents the judgment of the Commission, made after extensive public comment, on the required elements of the basic information package sent to shareholders.

In sum, I believe that when the company's "audience" is the current shareholder, corporate America is most concerned with its proxy statement and the annual report. They should be distributed efficiently, and should contain all the relevant information, but no more. And corporations should have the opportunity to tailor their speeches to fit their audience, within the bounds of full and fair disclosure.

When Corporate America Talks...Analysts Listen

I'd like to turn now from the shareholders and look at a different type of audience -- the financial analyst, the investment adviser, the institutional investor, and the rating agency. We have a shorthand term for these people -- "sophisticated investors." Whether that term is accurate or not, it suggests that their information needs are very different from the current shareholder. It is for these "sophisticates" that the Commission's full disclosure program is probably most valuable. Even Professor Homer Kripke, a vigorous critic of the Commission's disclosure programs, admitted that full disclosure is necessary. He notes that it is only

because there are a sufficient number of disbelievers who search actively for information and trade thereon that the market is made efficient. Given the strong elements of disbelief and contrary conduct, we cannot basically fault the SEC for continuing along the course of individual security disclosure. 12/

It is this audience that seeks the fullest disclosure from corporate America.

An initiative of major importance to analysts is the Commission's decision in February of 1984 to revisit the issue of interim segment reporting -- a mission it had postponed in 1977. In the release for comment, the Commission noted its belief that interim segment reporting would permit better operational and financial trend analysis. The Commission recognized that there are costs as well as benefits to fuller disclosure, and recommended

12/ Kripke, A Search for a Meaningful Securities Disclosure Policy, 31 Bus. Law. 293, 309 (1975).

limiting the interim segment financial information to "captioned" items in Regulation S-X, and also recommended broadening that list to include accounts and notes payable and the current portion of long-term debt. The Commission also requested comment on whether different interim segment disclosure might be appropriate for smaller companies. 13/

Almost 300 letters were received in response to this release. The FEI, through your Committee on Corporate Reporting, opposed the proposed requirements, with the exception of industry segment revenues and earnings. The FEI's concern is that the Commission's proposal was not cost-justified, noting that interim segment information, most notably geographic segment information, is difficult to produce, especially within the time constraints on interim reporting. As might be expected, most analysts who commented favored the interim segment reporting rules, but all other commentators were generally opposed. As was the case with the FEI, most opponents cited failure to pass a cost-benefit test as the reason for their opposition. 14/

I believe this presents a striking example of the corporate schizophrenia I've been talking about. The analysts, as one audience, would very much like to have more detailed interim segment information, especially if they can get this information at zero cost. The companies, however, don't believe that the wider audience of shareholders and potential investors want this information -- and the company of course has to give the same "speech" to all its "audiences," even if each wants to hear very different things. I believe that this may raise difficult policy questions if the Commission considers final adoption of interim segment rules. Currently, the Commission staff is still evaluating the comments received, and has not yet recommended any action.

Another current issue important to analysts is the development of MD&A disclosure. Indeed, this was one aspect of the interim segment reporting release. 15/ Again, predictably, analysts favored segment discussion in the MD&A. All the other commentators were evenly split, but opposition was based in part on the perceived restriction of the flexibility, which now exists in MD&A, to use an approach which has the most meaning for an individual company.

This provides a partial answer to a basic question in this area: do "sophisticated" investors rely on the MD&A? The above

13/ See Securities Act Release No. 6514, 29 SEC Docket 1319, 1321-23 (Feb. 22, 1984).

14/ The comment letters and a staff summary are available for inspection and copying in the Commission's Public Reference Room (see File No. S7-10-84).

15/ See supra Securities Act Release No. 6514, 29 SEC Docket at 1321; Item 303(b) of Regulation S-K, 17 C.F.R. 229.303(b).

response to our request for comment suggests that they do, or at least they would like to. The elements of MD&A indicate its value to analysts: companies are encouraged to report on external events which may affect the company or its industry; to analyze needs and uses of liquid funds, beyond the traditional statement of working capital; and to give forecasts of significant financial items. 16/ In addition, the Commission is relying on the MD&A as a place for companies to disclose the bad news with the good news, or perhaps even the bad news all by itself. 17/

In sum, I believe that when the "audience" is the industry analyst or other person we would label as "sophisticated," then corporate America is most concerned with the current issues of interim segment reporting and MD&A disclosure. They believe that interim segment reporting may have benefits but probably has greater costs, and that MD&A disclosure, although a valuable field for specialized disclosure, is not without its hazards.

When Corporate America Talks...The SEC Listens

Let me turn now to the third "audience" listening to corporate America -- the Securities and Exchange Commission. I want to emphasize at the outset that there are different "listening posts" at the Commission. There is the audience which reviews the adequacy of corporate disclosure in registration statements under the Securities Act of 1933, in periodic reports under the Securities Exchange Act of 1934, or through enforcement actions to remedy inadequate disclosure. There is also the audience in our rulemaking and interpretive branches that listens when corporate America talks. How does the Commission listen as an "audience" to corporate America on each of these four current issues?

First, turning to the issue of MD&A, the Commission has suggested better ways to use this part of a company's "speech" to shareholders and others. I believe that it is the best place for a company to "complete the story," if that story is told only in part by the company's financial statements. The company should use the MD&A to be candid: to explain a fortuitously good or "flat" performance that would otherwise be much worse, or to disclose practices which may jeopardize future earnings.

The Commission has brought recent enforcement actions based on allegedly inadequate MD&A. Just last month, the Commission brought an injunctive action as part of the package of relief sought against the E. F. Hutton Group. The Commission's complaint

16/ See generally Item 303(a) of Regulation S-K, 17 C.F.R. 229.303(a), setting forth the general requirements for MD&A.

17/ See infra notes 18-21, discussing recent Commission enforcement cases based on allegedly inadequate MD&A.

alleged that Hutton failed to disclose in its MD&A certain bank account overdrafting practices, which were a significant part of material changes in net income in 1981 and 1982, and also failed to disclose the risks and uncertainties associated with those practices. 18/ Earlier this year, the Commission brought an administrative proceeding against the Charter Company, in which the Commission alleged that Charter's annual report disclosure

was deficient in that it failed to contain in its Management Discussion and Analysis ("MD&A") a statement as to the dollar effect resulting from treating [single-premium deferred annuity] rollovers as 'restructured' contracts instead of new issues.

* * *.

* * *. The discussion should have made clear that the significant rollovers into higher rate contracts in 1981 could be expected to reduce substantially the future profitability of [single-premium deferred annuities] sold in 1979 and 1980. 19/

In 1984, Florafax International was enjoined by consent from violations of the reporting provisions of the Exchange Act. The Commission's complaint charged that Florafax "failed to fairly and accurately disclose the different methods used to market products, the magnitude of product returns which it experienced, and the deterioration of its customer relations as a consequence of its product sales practices." 20/ And in 1983, Ronson Corporation was enjoined by consent from violations of the reporting provisions. The Commission's complaint alleged that Ronson failed, in a quarterly report, to mention the loss of its largest customer, which accounted for about one-third of Ronson's sales. 21/ I believe that these actions indicate that the Commission views MD&A disclosure as important. Companies should carefully write their MD&A, keeping the "whole truth" a top disclosure priority.

Second, in the area of proxies and shareholder communications, the Commission has been a good "audience," in that we have listened carefully to the needs of corporate America. The Commission staff has indicated in both recent rulemaking initiatives that

18/ See Litigation Release No. 10915, at 4-5 (Oct. 29, 1985).

19/ See Securities Exchange Act Release No. 21647, 32 SEC Docket 367, 376 (Jan. 10, 1985).

20/ See Litigation Release No. 10617, 31 SEC Docket 1425, 1426 (Nov. 27, 1984).

21/ See Litigation Release No. 10093, 28 SEC Docket 1040 (Aug. 15, 1983).

the rules are intended to assist companies in their disclosure efforts. The proxy rules rely more on integrated disclosure than they did in the past. And the shareholder communications rules, while directed primarily to brokers and other intermediaries, assist companies in their pursuit of efficient shareholder communications.

Third, the issue of interim segment reporting is one which the Commission has wrestled with many times in the past. I recognize that there may be significant costs incurred by companies in producing this information; in addition, the "segment" disclosure could reveal sensitive product line information for smaller companies. However, efficient market operation requires timely information about individual factors of production -- not just reporting by certain groups of productive assets which happen to be collected under the same or related legal entities.

Finally, in the area of summary annual reports and so-called "differential disclosure," I believe that the Commission listened attentively to corporate America in 1981, and produced the system of integrated disclosure, which relies in some instances on already-existing information about a company and market efficiency to substitute for further disclosure by the company. However revolutionary the change to integrated disclosure might be, it is no longer recent, and it may be difficult for the Commission to continue to rely on this as its only response to the "differential disclosure" issue. I understand your Institute and the Financial Executives Research Foundation are continuing research into the needs of users of annual reports, with a view toward eventually proposing minimum guidelines for the summary annual report. 22/ I believe that any further responsible research on the needs of users of financial statements and reports can only be helpful to the Commission's future deliberations in this area.

It is possible that technology may soon make this problem obsolete, as individuals -- whether small shareholder, analyst, or Commission staff member -- will be able to analyze, digest and manipulate public information any way they desire. The Annual Report to Shareholders may, in the future, be valuable only as a marketing or public image tool. For even individual investors, with the help of on-line SEC filings and some portfolio strategy analysis software, will be able to use the most sophisticated data, and reduce it to formats which suit their needs. Obtaining the right information may, in the final analysis, become more a responsibility of the investor than the company.

22/ See The Annual Report Part One: Is it Filling its Role?, FE, Nov. 1985, at 30 [released after these remarks were delivered].

Conclusion

I indicated at the outset that I wanted to review some major issues in the context of three different "audiences" that corporate America speaks to regularly. Now that I've done that, I believe I've reinforced my diagnosis of schizophrenia. In each of these areas different issues were most important -- each "audience" wanted to hear different things. And perhaps the "market" -- that amorphous, anonymous and supremely powerful group of individual actors -- may hear and be listening for still other things.

But fortunately, although I believe the diagnosis of our patient is certain, the prognosis remains excellent. For the schizophrenia of corporate disclosure is not a disease which we need to cure; it is only a condition to which we need to adapt. The variant nature of corporate disclosure requires adroit review, enforcement, and rulemaking by the SEC. In my discussion above, I noted that the Commission has two distinct roles as "audience." In one, we review the disclosures made by corporate America in an effort to ensure their adequacy. And in the other, we review the policy statements made by corporate America in response to our requests for their commentary. In this latter role, the FEI has been extremely helpful. We appreciated hearing from your Institute in response to our requests for comments on many of the issues I have discussed today. I look forward to working with you in an effort to pursue and adapt to the changing needs of investors.