The Disclosure Process in Federal Securities Regulation: A Brief Review

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ON February 23, 1973 the Chairman-Designate of the Securities and Exchange Commission predicted in a speech before the Practicing Law Institute of Washington, D.C. that "the next few years will produce very fundamental changes in the disclosure process . . . . [because] [t]he disclosure process must make more sense." The novice in the field of federal securities regulation might wonder why such a basic goal as a disclosure process that "makes sense" remains a hope rather than an achievement four decades after the enactment of the Securities Act of 1933 and the Securities Exchange Act of 1934, the basic disclosure statutes administered by the Securities and Exchange Commission. Indeed, even securities commentators have expressed the same wonder and have recently questioned the logic of the disclosure process.8

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Critics inside and outside the commission allege that current disclosure policies not only fail to achieve satisfactorily their stated purpose of enabling "investors to evaluate the securities of companies on an informed and realistic basis" but even seem to put barriers in the path of the investor seeking information. This criticism is based on the current disclosure policies excluding highly material information, like projections, from disclosure documents, while requiring that included information be stated in such a negative manner as to be possibly misleading. Criticism is further aroused by the prospectus, the main disclosure document, viewed by many as a composite of meaningless boilerplate, exaggerated disclaimers, and useless visual aids. Financial statements in the prospectus are too complex to be understood by the average investor but not sufficiently comparable to facilitate sophisticated investment analysis. Moreover, the rules defining the occasions on which these disclosures must be made are criticized as almost deliberately vague, with the occasions themselves often seeming to have been selected by the commission without regard for the investor's need for information.

Although this critical commentary on disclosure is widely accepted, it coexists, paradoxically, with a parallel consensus that the commission's disclosure policies have contributed substantially to the

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4. "A basic purpose of the Federal securities laws is to provide disclosure of material financial and other information on companies seeking to raise capital through the public offering of their securities, as well as companies whose securities are already publicly held. This aims at enabling investors to evaluate the securities of these companies on an informed and realistic basis." 38 SEC ANN. REP 23 (1972). As this article will discuss, the goal of an "informed and realistic" evaluation of securities by investors includes not only sophisticated and accurate investment analysis to identify the most desirable investments but also the effective communication to the unsophisticated investor of the risks involved in securities transactions in general and the special risk factors accompanying a particular security.


strength of the American securities markets. This paradoxical view exists in part because of uncertainty about both the specific goals of the disclosure process and their relative priorities. Much of the recent critical commentary on the commission's disclosure policies seems to proceed from the implicit assumption that the primary, or even the sole, purpose of the current disclosure process is to facilitate the kind of investment analysis which will enable sophisticated investors to make the best possible choice among competing investment opportunities. As noted above, some of the commission's current disclosure policies seem inconsistent with that purpose. It is clear, however, that the commission has traditionally been at least equally concerned with using disclosure to protect investors, especially unsophisticated investors, from fraud and from more subtle forms of exploitation.


There was little discussion of the reasons for adopting a disclosure approach to securities regulation when the original legislation was enacted in 1933. Knauss, A Reappraisal of the Role of Disclosure, 62 Mich. L. Rev. 607, 613-15 (1964). Partly as a result, many securities lawyers concurred with A.A. Sommer, Jr., when he stated in reference to the securities laws: "I think all of us have had a long lurking conviction that we are dealing with concepts, ideas, and propositions that perhaps were lacking sufficient theoretical underpinnings." Sommer, Discussion and Comments on Papers by Professor Demsetz and Professor Benston, in Economic Policy and the Regulation of Corporate Securities 88 (H. Manne ed. 1969).

10. See Myths, supra note 3, at 1165-69; Prospectuses, supra note 3, at 224-27.

Although the theoretical assumptions underlying the use of disclosure as a regulatory device may not have been adequately explored, the dual function of disclosure—promoting accurate investment analysis and protecting unsophisticated investors from unfair treatment—has always been implicitly recognized. On the one hand, disclosure makes available the information needed for accurate investment analysis, thus promoting efficient securities markets which in turn result in better allocation of the nation’s capital resources. Conversely, as a protective device, disclosure prevents the kind of defrauding and exploitation of inexperienced investors which depends for its success on nondisclosure, or inadequate or misleading disclosure, by securities dealers or corporate insiders. Furthermore, disclosure indirectly encourages those in the securities industry and the corporate world to adhere to higher standards of conduct.

Any attempt to identify particular disclosure requirements as solely “informational” or solely “protective” in their impact must necessarily be fruitless, since most disclosure required by the commission promotes, to a greater or lesser degree, all the purposes mentioned above. The emphasis which the current spate of criticism places on the informational purpose of disclosure, however, suggests that a review is warranted of the role which protective disclosure has played in


12. See Report of the Special Study of Securities Markets of the Securities and Exchange Commission, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 3, at 1 (1963); Knauss, supra note 9, at 43-44. Because most disclosure furthers both purposes, the commission rarely distinguishes between the two purposes but simply refers to disclosure as promoting “informed and realistic” decisions by investors. E.g., 38 SEC Ann. Rep. 23 (1972). In its early years, the commission was more apt to emphasize the antifraud aspects of disclosure requirements, describing them as intended “to place adequate and true information before the investor and to prevent the sale of securities through misrepresentation—perhaps the only way in which fraudulent securities can be sold to the public.” 1 SEC Ann. Rep. 27 (1935).


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the development of the disclosure process. Thus, this article describes the origins of the commission's concern with protective disclosure and suggests that the commission's initial emphasis on use of disclosure in a protective fashion, with generally approved results, is at least partly responsible for those aspects of the current disclosure process which, measured against the goal of providing useful investment information, are now seen as illogical or even counterproductive.

The article concludes that the commission's recent attempts to develop a disclosure process primarily aimed at providing useful investment information reflects a shift in the commission's attitude toward the proper role of disclosure. It must always be kept in mind, however, that increasing the informational value of disclosure is not simply a matter of stamping out illogical disclosure requirements, but rather, of resolving conflicts between policies intended to protect the unwary investor, on the one hand, and policies designated to increase information available to sophisticated investors on the other.

The Origins and Functions of the Disclosure Process

The basic disclosure program of the commission is usually considered to be based on the Securities Act of 1933 and the disclosure provisions of the Securities Exchange Act of 1934.16 These statutes

16. Cf. WHEAT REPORT, supra note 7, at 3; Truth in Securities, supra note 3, at 1341-42. The commission has recently been attempting to create a single, coherent disclosure system by coordinating or "integrating" the provisions of the two statutes. Address by SEC Chairman Cook, American Society of Corporate Secretaries, April 19, 1973, in CCH FED. SEC. L. REP. ¶ 79,341, at 83,025. In addition, the American Law Institute is currently engaged in a project to codify all the federal securities laws, combining the disclosure requirements of the 1933 and 1934 Acts into a single disclosure process. See ALI FED. SEC. CODE (Tent. Draft No. 1, 1972; Tent. Draft No. 2, 1973); Loss & Blackstone, Codification of the Federal Securities Laws, 28 BUS. LAW. 381 (1973).


"Then too, there is the recurrent theme throughout these statutes of disclosure, again disclosure, and still more disclosure. Substantive regulation has its limits. But 'the truth shall make you free.'" 1 L. LOSS, SECURITIES REGULATION 21 (2d ed. 1961) [hereinafter cited as L. Loss].
were enacted primarily to prevent the recurrence of those abuses in the securities markets which were regarded as partially responsible for the October 1929 stock market crash and the subsequent depression.\textsuperscript{17} Thus, the overriding concern of Congress in passing the legislation was to provide protection for small investors, many of whom had lost their savings by investing in the securities markets in the late twenties and early thirties.\textsuperscript{18}

The Historical Background

In the general prosperity of the late 1920s the relatively unsophisticated small scale investors entered the stock market in substantial numbers for the first time.\textsuperscript{19} Their participation in the market was encouraged by the securities industry through newly developed distribution techniques, aggressive advertising and promotional campaigns, increasing numbers of securities salesmen using high pressure sales tactics, and public promotion of the practice of buying securities on margin.\textsuperscript{20} The resulting increase in demand for securities, along with the general economic conditions, meant rising stock prices, which in turn meant further increasing numbers of investors. This increase succeeded in driving stock prices up even higher and supported public expectations that "the price of securities would indefinitely advance."\textsuperscript{21} The price of securities did not "indefinitely advance," of course, and the October 1929 stock market crash followed by deep market declines resulted in enormous real and paper losses to individual investors.\textsuperscript{22}

Widely publicized hearings conducted by the Senate from 1932 to 1934 provided evidence of unethical and fraudulent conduct on the part of many investment bankers and corporate promoters during the


\textsuperscript{21} Investment Banking, supra note 19, at 253 (quoting Secretary of the Treasury Mellon); see id. at 240.

\textsuperscript{22} H.R. Rep. No. 85, supra note 14, at 2-3; Investment Banking, supra note 19, at 306.
late twenties and early thirties, including outright manipulation of stock prices, the taking of excessive promotional profits, and multiple conflicts of interest and self-dealing.\textsuperscript{23} Underwriters, faced with the insatiable public demand for securities, had abandoned traditional standards of banking judgment and ethics. They urged corporations to undertake new issues even when they needed no additional capital and knowingly sold highly speculative or fraudulent securities to unsophisticated investors.\textsuperscript{24} Such behavior by members of the investment community was regarded as "unscrupulous exploitation of public gullibility and avarice."\textsuperscript{25}

The specific instances of fraud and unethical behavior were seen by many reformers and commentators as merely one aspect of a broader problem affecting both the financial community and the corporate world.\textsuperscript{26} Writers like Louis D. Brandeis and Adolf A. Berle had publicized the view that neither the members of the financial community nor those who managed large public corporations were subject to effective controls in the interest of the investing public.\textsuperscript{27} This lack of control left the investing public with no remedy for resulting losses when such individuals, theoretically trustees with respect to the investors whose money they controlled, failed to abide by fiduciary standards, as they frequently did.\textsuperscript{28} Furthermore, since the major part of the securities business was interstate and not subject to state control,
state regulation of securities transactions provided little protection.\textsuperscript{29} Moreover, the more important members of the securities industry had gained exemption from state regulation early in the 1920's by persuading state legislatures of the virtues of self-regulation.\textsuperscript{30} By the early thirties, however, it was clear that self-regulation in the securities field was ineffectual.\textsuperscript{31}

Reform of the securities markets became a significant political issue in the 1932 presidential campaign primarily because of the specific abuses associated with the stock market boom and crash of the twenties, but also because of uncontrolled financial and corporate power and the failure of both state regulation and industry self-regulation. Franklin Roosevelt had long been an advocate of corporate and securities reform, and the 1932 Democratic party platform contained a specific plank calling for compulsory disclosure in connection with securities issues and for regulation of the securities exchanges.\textsuperscript{32}

The demand for reform was concerned with the need for creating some means of public control over the conduct of financial and corporate leaders, both to prevent the recurrence of recent abuses in the securities markets, and more generally to insure that such persons observed the proper fiduciary standards in managing the invested funds of individual investors. It might be supposed that these goals could have been met most effectively by establishing a federal system of substantive regulations, perhaps an expanded version of the direct regulation practiced by state securities commissions which simply prohibited fraudulent or highly speculative offerings. The legislation actually passed, however, was less substantive; the Securities Act of 1933 imposed only disclosure and antifraud requirements, and the Securities Exchange Act of 1934, although directly prohibiting some manipulative activities, primarily relied on disclosure and industry self-regulation to control the conduct of those in the investment community.

The choice of disclosure as the primary means of policing the securities industry reflected the influence which the views of Louis D. Brandeis had had on President Roosevelt and on individuals involved in drafting the securities legislation.\textsuperscript{33} As mentioned earlier, Brandeis

\textsuperscript{29} See 1 L. Loss, \textit{supra} note 16, at 105-06; M. Parrish, \textit{supra} note 24, at 28-29 (1970).
\textsuperscript{30} M. Parrish, \textit{supra} note 24, at 23-24, 31.
\textsuperscript{31} \textit{Id.} at 38-40.
\textsuperscript{32} See R. de Bedts, \textit{supra} note 23, at 30-33; \textit{Investment Banking, supra} note 19, at 353. The language of the Democratic party platform is quoted in R. de Bedts, \textit{supra} note 23, at 25.
\textsuperscript{33} See R. de Bedts, \textit{supra} note 23, at 34, 199; W Leuchtenburg, \textit{Franklin
had been a leading critic of those controlling the major financial institutions because of their failure to abide by fiduciary standards required of those who manage other people's money. Brandeis had argued persuasively that publicity was the most effective means of enforcing such standards and of markedly curtailing self-dealing and conflicts of interest. Disclosure was a desirable regulatory device because it not only inhibited illegal activity but also tended to discourage conduct which, although technically legal, was not entirely consistent with the highest fiduciary standards of behavior. Moreover, disclosure could achieve such effects with a minimum of government intervention, reflecting the dislike of Brandeis and his followers for extensive governmental reform programs.

The disclosure concept suited both the general philosophy and the immediate political needs of the Roosevelt administration. Roosevelt and his advisers, believing that the nation's economic recovery depended on a revival of confidence in, and within, the private sector, saw the immediate goal of financial reform as the restoration of the public's confidence in the securities markets. Presumably this could be done only if the public believed that the abuses which characterized the securities markets of the twenties would not recur. On the other hand, if business were to revive, the administration did not want to destroy the confidence of the business community by excessive governmental intervention in the "delicate mechanism" of the stock market.

A disclosure approach to securities regulation responded to both of these needs. Disclosure would enable public investors to protect
themselves against the more blatant forms of exploitation. According to the Brandeis theory, disclosure would also protect investors by indirectly deterring fraud and unethical behavior. At the same time, the financial community generally considered a disclosure statute acceptable. Investment bankers had an affirmative interest in obtaining information about their corporate clients, while the major corporations were already used to revealing some information as a prerequisite to having their securities listed on the stock exchanges. Moreover, it was difficult to oppose disclosure without appearing to advocate fraud. Finally, mild regulation in the form of disclosure had some appeal to the financial community as a whole because it would tend to eliminate the marginal members of the investment community who created "unfair" competition for established firms. Thus a law requiring disclosure and little more would aid in protecting the public and restoring its confidence and yet would not adversely affect the morale of the business community.

The Disclosure Statutes

It was apparent from the outset that the 1933 and 1934 Acts were not ideally suited to protect the small investor against the kinds of abuses about which Congress expressed concern. Contemporary commentators argued that although the required disclosures would obviously deter some fraud on unsophisticated investors, their primary use would be to enable investment professionals to evaluate securities more accurately. The small investor, then, would receive only

40. H.R. REP No. 85, supra note 14, at 3, INVESTMENT BANKING, supra note 19, at 357; M. PARRISH, supra note 24, at 47
43. See H.R. REP No. 85, supra note 14, at 3.
44. See S. REP No. 47, supra note 11, at 1; R. DE BEDTS, supra note 23, at 49.
46. The Congressional reports relating to the 1933 Act contained no explicit discussion of promoting accurate investment analysis, see H.R. REP No. 85, supra note 14; S. REP No. 47, supra note 11, but the legislative history of the 1934 Act does seem to refer to efficient markets as well as honest markets as one goal of disclosure laws. See H.R. REP No. 1383, supra note 14. Moreover, although the disclosure
the indirect benefit of having market price of securities more reliably reflect their true intrinsic value. From the beginning, therefore, the statutory disclosure process contained an inherent conflict: on the one hand, Congress expected disclosure to be effective in protecting unwary investors while on the other hand it had created a statutory scheme more suited as a whole to making useful investment information generally available than to protecting unsophisticated investors from fraud and unscrupulous behavior.

Although some of the weaknesses of the protective function were inherent in the choice of disclosure instead of direct substantive regulation, there were particular provisions of the 1933 and 1934 Acts, expected by Congress to serve a protective function, which in several instances were not well designed for that purpose. This section reviews the provisions of the 1933 and 1934 Acts which illustrate this dual role, examines the weakness of the protective provisions, and suggests that many of the commission's rules now seen as illogical were in fact a rational attempt to increase the protection of the unwary investor in spite of the limitations of the statutory scheme.

The Securities Act of 1933

The Securities Act of 1933 established disclosure requirements for the issuance of new securities. Under the statute, no new security could be offered or sold in interstate commerce, unless a specific exemption was available, until a registration statement covering the security had been filed with the commission and had become effective.

47. Douglas & Bates, supra note 45, at 172.
49. Securities Act of 1933, §§ 3-5, ch. 38, §§ 3-5, 48 Stat. 75-77 (1933), as amended 15 U.S.C. §§ 77c-77e (1970); H.R. REP. No. 85, supra note 14, at 6-7. Some exemptions from the registration and prospectus delivery requirements were based on the nature of the security being sold and other exemptions applied to all securities sold in particular types of transactions. Securities Act of 1933, §§ 3, 4, ch. 38, §§ 3, 4, 48 Stat. 75-77 (1933), as amended 15 U.S.C. § 77c, 77d (1970). Registration was required if outstanding securities were sold by the issuer, an underwriter with respect to the issuer, or a "control person" of the issuer. Securities Act of 1933, §§ 4(1), 5, ch. 38, §§ 4(1), 5, 48 Stat. 77 (1933), as amended 15 U.S.C. §§ 77d(i), 77e (1970). The legislative history noted that the exemptions served to limit the bill to transactions
The commission in principle had no authority to pass on the quality of the registered securities.\textsuperscript{50} Thus, although a waiting period of twenty days between the filing date and the effective date was provided to give the commission time to determine whether the registration statement complied with the appropriate disclosure requirements, the statement became effective automatically at the end of the twenty day period if disclosure was adequate, regardless of the apparent quality of the security.\textsuperscript{51} The commission could issue a stop order and prevent the statement from becoming effective only if disclosure was inadequate or misleading.\textsuperscript{52}

Once the registration statement became effective, the securities could be sold, but a prospectus containing the information in the registration statement had to be delivered to all the purchasers.\textsuperscript{53} The statute listed the specific information required to be included in both the registration statement and the prospectus, but gave the commission broad discretion to vary such requirements.\textsuperscript{54} In addition to establishing a disclosure procedure for new issues, the Securities Act directly prohibited certain actions in connection with the sales of securities and established private remedies for those who had purchased securities which were sold without proper disclosure or by the use of misleading statements.\textsuperscript{55}

\textsuperscript{50} Where there was “need of public protection to prevent recurrences of demonstrated abuses.” H.R. REP No. 85, \textit{supra} note 14, at 7


\textsuperscript{52} Id.

\textsuperscript{53} Securities Act of 1933, §§ 5(b)(2), 10, ch. 38, §§ 5(b)(2), 10, 48 Stat. 77, 81 (1933), as amended 15 U.S.C. §§ 77e(b)(2), 77j; (1970). The prospectus delivery requirement did not apply to sales by persons other than issuers, underwriters, or dealers, to unsolicited sales by brokers, or sales by dealers after the period of the initial offering. Securities Act of 1933, § 4, ch. 38, § 4, 48 Stat. 77 (1933), as amended 15 U.S.C. § 77d (1970). Because the act applied only to transactions in interstate commerce, the prospectus delivery requirements did not apply if securities were sold and delivered without use of the mails of interstate commerce. Until the early 1940s, the prospectus consisted of the repetition in narrative form of the information already set forth in the registration statement, although condensation was allowed. Since the early 1940s, the prospectus has constituted part of the registration statement itself, the remainder of the registration statement consisting of information not required to be distributed to investors, such as exhibits. \textit{Wheat Report, supra} note 7, at 70-71.


\textsuperscript{55} Section 17 prohibited any sale of securities by means of misrepresentation or other fraudulent devices and also prohibited the publication of any article or “tip-
As previously suggested, the set of rules just reviewed was intended to serve two broad purposes. The statute was intended on the one hand to promote efficient allocation of capital resources through well-informed securities markets, and, on the other hand, to prevent those forms of fraud dependent on secrecy of misinformation and to discourage activities by securities sellers, underwriters, and corporate insiders which are inconsistent with "high standards of trusteeship." 56

The manner in which the 1933 Act advanced the first goal, an increase in useful investment information, was self-evident. Schedule A of the statute required that the registration statement filed with the commission and the prospectus given to the purchaser must describe the business of the issuer, the nature of the securities being sold, and the identity and relevant financial interests of those distributing the securities and managing the issuer. 57 The draftsmen expected that, during the waiting period, the information in the registration statements would be disseminated to the public by investment services and advisers. 58 Thus, although it was frequently pointed out that the average investor was incapable of making an informed investment judgment on the basis of the complicated disclosures in the prospectus, it was expected that the statutory purpose of facilitating accurate investment analysis would be fully achieved if professional advisers utilized the registration statements and prospectuses to evaluate the securities for investors. 59

The effect of the 1933 Act was less direct in achieving the second goal of protecting investors from fraud and improving business standards. Nevertheless, given the present assumption that the purpose of disclosure is largely to provide information, it bears emphasizing that the 1933 Act was clearly intended to protect as well as to inform. The...
legislative history indicates that four particular requirements—the filing of the registration statement, the waiting period, the prospectus delivery requirement, and the provision imposing civil liability on the issuer and its officers, directors and underwriters—were all intended to have a significant impact.

The registration statement was generally believed to be an effective deterrent to the most blatantly fraudulent schemes, presumably because the promoters either would realize that their plan could not succeed without secrecy or would be reluctant to disclose the nature of their activities to public officials. In addition, it was intended to discourage both illegal and unethical actions by corporate management and promoters. In order to achieve this latter effect, the statute required extensive disclosures about all forms of underwriters’ compensation and about any dealings between the corporation and its officers, directors or major shareholders. Such disclosures, required chiefly to discourage improper conduct in those areas, had little relevance for investment analysis purposes.

The waiting period was intended to discourage high-pressure salesmanship by preventing sales of the securities until information in the registration statement could be disseminated. Thus, retail securities distributors would not be forced to make commitments blindly and then to unload the securities on the public by any means in order to get rid of them.

The prospectus contained basically the same information as the registration statement, but was expected to serve additional protective functions. In particular, the prospectus delivery requirement was intended to limit the selling arguments used by securities salesmen. First, the prospectus delivery requirement directly limited inaccurate or

60. See H.R. Rep. No. 85, supra note 14, at 7; Douglas & Bates, supra note 45, at 172. It was expected that state securities commissions would examine the registration statement filed with the commission presumably in order to detect violations of state securities laws. See H.R. Rep. No. 85, supra at 5-6.
61. Frankfurter, supra note 35, at 106; James, supra note 19, at 646.
62. Of the twenty-seven required items of information in Schedule A, eight involved such matters. Items 7, 10, 14, 16, 17, 20, 21, 22, 24, Securities Act of 1933, Schedule A, 48 Stat. 88 (1933); see Douglas & Bates, supra note 45, at 188 (commenting on stress on such items).
63. See Frankfurter, supra note 35, at 55.
64. See Myths, supra note 3, at 1171 & n.90; Soft Information, supra note 3, at 264 n.36.
66. Id. at 8.
67. Id.
overly optimistic selling arguments which involved written material. No written material advertising or offering for sale any new security could be used unless it was a prospectus which complied with the statutory requirements or was accompanied by such a prospectus.

Second, it was expected that oral arguments would be affected by the knowledge that the potential buyer had access to the thorough and reliable information in the prospectus. Finally, by making the buyer aware that securities were “intricate merchandise,” the prospectus apparently was intended to make investors more wary of buying securities on the basis of a few glib promises.

Although the prospectus was seemingly intended to have a quite significant protective impact, its effect in practice was undermined by the statutory provision that the prospectus need not be delivered to the buyer until the purchased securities were delivered to him. As a practical matter, then, an investor could be persuaded to buy securities on the basis of misleading oral statements and would not receive his prospectus until delivery of those securities. Although at the time of delivery the buyer could of course refuse to complete the purchase once he had seen the prospectus, the prospectus disclosures would obviously have been much more effective had they reached the investor before the initial decision, and the resultant psychological commitment to buy, had been made. Moreover, as noted earlier, the prospectus was so elaborate that many investors were unable to detect even blatant fraud solely by reading it. Thus, although the prospectus provisions may have curtailed misleading promotional literature, they were not well suited to deter sales based on misleading oral statements.

The fourth protective element of the 1933 Act was section 11.
Its civil liability provisions were intended to bring "into the general field of security selling, ethical standards of honesty and fair dealing common to every fiduciary undertaking." To this end, section 11 imposed what was regarded at the time as staggering civil liability on the issuer, its officers and directors, the underwriters and any other experts involved, for misleading or inadequate disclosure in the registration statement. Any such person could protect himself from liability by showing that after a reasonable investigation he had a reasonable belief in the statement's accuracy, with reasonableness being determined by the standards applicable to one in a fiduciary position.

Although the only obligation imposed directly by the provisions was that of making full disclosure, it is clear that Congress expected the provision to produce not only full disclosure but "honesty, care, and competence" on the part of those subject to the liability. The "reasonable investigation" obligation of section 11 was expected to encourage the honest but negligent director to become more deeply involved in corporate affairs, with presumably beneficial effects on the corporation and the investors. Moreover, to the extent that corporate abuses resulted from self-dealing or fraud, the obligation to disclose such activities or face personal liability under section 11 would

76. Securities Act of 1933, § 11(c), ch. 38, § 11(c), 48 Stat. 83 (1933). The statute was amended in 1934 to provide that the standard of reasonableness should be that of "a prudent man in the management of his own property," 15 U.S.C. § 77k(c) (1970), but the change was not regarded as very significant. See 3 L. Loss, supra note 16, at 1726; Dooley, The Effects of Civil Liability on Investment Banking and the New Issues Market, 58 Va. L. Rev. 776, 806 n.141 (1972).
77. In discussing the civil liability provisions, the House report stated: "Their essential characteristic consists of a requirement that all those responsible for statements upon the face of which the public is solicited to invest its money shall be held to standards like those imposed by law upon a fiduciary. Honesty, care, and competence are the demands of trusteeship. If it be said that the imposition of such responsibilities upon these persons will be to alter corporate organization and corporate practice in this country, such a result is only what your committee expects. Directors should assume the responsibility of directing and if their manifold activities make real directing impossible, they should be held responsible to the unsuspecting public for their neglect. Instead of impeding honest business, the imposition of liabilities of this character carries over into the general field of security selling, ethical standards of honesty and fair dealing common to every fiduciary undertaking." H.R. Rep. No. 85, supra note 14, at 5; see SEC Securities Act Release No. 5275, at 6-7 (July 26, 1972).
78. See Frankfurter, supra note 35, at 111.
presumably encourage underwriters or corporate insiders to avoid such activities.\textsuperscript{79} If the activities were illegal under state law, disclosure could result in state enforcement action or private suits. If the activities were not technically illegal, but simply dubious or unethical, many would forego such activity rather than publicly disclose it.

Section 11 represents the most direct attempt to protect unwary investors by imposing "high standards of trusteeship" on those responsible for the investment of "other people's money." Nevertheless, section 11 imposed liability only for failure to file an accurate registration statement, meaning that a reasonable investigation followed by accurate disclosure of fraud, self-dealing or other behavior would be entirely consistent with the statutory terms. Again, it was hoped that the obligation to disclose would indirectly result in responsible underwriting behavior and ethical corporate management.

\textit{The Securities Exchange Act of 1934}

The disclosure provisions of the Securities Exchange Act of 1934, also reflected congressional intent to use disclosure for protective as well as informational purposes. Basically, the 1934 Act sought to extend to existing securities many of the rules the 1933 Act introduced for new securities. Thus, the statute required issuers of securities listed on stock exchanges to register such securities with the commission and to file periodic reports designed to keep current the information in the initial registration statement.\textsuperscript{80} In addition, corporate insiders were required to report any securities holdings in their corporation and any changes in such holdings.\textsuperscript{81} Finally, the statute authorized the commission to promulgate regulations governing the solicitation of proxies from shareholders. In accordance with suggestions in the legislative

\textsuperscript{79} See id. at 55.
\textsuperscript{80} Securities Exchange Act of 1934, §§ 12, 13, ch. 404, §§ 12, 13, 48 Stat. 892-95 (1934), as amended 15 U.S.C. §§ 78l, 78m (1970). In 1936, the act was amended by the addition of § 15(d), which required issuers of unlisted securities who had filed a registration statement under the 1933 Act with respect to an offering of a certain aggregate amount to comply with the periodic reporting requirements of section 13 so long as they had outstanding securities worth a certain amount. Act of May 27, 1936, ch. 462, § 3, 49 Stat. 1377, as amended 15 U.S.C. § 780(d) (1970).
history, the commission almost immediately imposed disclosure requirements as the means of regulating such solicitation. 82

The registration and periodic reporting requirements were intended both to provide useful investment information and to protect against stock market manipulations which were believed to depend on secrecy for their success. 83 It was presumed that if reliable information about an issuer were available, investors could determine more readily when stock prices reflected manipulative activity rather than the intrinsic value of the security, and thus could protect themselves from fraud. This protective function was somewhat lessened because periodic reports were filed only with the commission and were not made directly available to investors. 84 Investors did not, therefore, have access to the detailed and conservatively stated disclosures required by the commission—disclosures designed to reveal price manipulation or unfair aspects of the securities. 85 The lack of a delivery requirement did not undercut the informational purpose of the reports as much, however, since investment services and advisers had a financial interest in conveying the basic data about securities to investors. Moreover, from an investment analysis point of view, investors would benefit by trading in a market which reflected the general availability of reliable information whether or not they learned of such information individually. 86

84. Tracy & MacChesney, supra note 27, at 1057-58.
85. The commission required disclosure documents to be not only detailed and accurate but also to present information conservatively or even pessimistically. Much of the protective impact of such disclosures resulted from exposing investors directly to a pessimistic rather than optimistic picture of the issuer's prospects. This impact depended on delivery of the required disclosure document to the investor, since pessimistic aspects were apt to be filtered out when the information was conveyed to the investor by those interested in selling him the security. See text accompanying notes 126-136 infra.
86. Tracy & MacChesney, supra note 27, at 1058.
The insider reporting requirements and the proxy solicitation provisions both employed disclosure for protective purposes. The insider reporting requirements reflected a primarily regulatory use of disclosure, since the disclosure was intended to deter improper use of corporation information by insiders. Though the statute provided a specific sanction for certain insider trading, the disclosure requirement was expected to deter insider trading not reached by that sanction. The proxy provisions simply authorized the commission to regulate proxy solicitation in any appropriate manner. The provisions were explicitly protective in purpose; the legislative history shows that the problem caused by the separation of ownership and control in large corporations was noted and that the proxy provisions were described as designed to prevent corporate insiders from using proxies to take "selfish advantage" of shareholders. The commission's choice of disclosure to implement its authority underlines the contemporary view of disclosure as effective to protect investors from exploitations.

The Dual Function of the Disclosure Process

The foregoing survey of the background and legislative history of the Securities Act of 1933 and the Securities Exchange Act of 1934 suggests the nature of the two basic purposes—informational and protective—which disclosure requirements were expected to serve as part of a scheme of federal securities regulation. Both the 1933 and 1934 Acts were well-designed to provide disclosure for informational purposes. Detailed information useful for investment analysis was made available through the commission; and presumably its utilization by sophisticated investors and investment professionals would lead to efficient securities markets. Such disclosure would indirectly benefit the small investor in his investment decisions by affording him better in-

88. "It is hoped, however, that the publicity features of the bill will tend to bring these practices [improper use of inside information] into disrepute and encourage the voluntary maintenance of proper fiduciary standards by those in control of large corporate enterprises whose securities are registered on the public exchanges." H.R. Rep. No. 1383, supra note 14, at 13.
vestment advice and by making market prices more accurate indicators of security values. It was recognized, however, that the average investor could make little direct use of the detailed disclosures required and that the informational benefits of disclosure depended upon effective use of the information by those able to understand it. Therefore, the informational effect of disclosure was not dependent upon physical delivery of the disclosures to individual investors. For this reason, the defects in the prospectus delivery rules and the absence of any disclosure delivery requirements in the 1934 Act did not prevent the statutory disclosure scheme from effectively achieving its informational purpose.

The statutory scheme was somewhat less effective in achieving the protective purposes intended by Congress. A glance at several aspects of the statutes' investor protection goal shows that the statutes operated only indirectly to achieve this purpose. First, it was hoped that the mere existence of the disclosure requirements would improve general ethical standards in the corporate and financial communities. The effect thus depended on the voluntary abandonment of unethical practices by those subject to disclosure requirements, which, as has been seen, included conflict of interest disclosure requirements, insider trading sanctions, and section 11 civil liability. Second, it was believed that disclosure would deter those fraudulent practices dependent for their success on secrecy or misinformation both in the new issue market and in the trading markets. Finally, the 1933 Act's waiting period and prospectus delivery requirements were designed to present the investor accurate and detailed information about securities and in this way to curtail misleading promotional literature and to counteract misleading or glib sales arguments.

Disclosure is a rather indirect way of achieving the protective purposes listed above. A comparison between the specific disclosure provisions of the 1933 and 1934 Acts and the discussion of them in the legislative history suggests that from the outset there was some inconsistency between the statutory scheme itself, which functioned most effectively to provide informational disclosure, and the articulated expectations about the impact of disclosure, which emphasized its protec-


tive purposes. The choice of a disclosure scheme rather than direct regulation was in part motivated by political considerations, and was not an entirely effective remedy for the abuses which Congress wished to eliminate.

As a result, in its early years, the commission continued to be faced with distasteful practices, although such practices were now disclosed. In response, the commission used its discretionary powers to develop a disclosure process which provided more protection to investors than the bare statutory scheme seemed to permit. While some of the resulting distortions in the process can now be criticized, the legislative history of the disclosure laws indicates that the commission had a mandate to use its statutory authority to the greatest extent possible to protect unwary investors from fraud and exploitation.

**Administrative Development of the Disclosure Process**

When the commission first began its work in 1934, it was charged with administering a disclosure scheme best suited to eliciting information useful for investment analysis purposes by sophisticated investors even though Congress had clearly intended that this scheme be used to improve business standards and protect unwary investors against fraud or exploitation. This section reviews the commission's efforts to increase the protection afforded investors by, for example, emphasizing the 1933 Act which required direct disclosure rather than the 1934 Act which did not, and by imposing substantive requirements on issues subject to the registration by use of its enormous discretionary power over the manner in which information was disclosed.

In some instances, the commission's concern with protecting investors resulted in disclosure policies which undercut the disclosure's informational effect by emphasizing information of little interest to investment analysts, by requiring disclosures so pessimistic as to be

95. The commission has relied on disclosure because, although it has substantial direct regulatory powers over the securities industry under the 1934 Act, until recently it has been reluctant to exercise such powers.

"This hesitancy was due in part to the political power of the industry organizations, which in turn rested heavily on the traditionally American belief that businessmen know more about how business should be run than government officials do, and in part to the Commission's actual incapacity to conduct the sort of extensive inquiry that would enable it to establish the case for changes in the way the game is played." Ratner, *The SEC: Portrait of the Agency as a Thirty-Seven Year Old*, 45 St. John's L. Rev. 583, 591 (1971); see Subcommittee on Securities, Senate Committee on Banking, Housing & Urban Affairs, 93d Cong., 1st Sess., Securities Industry Study 180 (Comm. Print 1973).
misleading, and by imposing burdensome restrictions which had no function in terms of the disclosure's informational purpose. To some extent these protective aspects of disclosure are responsible for the criticism currently leveled at the disclosure process as illogical or nonfunctional.

The Framework of Protective Disclosure

The commission has traditionally emphasized disclosure requirements imposed by the 1933 Act, treating 1934 Act disclosures as somewhat less important. The emphasis reflects the fact that, because of the special compensation paid to those selling newly issued securities, initial distributions of securities are regarded as much more likely than trading transactions to involve the fraud or improper selling activities which necessitate protective disclosure. Moreover, disclosures under the 1933 Act have a greater protective impact than reports under the 1934 Act because they are actually delivered to investors. As a result, disclosures in 1933 Act prospectuses can serve to counteract misleading sales promises, to warn the investor of risk factors, and generally to emphasize the negative rather than the positive aspects of the security. Emphasis on 1933 Act disclosures thus meant emphasis on those disclosures most needed and best suited to protecting investors.

The commission's protective concern is further illustrated by its administration of the proxy disclosure requirements of the 1934 Act. Before 1964, only issuers with securities listed on a stock exchange were subject to the reporting requirements of the 1934 Act. It was therefore argued that the commission had focused on 1933 Act disclosure because it thought that imposition of strict disclosure standards under the 1934 Act would cause issuers to delist rather than comply.

96. Truth in Securities, supra note 3, at 136, see Wheat Report, supra note 7, at 11.
97. Wheat Report, supra note 7, at 60; Truth in Securities, supra note 3, at 1385.
99. See Wheat Report, supra note 7, at 62. The argument is not entirely persuasive because, at least with respect to the registration and periodic reporting requirements, section 15(d) of the 1934 Act subjected most companies filing a registration statement under the 1933 Act to 1934 Act disclosure requirements, whether or not they had securities listed on an exchange. See note 80 supra. Moreover, as discussed in the text, the commission did enforce the proxy disclosure rules quite vigorously, although the proxy rules applied only to issuers with listed securities and not to section 15(d) companies.
Despite this delisting problem, the commission has traditionally enforced the proxy disclosure requirements of the 1934 Act as stringently as the prospectus disclosure rules of the 1933 Act. The proxy rules, intended primarily to protect investors, require that proxy statements, like prospectuses, be physically delivered to the investors. The commission's emphasis on prospectus and proxy disclosure and its downgrading of 1934 Act periodic reports reflect its preference for protective disclosure over informational disclosure.

The same point is illustrated by the commission's enforcement of the 1933 Act disclosure requirements, in connection with which it developed a discretionary review process which enabled it to prevent or hamper sale of undesirable securities. The commission had authority to refuse to allow a registration statement to become effective or to suspend its effectiveness if the statement was "incomplete or inaccurate in any material respect." By interpreting "incomplete or inaccurate" broadly, the commission could always find some defect in the registration statement if it wished. Therefore, whether a registration statement became effective was almost entirely dependent on the commission's discretion and was not as automatic as the statute itself seemed to suggest.

The commission utilized this discretion in a selective way, making the disclosure process easy for reliable issuers, while making it difficult for issuers of fraudulent or highly speculative securities.

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100. See 2 L. Loss, supra note 16, at 880; Codification Conference, supra note 3, at 837; Truth in Securities, supra note 3, at 1361-62.
104. See Chilgren, supra note 102, at 91, MacChesney, Further Developments in "Disclosure" under the Securities Act, 33 ILL. L. REV. 145, 168 (1938) [hereinafter cited as Further Developments] (commission more insistent on particular disclosure where dubious about merits of security); MacChesney, supra note 102, at 69 (list of fraudulent promoters maintained by the commission and registration statements in which their names appeared more thoroughly investigated).
closure process did not discourage the latter group altogether from floating their issues, they were forced to make such negative disclosures that it was very difficult for them to sell their securities. Moreover, some promoters actually changed financing plans rather than attempt to sell securities after the commission forced them to disclose the excessive profits going to promoters or the lack of protection for the interests of public investors.

The commission also utilized stop order proceedings in a selective manner, proceeding primarily against those whom it regarded as fraudulent or unethical. Faced with registration statements which it viewed as defective but which were good faith attempts to comply with the requirements, the commission used an informal deficiency letter review process to correct defects. By contrast, it was quick to commence formal stop order proceedings in connection with registration statements which it regarded as deliberate attempts to evade the disclosure requirements. Similarly, after amendments were made to correct a registration statement, the commission would dismiss stop order proceedings against the good faith registration statements, but would continue the proceedings and publish an opinion when it believed the issuer had been guilty of a "disregard of fundamental business ethics." Publicity was thus used as a substitute for the power to bar unqualified securities from the market.

105. See PLI DISCLOSURE REQUIREMENTS OF PUBLIC COMPANIES AND INSIDERS 8 (Flom, Garfinkel & Freund eds. 1967) [hereinafter cited as DISCLOSURE REQUIREMENTS]; Comment, Administrative Interpretation of the Securities Act of 1933, 45 YALE L.J. 1076, 1097 (1936).

106. See 1 L. Loss, supra note 16, at 185-86; E. McCormick, supra note 14, at 302-04. Comparable alterations in insider transactions have occurred as a result of disclosure requirements. See WEAT REPORT, supra note 7, at 51.

107. See Further Developments, supra note 104, at 165-66; Comment, Administrative Interpretation of the Securities Act of 1933, 45 YALE L.J. 1076, 1097 (1936). Registration statements which failed to become effective in the early years because of stop orders, refusal orders, or withdrawal orders tended on the merits to be poor risks for investors. See Cale, A Study of Ineffective Investment Trust and Precious Metal Mining Issues, 4 L. & CONTEMP PROB. 3, 43 (1937).


109. In re Haddam Distillers Corp., 1 S.E.C. 37, 47 (1934); Further Developments, supra note 104, at 164-65.

110. See Krupshaw, Opinions of the Securities and Exchange Commission, 10 Miss. L.J. 8, 11 & n.15, 16 & n.39 (1937); MacChesney & O'Brien, Full Disclosure Under the Securities Act, 4 L. & CONTEMP. PROB. 133, 152-53 (1937) [hereinafter cited as Mac-
In a more subtle fashion, the commission interpreted disclosures in such a way as to effectively create certain substantive requirements for securities issues. An issuer's statement of the value of its assets was treated as a representation that a bona fide method of appraisal had been used. More generally, the commission interpreted what were commonly considered to be matters of opinion as if they contained certain assertions of fact, and if those facts were not true in the issuer's case, the expression of opinion was regarded as misleading. For example, persons could not be described as experts unless they had certain qualifications and had performed their jobs consistently with the normal professional standards of experts in their particular field. Furthermore, even where a statement of opinion involved a matter over which reasonable men could differ, the commission would insist that its point of view was the only accurate one if it regarded the securities as of dubious merit.

By applying the kinds of disclosure rules described above, the commission was able to treat issuers of speculative securities in a way that approached direct regulation on the basis of fairness. Few would dispute that the disclosure process was made easy for reliable issuers but difficult for fraudulent or dubious promoters. The commission was established to protect investors and utilized disclosure aggressively to do so. In a few instances, however, the commission's protective...
impulses resulted in a disclosure process less effective than it might have been in providing sophisticated investors and professionals with information useful in investment analysis.  

The Drawbacks of Protective Disclosure

Concerned with protecting investors, the commission developed practices which were either useless or counterproductive in terms of providing better information for investment analysis purposes. These included the delegation of its authority to regulate accounting, its insistence on "factual" disclosure, with a pessimistic tone, and the adoption of illogical and vague rules defining those transactions subject to the registration requirement of the 1933 Act. Such practices, though developed in response to particular abuses and effective in protecting investors, imposed a cost in informational terms.

Accounting Policies

The disclosure statutes gave the commission ample authority to establish the accounting methods to be followed for the required financial statements, thus giving the commission an opportunity to require issuers to use a uniform method of accounting. Because informed investment choices among competing securities can be made more accurately if the disclosed financial data are comparably computed, uniformity would have increased the usefulness of these disclosures for informational purposes. The commission did not adopt a required method of accounting, but, in effect, delegated the formulation of accounting principles to the accounting profession and the corporate community by requiring that financial statements be prepared and presented in accordance with "generally accepted auditing standards."

Since the accounting profession had generally adopted conservative accounting principles which minimized asset values, the accountants could be expected to aid in policing the most egregious overstate-
ments of the value of securities offered to unsophisticated investors.\textsuperscript{122} The accountants, however, had no strong interest in furthering comparability, because their clients' interests were best served by flexible accounting principles allowing each enterprise to choose among "generally acceptable principles" in order to put its best foot forward.\textsuperscript{123} Without sustained pressure from the commission, therefore, it was doubtful whether the accounting profession or the business community would work to improve the comparability of financial reporting. After its early years, however, the commission abandoned its activist role in the accounting area and generally accepted whatever the accounting profession approved or adopted.\textsuperscript{124} By delegating all of its authority in the accounting area to the accountants, the commission provided some protection against fraud but did little to improve the usefulness of financial reporting for investment analysis purposes.\textsuperscript{125}

"Factual" Disclosure

With respect to accounting, the commission's action was in essence a sin of omission in that it failed to utilize an opportunity to improve the usefulness of required financial disclosures for the purpose of investment analysis. The commission's insistence on "factual" disclosure and the exclusion of "soft" information from prospectuses, however, was a sin of commission.\textsuperscript{126} The commission took the position that earnings projections, asset appraisals, evaluations of an enterprise's market position, and other information based on opinion or estimates rather than historical fact were inherently manipulative, objectively nonverifiable, and detrimentally relied upon by the small investor. Thus, such information could not be disclosed in prospectuses and other commission filings, even though such information could


\textsuperscript{123} Knpke, Conglomerates and the Moment of Truth in Accounting, 44 St. John's L. REV. 791, 792-94 (1970); see Myths, supra note 3, at 1184-86. For a general discussion and case studies of manipulation of accounting methods, see A. BRILLOFF, UNACCOUNTABLE ACCOUNTING (1972).

\textsuperscript{124} Myths, supra note 3, at 1177.


\textsuperscript{126} The term "soft information" in the context of the commission's disclosure policies was coined by Carl W. Schneider to refer to various kinds of information or statements not susceptible of objective verification and therefore traditionally excluded from disclosure documents filed with the commission. Mr. Schneider includes within the term statements about the future, statements about past or present situations not supported by specific data, subjective evaluations or opinions as to quality, and statements of motive or intention. Soft Information, supra note 3, at 255.
be highly useful for investment analysis purposes. Because such information was not subject to objective verification, it could be manipulated to mislead investors into thinking a security was more desirable than it was in fact. The commission's own experience had taught it that such "soft" information frequently was disclosed in a misleading fashion by fraudulent or unethical promoters. In order to protect the small investor who would tend to regard such information as more definite and reliable than it was, the commission barred all such disclosures from documents required to be filed with it. In doing so, the commission deprived sophisticated investors of information which was considered highly useful for investment analysis purposes.

Pessimistic Disclosure

The commission's practice of excluding "soft" information from disclosure documents was one aspect of its broader policy of requiring disclosure that was pessimistic in tone. While favorable information which could not be objectively verified was excluded from filings, adverse information had to be included even if it was highly uncertain. Risk factors had to be thoroughly described and emphasized in the overall presentation. Where required disclosures were not strictly factual, as was the case for disclosures describing an issuer's dividend policy or its competitive position, the commission required the inclusion of disclaimer language which underlined the negative aspects of the disclosures.

Because most issuers were required to make these pessimistic disclosures, investors had difficulty distinguishing between moderately successful enterprises and those on the verge of bankruptcy. More-
over, the resulting disclosure could be affirmatively misleading to existing shareholders who might undervalue and therefore sell their securities because of the unrealistically pessimistic image presented in the prospectus. The disclaimer boilerplate and the negative bias thus resulted in disclosure which ranged from useless to actually misleading for informational purposes.

The commission's accounting policy, its attitude toward "soft" information and its insistence on a pessimistic bias and emphasis of risk factors, indicated its concern with protecting the small investor from buying a bad security rather than with enabling him to make an affirmatively good investment decision. The commission's actions suggest that its aim of promoting "informed investment decisions" refers not to enabling investors to choose rationally among investments on the basis of economic desirability, but to assuring that the investor has been exposed to all the possible dangers involved in buying a particular security before he makes his decision. Moreover, as the prior discussion suggests, when the commission staff believes that a security is "highly speculative," it may require such negative disclosure that the buyer is not only warned of all the risks twice over but, in effect, is discouraged from buying the security As has been widely remarked, this practice comes close to a determination with respect to the quality of the security rather than to the adequacy of the disclosure. Each of these approaches emphasizes protection at the expense of information.

Registration Requirements as Investor Protection

Another criticized aspect of the disclosure process is the illogical

135. Address by SEC Chairman Casey, National Investor Relations Institute, Oct. 3, 1972, in Soft Information, supra note 3, at 268-69 n.46. The commission's emphasis on conservative disclosure which tends to protect the buyer rather than the seller of securities is consistent with its general emphasis on 1933 Act disclosure, which applies only to sales of securities. See text accompanying notes 96-98 supra; Manne, Accounting and Administrative Law Aspects of Gerstel v. Gamble-Skogmo, Inc., 15 N.Y.L.F. 304, 317 (1969).

136. Prospectuses, supra note 3, at 225; Soft Information, supra note 3, at 264.

137. "The act does not aim at the elimination of risk in investment, but only at the disclosure of sufficient information to enable the investor to measure the risk." SEC Ann. Rep. 1 (1947); see Wheat Report, supra note 7, at 52. The commission's recent concern with "hot issue" markets primarily involving new ventures reflects this attitude; the commission believes that "disclosure relating to new ventures is particularly necessary, since investing in this type of venture may involve a greater risk of loss." SEC Securities Act Release No. 5395 (June 1, 1973); see Soft Information, supra note 3, at 262-63.

138. See Disclosure Requirements, supra note 105, at 8.

139. Id.
and uncertain line between securities transactions requiring registration and those exempt from registration. The lack of precision frequently imposes a heavy burden on issuers trying to comply with the law. The specific rules or guidelines which do exist often have little or nothing to do with the need of investors for investment information.

The commission's interpretation of exemption provisions appear illogical with respect to the informational purpose of disclosure because its primary concern has been protective, that is, to prevent misuse of the exemption provisions by those with fraudulent or unethical motives.

For this reason, the commission has been adverse to laying down specific rules for fear that such rules would simply allow unscrupulous persons to work around them. It has instead attempted to be flexible in its administration of the statutes, so that it could crack down hard on activities regarded as abuses while applying the rules somewhat differently in other cases. The resulting uncertainty, however, has not only imposed a significant burden on legitimate issuers and securities dealers but has come to be counterproductive in policing fraud. In the absence of precise rules, unethical persons have been able to mold the commission's broad interpretations to suit their own purposes, with the commission's enforcement actions being hampered because there is no clear violation of an established rule.

The uncertainty and the illogicality of commission interpretations are related to each other. Although the commission has generally been reluctant to establish precise lines distinguishing exempt securities transactions from those required to be registered, it has nonetheless often reacted to widespread use of a particular exemption provision by promulgating quite specific rules restricting the availability of the exemption. The commission assumed that attempts to evade registration

140. Truth in Securities, supra note 3, at 1347-50.
142. See 25 SEC ANN. REP 5 (1959); Schneider & Kant, Uncertainty Under the Securities Act, An Open Letter to William J. Casey, Chairman, Securities and Exchange Commission, 26 Bus. LAW 1623, 1635 (1971) [hereinafter cited as Schneider & Kant]. Congress apparently structured the original statutory exemptions in terms of the need for protection from fraud rather than the need of investors for information. See H.R. Rep. No. 85, supra note 14, at 7, 16 (1933) (exemptions limit bill to protection needed to "prevent recurrences of demonstrated abuses"; exemption for stock subscriptions based on absence of sales pressure).
143. Schneider & Kant, supra note 142, at 1635.
144. Id.
145. Wheat Report, supra note 7, at 177; Schneider & Kant, supra note 142, at 1635.
146. See Codification Conference, supra note 3, at 836.
requirements were generally fraudulent schemes to sell securities which could not have been sold if full disclosure had been made. Because the resulting restrictive rules represented ad hoc reactions to undesirable practices, they appear illogical in terms of the general need of investors for investment information.

For example, in the late fifties the practice developed of using the private placement exemption to distribute unregistered securities to the public. The commission responded by tightening the rules governing resales of such private placement securities. The resulting rules, which focused on the "investment intent" of the original purchaser as evidenced by a long holding period for his securities and by some "change of circumstances" necessitating the resale, did little to assure that ultimate purchasers would have useful investment information about the securities being sold. The rules did have some tendency to deter fraudulent schemes, however, since few fraudulent promoters would be willing to hold the securities for the long period needed to prove their investment intent, and few would be able to show the requisite change of circumstances justifying resale to the public without registration.

Similarly, under Rule 133, new and restrictive resale requirements were promulgated following a wave of attempts to utilize unregistered mergers to distribute dubious stock to the public. Again, the new rules did little to provide needed information to investors, but they did hamper certain fraudulent schemes. Finally, in 1969 the commission responded to a sudden increase in the use of spin-offs as vehicles for selling unregistered stock, and issued a release interpreting certain corporate spin-offs as sales requiring registration. In each case, the commission's imposition of registration requirements was not in response to a need for information, but was designed to restrict technical chan-

148. See, e.g., WHEAT REPORT, supra note 7, at 168.
150. See Garrett, Concept of Restricted Securities and Eligible Insurers, in PLI 3D ANN. INST. ON SEC. REG. 12 (1972).
151. WHEAT REPORT, supra note 7, at 168.
152. Bialkin, Corporate Acquisitions and the Securities Act of 1933, in PLI 1ST ANN. INST. ON SEC. REG. 159, 161 (1970); Codification Conference, supra note 3, at 836.
nels for legally selling unregistered stock to the public, which had become deluged with fraudulent securities. Obviously, such rules cannot seem rational if investment information is thought to be the basis of the 1933 Act.

Summary: 1934 to the 1960's

The disclosure process developed by the commission from 1934 through the mid-sixties clearly resulted in the availability of more complete, reliable information about securities and their issuers and thus achieved much in terms of the informational purpose of disclosure.\textsuperscript{155} The overall disclosure process, however, was significantly affected by the continuing concern of the commission and its staff to protect the small investor both by utilizing the disclosure process to emphasize the negative and the risk factors of securities and by using the process of administrative review to deter fraudulent individuals and to discourage unethical ones. Thus, the resulting disclosure process reflected mixed motives: a desire to provide useful information, a wish to make life difficult for irresponsible promoters, and a hope of educating the small investor in the dangers of securities transactions.

The end product was disclosure which was less useful than it might have been for investment analysis purposes. Accounting, the heart of investment analysis, was left to the accountants; the commission thus lost its chance to promote comparable financial reporting. The commission's mildly coercive tactics in connection with the administrative review process led to the proliferation of boilerplate as issuers and their lawyers could thus minimize the time spent in the review process.\textsuperscript{156} Pessimistic disclosure, effective in protecting investors from being misled by the unrealistic optimism of promoters, was neither particularly informative nor entirely accurate. Finally, the commission's attempts to combat fraud through uncertain rules and \textit{ad hoc} pronouncements imposed unacceptable burdens on issuers willing, but unable, to comply with requirements which were vaguely defined and unevenly enforced.

The Current Disclosure Process

Beginning in the mid-sixties, the commission has to some extent and

\textsuperscript{155} See \textit{Soft Information}, supra note 3, at 258; \textit{Truth in Securities}, supra note 3, at 1344.

very gradually shifted its attitude toward disclosure. The concern with protecting the small investor from fraud, with educating him as to the risks of speculation, and with reforming the conduct of the securities and corporate worlds has remained, with disclosure still regarded as useful for these purposes. Recently, however, in order to make disclosure more meaningful for investment analysis purposes, the commission has relaxed to some extent its stringent requirements that disclosure be negative in tone and limited to "hard facts." This indicates a recognition by the commission that disclosure is most effective when used primarily for informational purposes and that direct regulation of conduct may be the best means of deterring fraud and undesirable practices.

There are a number of reasons for the change. First, the extension of 1934 Act disclosure requirements to the over-the-counter market in 1964 vastly extended the commission's ability to provide useful investment information in connection with the trading markets, where the bulk of securities transactions occur. As long as the 1934 Act applied only to listed securities, the commission's disclosure authority was restricted both because many issuers were not subject to its power at all and because promulgation of stringent disclosure standards for listed securities might have resulted in massive delisting rather than improved disclosure. After 1964, with disclosure mandatory for most companies with a significant public interest, the commission could begin to impose more demands.

Second, the demand for investment analysis information had grown significantly as the securities markets became more specialized and the class of professional money managers and analysts expanded. At the same time, the demand for information from investors increased as more and more individuals acquired direct or indirect interests in securities of publicly owned companies. Finally, the dis-


158. For example, the commission has recently increased its attempts to curtail undesirable selling practices by direct regulation. See SEC Securities Act Release No. 5275, at 14-16 (July 26, 1972); NASD Notice of Proposed Rules of Fair Practice to Govern Member Conduct with Respect to Distribution of First-time Public Offerings, March 14, 1973, in 194 BNA SEC. REG. & L. REP. I-1 (March 21, 1973); Address by SEC Chairman Casey, Investment Bankers Association of America, Dec. 1, 1971, in 129 BNA SEC. REG. & L. REP. I-1, at I-2 (December 1, 1971).

159. See WHEAT REPORT, supra note 7, at 62-63.

160. See id. at 47.
closure process was increasingly criticized as burdensome and illogical, with more attention being paid to its deficiencies than to its past accomplishments. The commission has responded in a number of ways both to eliminate defects in the disclosure process and to make that process more useful for investment analysis purposes. Although many of the commission's actions reflect a continued concern for investor protection, the overall impact is to emphasize the informational function of disclosure and to downgrade somewhat its protective role.

"Integration" of the Disclosure Statutes

The commission has recently attempted to "integrate" its disclosure rules by reducing disclosure requirements under the 1933 Act, if the issuer of the securities being sold is subject to the continuous disclosure requirements of the 1934 Act. At the same time, disclosure requirements under the 1934 Act have been increased and are more stringently enforced. As discussed earlier, the prospectus disclosures of the 1933 Act were thought to have a significant protective impact. Its detailed and pessimistic disclosures are actually delivered to investors and are intended to discourage high-pressure, over-optimistic, or misleading sales tactics associated with new issues. However, the mere filing of information with the commission without delivery to the investor does not have potential for this kind of impact, although it makes important investment information indirectly available to the investing public. To the extent that the commission accepts 1934 Act disclosure as a substitute for prospectus disclosure, it is foregoing some of the protective impact of disclosure while preserving its informational function.

161. See Wheat Report, supra note 7, at 46, 48; Truth in Securities, supra note 3, at 1344. For a general discussion of the achievements and defects of the disclosure process, see Codification Conference, supra note 3.


164. See text accompanying notes 67-69 supra.

165. See H.R. Rep No. 85, supra note 14, at 8 (prospectus delivery needed to
The commission's integration actions have included limiting the information required in a prospectus or excusing the prospectus delivery requirement altogether where the issuer of the new securities is currently making the periodic disclosures required by the 1934 Act. In addition, owners of unregistered securities acquired in private placements may now resell them more readily if the issuer files 1934 Act reports. The commission has only reduced 1933 Act requirements for seasoned securities, which evidence less need for special protection or where special rules supply all the protection needed. In addition, the commission has recently increased its direct regulatory control over selling practices through more stringent enforcement of the "suitability" and "adequate basis" rules which attempt to curtail improper selling activities by directly prohibiting them. The protective function of the prospectus is thus replaced to some extent by direct regulatory control over salesmen.

**Disclosure of "Soft" Information**

The commission's single most significant recent action showing its change in attitude was its announcement that projections would "frighten" buyers and curtail selling arguments; *Truth in Securities, supra* note 3, at 1352-53.


168. As noted, *supra* note 166, forms S-7 and S-16 may be used only by established issuers and not by new enterprises which involve greater risk to investors. See *Report of the Special Study of Securities Market of the Securities and Exchange Commission*, H.R. Doc. No. 95, 88th Cong., 1st Sess., pt. 1, at 552-53 (disclosure process must be "especially refined" for new issuers); cf. SEC Securities Act Release No. 5010 (Oct. 7, 1969), at 3 ("investment conditions with respect to the common stock and the senior securities of established corporations are significantly different, and restrictions may be relaxed . "). Rule 144 allows sales of unregistered securities of 1934 Act issuers only in limited amounts and by unsolicited brokers' sales, thus minimizing danger of high-pressure sales. SEC Rule 144(e), (f), 17 C.F.R. § 230.144(e), (f) (1972).

be allowed in commission filings under certain conditions. As dis-
cussed earlier, such "soft" information has traditionally been regarded
as manipulative per se and has been excluded from disclosure docu-
ments because of its high potential for misleading investors. The
information is central to sophisticated investment analysis, however,
and the commission's recent reversal in attitude indicates a willingness
to require disclosure which is highly useful even if it has some poten-
tial for misleading investors.

This is not to say that the commission is neglecting the pro-
tective aspects of disclosure in its new approach to projections. One
of the reasons for the commission's action was the desire to equalize
the access to such "soft" information by the small investor. Although
projections were not allowed in prospectuses and other documents filed
with the commission, they were circulated informally within the finan-
cial community and thus were available to insiders and institutional in-
vestors with inside sources. By allowing such information in com-
mision filings, the commission protects the small investor from com-
petitors with more accurate information.

In addition to allowing projections in required disclosures, the
commission has recently required certain disclosures which involve
"soft information," further reflecting its new attitude toward allowing
useful information even where it is not completely verifiable. The
commission will now require specific disclosures with respect to the
development of new products and the competitive position of the issuer
in its industry, although such information has traditionally been re-
garded as not sufficiently "hard" to be disclosed. Similarly, the
commission will require disclosure of compensating cash balance ar-
rangements although such arrangements are frequently informal and

171. See text accompanying notes 126-130 supra.
173. Id.
175. SEC Securities Act Release No. 5395 (June 1, 1973); see Soft Information, supra note 3, at 259 & n.12. The commission is also considering requiring first time issuers to disclose cash budgets for future periods, a form of projection. SEC Securities Act Release No. 5276 (July 26, 1972). The proposal has not yet been adopted because of the commission's recognition that it is difficult for issuers with limited track records and limited experience in the business to make reliable projections. SEC Securities Act Release No. 5395 (June 1, 1973).
therefore difficult to define with precision. Less reliability will be accepted because the information is clearly useful to investors.

Adoption of Precise Rules

The shift in emphasis by the commission from the protective to the informational function of disclosure is further illustrated by its recent attempts to increase the clarity and certainty of the rules surrounding registration requirements. As noted earlier, the commission had traditionally been reluctant to lay down precise rules in these areas because it felt that unscrupulous persons would simply work around them. That policy has been criticized as placing great burdens on the majority of ethical issuers in order to deter a few fraudulent persons and as failing to promote the informational function of disclosure.

In response, the commission has codified and clarified its interpretation of various exemptions from the registration requirements and has indicated a general willingness to rely more on specific guidelines and less on a case-by-case approach to particular problems. The commission has proposed or adopted rules clarifying the scope of the private placement exemption and the intrastate exemption and has clarified the restrictions on the resale of securities acquired in private placements. It has also abandoned the uncertain “no sale” theory in connection with corporate combinations and has replaced it with a straightforward registration requirement and definite rules governing the resale of securities acquired in such combinations. By providing “safe haven” situations in which exemptions are clearly available, the commission has reduced its ability to crack down on fraudulent promoters, but has lessened the burdens on legitimate issuers. In ad-

178. See text accompanying notes 143-45 supra.
179. See Schneider & Kant, supra note 142, at 1635.
dition, the rules increase the investment information available to investors by requiring that all business combinations be registered and by conditioning various securities transactions on the issuer’s compliance with 1934 Act reporting requirements.

The commission has also adopted rules defining more precisely the information which may be released without violating the 1933 Act when an issuer is in the process of issuing new securities.188 It has also announced that it will issue guidelines concerning the proper use of inside information and will provide “safe haven” rules concerning liability in connection with the use of earnings projections.184 These actions all involve areas in which the potential for using disclosure improperly is great, and in which the commission has traditionally preferred to proceed on a case-by-case basis, relying in part on uncertainty to discourage improper conduct.185 Uncertainty in these areas, however, has a great tendency to cut down on the flow of useful investment information.186 Apparently recognizing this tendency, the commission has decided to promulgate definite rules which will not have the in terrorem effect of the case-by-case approach but which will facilitate the free flow of information necessary for investment analysis.

The shift in the commission’s attitude should not be exaggerated. To some extent its greater willingness to promulgate specific rules arises from the disadvantages of uncertainty in the enforcement area. For example, there may be less risk in evading rules where their interpretation is unclear because it is difficult for the commission to show bad faith in such a case.187 Similarly, unethical lawyers will advise clients to act in violation of the “spirit” of commission’s rulings where there is no specific rule forbidding the transaction, while responsible lawyers and issuers will comply with the spirit as well as the letter.188

183. SEC Securities Act Release No. 5101 (Nov. 19, 1970) (release of information by broker-dealers concerning issuer who proposes to or has registered securities under the 1933 Act).
184. Address by Chairman-Designate Cook, supra note 1, at 82,701 (guidelines on inside information); Address by SEC Chairman Cook, supra note 162, at 83,026 (“safe harbor” rule for forecasts).
188. WHEAT REPORT, supra note 7, at 177.
Therefore, the commission’s shift to specific rules reflects in part the failure of flexibility as an enforcement tool. In conjunction with other recent commission actions, however, it also appears to indicate a greater concern with useful disclosure than with the regulatory aspect of disclosure rules.

Meaningful Financial Disclosure

The final area in which the commission’s actions show an increased concern with information of disclosure is in financial reporting. As discussed earlier, its traditional approach to accounting has been to adopt the standards of the profession because they were conservative and because delegation of accounting authority preserved its scarce resources for more important fields. More recently, however, the commission has emphasized the investment analysis function of disclosure by requiring financial disclosures which are more comparable and more informative about the quality of earnings and the “economic realities” of an enterprise.189

Issuers must now disclose the effect of choosing among various acceptable accounting methods and must indicate any change in accounting principles and its impact on their financial statements.190 By increasing the comparability of financial statements, these requirements will markedly improve their usefulness for investment analysis purposes. Other new disclosure requirements are intended to show the “quality of earnings” of an issuer. The effect of tax elections on financial statements must be revealed.191 The nature of unusual charges or credits to income must be disclosed, and, as the commission has proposed, timely disclosure must be made when significant charges to income appear likely in the near future.192 As noted earlier, the impact of compensating balance arrangements must be disclosed, and lease financing terms must be revealed in greater detail.193


Sales and earnings must be broken down by lines of business, and a statement of the sources and application of funds must be included.\textsuperscript{194} In addition, the optional inclusion of earnings projections will make required disclosure documents much more useful.\textsuperscript{195}

Most of the recent disclosure requirements result from increased sensitivity to the information needs of sophisticated investors and professional analysts, not those of average investors who are unable to use most of the new disclosure without professional assistance.\textsuperscript{196} The new disclosure requirements are thus chiefly designed to serve an informational purpose.

The commission has not neglected the protective aspects of disclosure, however, even in the area of financial disclosure. The newly required disclosures about accounting policies not only serve a useful informational purpose by increasing the comparability of financial statements, but also deter manipulative accounting and serve indirectly to warn investors about the flexible nature of accounting methods.\textsuperscript{197} In addition, the commission has recently issued a release in which it specifically warns issuers disclosing cash flow as well as net income that cash flow disclosures may "mislead the unsophisticated" and should only be used in certain circumstances and with proper qualifications.\textsuperscript{198}

Nevertheless, most of the commission's recent actions are clearly designed to enable professionals to perform better their investment analysis and investment advice function. The commission has recognized that it is difficult for the average investor to make an "informed


\textsuperscript{196} See SEC Securities Act Release No. 5275, at 4 (July 26, 1972) (disclosure efficacious only when properly verified and used by professionals); Address by SEC Chairman Cook, \textit{supra} note 162, at 83,027 (financial analysts important in disseminating information to investing public); \textit{cf.} Address by SEC Chairman Cook, N.Y Society of Security Analysts, March 27, 1973, in CCH \textit{Fed. Sec. L. Rep.} \textbar 79,301, at 82,914 (commission responsible for providing adequate information for sophisticated professional analysts).


investment decision” without professional assistance. Just as “integration” of 1933 and 1934 Act disclosure has reduced physical delivery of information to the average investor, so the information disclosed is increasingly aimed at the professional, with only an indirect benefit to the average investor.

The Readable Prospectus

In one respect, however, the commission’s recent activities in the disclosure area strongly reflect a continued concern with the protective function of disclosure. Throughout its history, the commission has tried to make the prospectus “readable” to the average investor; it has recognized that the complex and detailed information required to assure “full” disclosure is incomprehensible and confusing to the average investor. There is thus an inherent conflict between “full” disclosure useful to the sophisticated investor and “fair” disclosure which presents a comprehensible picture of the enterprise to the average investor. The latter type of disclosure is necessary if the prospectus is to serve its protective function by warning the investor of the negative factors involved in an enterprise and by providing the investor with reliable information.

The commission has consistently urged issuers to reduce the length and complexity of prospectuses and to avoid technical or legal jargon. In this connection, it has recently required that each prospectus contain a summary of its contents noting the salient features of the offering. Such summaries had been required in complex prospectuses and merger proxy statements prior to the recent adoption of the formal guideline. Use of such a summary has been criticized by commentators who ask how summary disclosure can be considered adequate if, in fact, great detail is required for full disclosure.

199. See authorities cited note 196, supra.
200. See Wheat Report, supra note 7, at 52.
203. See Myths, supra note 3, at 1165.
207. Myths, supra note 3, at 1165.
answer to such criticism is that summaries are not designed to inform the investor thoroughly about the enterprise but are simply intended to give him some idea of the essentials so that he can assess oral sales promises or detect blatant kinds of unfairness in the security. In other words, such summaries may not enable the investor to make a reasoned choice among competing investments, but can prevent him from buying a bad security. Summaries thus serve the same function as pessimistic disclosure and conservative accounting practices.

The commission has also recently required the inclusion of pie-charts and bar graphs in prospectuses to represent in graphic terms the dilution of the investor's equity resulting from the offering, the promoters' investment as compared to that of the public investors, and the use of proceeds. This development has also been criticized as not adding anything to the informational function of prospectuses. Clearly, however, the purpose of the graphic disclosures is not to convey additional information, but simply to underline for investors the possible negative aspects of the investment. In other words, the prospectus is designed to emphasize those negative aspects of the investment which might be sloughed over by an eager salesman. Such disclosure devices are aimed not at the sophisticated prospectus reader, but at the average reader, and they are designed not to inform but to warn. They are modern supplements to the prominent description of risk factors which the commission has traditionally required to be included in prospectuses for speculative securities.

211. Cf. Letter from Carl W Schneider to Alan B. Levenson, Esq., Director, Division of Corporation Finance, Securities and Exchange Commission, Aug. 11, 1971, in BNA SEC. REG. L & REP H-I, H-2 (Aug. 18, 1971) "A prospectus with a "dilution" paragraph bears a stigma. It clearly suggests to the public that a certain adverse evaluation has been made, since the dilution presentation is very rarely given for a seasoned stock."
212. A similar purpose apparently underlies the recent requirement that notes to financial statements be printed in larger type than heretofore required; the release proposing the rule emphasized the crucial financial information is often disclosed in the notes in fine print which is apt to be overlooked by investors. See SEC Securities Act Release No. 5145 (Apr. 30, 1971) (adopting rule); SEC Securities Act Release No. 5112 (Nov. 23, 1970) (proposing rule).
The commission’s persistent concern with the “readable” prospectus is to some extent inconsistent with its recent apparent shift toward more informative and less protective disclosure. In part, of course, attempts to make prospectuses more readable benefit sophisticated as well as average investors. Recent attempts to eliminate boilerplate and to discourage verbosity are designed to make the prospectus more useful to all readers, whether naive or sophisticated. The inclusion of pictorial disclosures and the emphasis on risk factors and negative aspects of the investment, however, are inconsistent with recent commission attempts to provide disclosure useful primarily to sophisticated investors for investment analysis purposes. Such actions can only be explained by the commission’s belief that disclosure can continue to be an effective protective device for the average investor.

It appears to be generally conceded that disclosure alone is not enough to prevent investors from buying highly risky or even worthless securities during bull markets. Yet the commission’s words and actions seem to indicate hope that disclosure can do even that. One may speculate that the commitment to the readable prospectus may be as much a matter of faith that the average man can be persuaded to act rationally if enough attempts of persuasion are made as it is a practical means of promoting more honest securities markets.

Conclusion

The commission’s administration of the disclosure provisions of the federal securities laws suggests that it historically has viewed the protection of the unsophisticated investor as its primary job; the providing of useful investment information in order to promote efficient securities markets has to some extent been subordinated to the former task. Recently, however, as the securities markets have become more complicated and the relative importance of professional analysts and money managers has increased, the commission has responded by focusing more on the provision of useful information and less on the necessity of utilizing disclosure to protect the unwary investor against bad investments.

214. See SEC Securities Act Release No. 5396 (June 1, 1973); Address by SEC Chairman-Designate Cook, supra note 1, at 82,700.
Nevertheless, the commission has not abandoned its protective role; its increased activities in the direct regulation of securities dealers indicates its realization that disclosure may be less effective than direct regulation in protecting investors. The commission's commitment to disclosure as a protective device is a longstanding one, however, and its maintained concern with such issues as the readable prospectus suggests the continuation of that commitment.