

THE ANNUAL REPORT: A PRIME DISCLOSURE DOCUMENT

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The "information explosion" has reached atomic, if not even graver, proportions: books, magazines, television, and radio pour out a constant stream of information on a near infinity of subjects. New technologies—microfilm, cassettes, Xerox, and long-distance transmission systems—unlock old sources and expand accessibility. Much of this information, both quantitatively greater and easier of access, is not of an enduring, or even honest, order: political oratory and cheap diatribes reach larger audiences than ever, despite what appears to be a deterioration in information that was even before of poor quality.

Surely few have in recent years been as concerned with the content of information and its dissemination as the securities industry and its regulators. Increasingly, shareholders, would-be investors and securities industry professionals, as well as the public in general, have been offered an almost embarrassing abundance of information concerning publicly-held securities and securities about to be publicly-held. While the quantity of information has increased perhaps geometrically, there has been a continuing concern with quality—a concern expressed constantly, and sometimes, when sanctions are imposed, dramatically, by the Securities and Exchange Commission and the various securities exchanges—and with dissemination, the extent to which the information gets into hands where it can do some good. At the moment the debate is urgent concerning what investors should be told, the manner in which they should be told, and the shortcomings of previous disclosure techniques. Increased emphasis is placed upon meaningful, comprehensible and available information for the shareholder, the investor and the professional.¹

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1. See generally SEC Securities Act Release No. 5276 (July 26, 1972), reprinted in CCH FED. SEC. L. REP., special ed. no. 434 (1972); SEC Securities Act Release No. 5278 (July 26, 1972), reprinted in CCH 1972 FED. SEC. L. REP. ¶ 78,888; SEC Securities Act Release No. 5279 (July 26, 1972), reprinted in CCH FED. SEC. L. REP., special ed. no. 434 (1972).

THE FOLLOWING HEREINAFTER CITATION IS USED IN THIS ARTICLE:
L. LOSS, SECURITIES REGULATION (2d ed. 1961) [hereinafter cited as Loss].

STATE LAWS AND INFORMATION TO SHAREHOLDERS

Despite the mounting demand for disclosure to persons whose capital finances enterprises, state laws are still, as they have always been, singularly deficient in affording shareholders and investors effective means of learning about the operations of the companies in which they have invested or may wish to invest. One commentator in 1964 said:

There are virtually no requirements that a company not listed on an exchange send even an annual report to its stockholders. A recent check of the corporation laws of all fifty states and the District of Columbia reveals that twenty-two states have corporate reporting requirements of one type or another. Of these, in only fourteen states are the reports available to shareholders, and in three the requirement may be dispensed with by including a contrary stipulation in the by-laws. Specific requirements of content for reports are generally nonexistent, and only two states require certification by a public accountant. In no state is there any requirement dealing with proxy solicitation or allowing a state agency to exercise control over the form or content of proxy material.²

Virtually all states require the filing of annual reports with the Secretary of State or some other state authority; generally in connection with franchise tax matters,³ but for the most part these files are not available to the public. In the five states (California, Oklahoma, Pennsylvania, Connecticut and Michigan) which require that reports be sent to shareholders,⁴ and in those states which require that corporations furnish reports to shareholders upon request, the requirements are generally regarded as ancillary to the almost uniformly given right to examine corporate records.⁵ Professor Cary has, in something of an understatement, characterized the information required to be given shareholders under the typical corporation statute as of a "somewhat meagre character."⁶ In some instances, state blue sky laws require the filing of reports as long as a registration under the state law is effective, but again, no provision requires that this information be furnished to shareholders or to the state on a continuing basis.⁷

2. Knauss, *A Reappraisal of the Role of Disclosure*, 62 MICH. L. REV. 607, 625 (1964).

3. 2 ABA MODEL BUS. CORP. ACT ANN. § 126, ¶ 2, Comment (2d ed. 1971).

4. CAL. CORP. CODE § 3006 (West 1955); CONN. GEN. STAT. ANN. § 33-334 (Supp. 1972); MICH. STAT. ANN. § 21.45 (1963); OKLA. STAT. ANN. tit. 18, § 1.72 (1951); PA. STAT. ANN. tit. 15, § 1318 (1967).

5. 2 ABA MODEL BUS. CORP. ACT ANN. § 52, ¶ 2, Comment (2d ed. 1971).

6. W. CARY, CASES AND MATERIALS ON CORPORATIONS 1029 (4th ed. 1969).

7. 2 LOSS 824; 5 LOSS 2791-92 (Supp. 1969).

THE FEDERAL DISCLOSURE SCHEME

As has happened frequently, the deficiencies of state law, in this case, securities law, led to federal action to meet an evident social need. Thus, after some twenty-two years of experience with state legislation, an experience that indicated an unevenness and grave inadequacy of efforts to protect the investing public, the federal government in 1933 entered the field of express securities regulation.

The persistent thrust of the federal securities regulation scheme has been disclosure—in the words of former President Franklin D. Roosevelt when proposing the first broad-scale federal legislation on the subject in 1933: “put[ting] the burden of telling the whole truth on the seller.”⁸ The prevalence of this philosophy is reflected in Professor Loss’s often-quoted statement: “Then too, there is the recurrent theme throughout these statutes of disclosure, again, disclosure, and still more disclosure.”⁹

The first federal venture into disclosure was the Securities Act of 1933¹⁰ which was directed principally to disclosure in connection with significant offerings by issuers and those persons controlling such issuers. As an administrative tool, Congress included in this legislation section 17(a)¹¹ which forbade half-truths, fraudulent devices, schemes and artifices, misstatements, and other fraud-like conduct in connection with the sale of securities. Apart from the remedies related to the registration process, a civil remedy was also provided for misstatements of material facts made in connection with the sale of securities, or omissions of material facts necessary to make the statements made not misleading.¹²

In 1934 Congress followed these innovations with the Securities Exchange Act of 1934,¹³ which sought, among many other things, to establish a system of continuous disclosure, but only for companies with securities registered on an exchange. In 1936 Congress somewhat awkwardly extended the continuous reporting requirements to most companies which registered securities under the 1933 Act by requiring in such registration statements an undertaking to file reports equivalent to those required of listed companies.¹⁴ It was only

8. H.R. REP. No. 85, 73d Cong., 1st Sess. 2 (1933).

9. 1 Loss 21.

10. 15 U.S.C. §§ 77a *et seq.* (1970).

11. *Id.* § 77q(a).

12. *Id.* § 77l(2).

13. *Id.* § 78a *et seq.*

14. 2 Loss 818.

in 1964, when the "section 12(g) company" category of issuer—a company which had, initially 750, later 500, holders of a class of equity securities and one million dollars of assets—was created that continuous reporting was mandated for substantial over-the-counter companies regardless of undertakings.¹⁵

The concept of disclosure was also expressed in section 14(a) of the 1934 Act,¹⁶ which gave the SEC broad rule-making power in connection with proxy solicitations. Under the rule-making authority of section 14(a), the SEC gradually developed the now familiar proxy statement containing extended disclosures of certain particulars, depending on the nature of the action sought from shareholders.¹⁷ In 1964 Congress broadened these disclosure requirements by giving the SEC authority to require compliance with the proxy rules by section 12(g) issuers and required similar disclosures by listed companies and section 12(g) companies which for one reason or another chose not to solicit proxies for their annual meetings.¹⁸

Unlike the Securities Act of 1933 which specifically prescribes delivery of disclosure documents in specified circumstances to members of the public,¹⁹ the periodic reporting requirements of the 1934 Act contain no such requirement.²⁰ While efforts have been made to facilitate the availability of this information in SEC files, in general these filing requirements have resulted in the accumulation of vast and usually unused information concerning American business. However, there is general agreement²¹ that requiring such filings has had a beneficial impact on the integrity of corporate disclosures which do receive wider public circulation—for example, press releases and annual reports—and does often sift information into the market place through analysts and other experts who dig it out of SEC files. Recently, the process has been assisted by the availability of these periodic reports on "microfiche" which are microfilm copies mounted on easily stored cards available at a relatively low price.²²

15. 15 U.S.C. § 78l(g) (1970).

16. *Id.* § 78n(a).

17. The requirements for proxy statements are specified in schedule 14A under the 1934 Act, 17 C.F.R. § 240.14a-101 (1972).

18. 15 U.S.C. § 78n (1970).

19. *Id.* § 77f(d).

20. *See id.* § 78m. The proxy rules, of course, forbid proxy solicitations unless a proper proxy statement is used, 17 C.F.R. § 240.14a-3 (1972), and, since 1964, require certain disclosures if no proxies are solicited. *Id.* § 240.14e-2.

21. 1 Loss 349.

22. SEC, DISCLOSURE TO INVESTORS 313-18 (1969) (The Wheat Report).

The federal system began with emphasis upon disclosure in connection with distributions—substantial sales by issuers and their controlling persons. Presumably this approach was the consequence of testimony in the Congressional hearings following the 1929 debacle which dramatized the wrongs that had occurred in connection with the distribution of new issues.²³ The 1934 Act shifted the emphasis somewhat by addressing itself to continuous reporting for listed companies. Despite this effort to construct a continuous reporting system, the orientation of the bar and financial community continued toward the 1933 Act disclosure in connection with distributions. Consequently, the quality of such disclosure was higher than in the 1934 Act reports; 1933 Act prospectuses received wider distribution than 1934 Act reports; and the SEC staff studied with far greater intensity and commented with far greater rigor upon the 1933 Act filings.²⁴ Yet, the trading market continued to grow, with far more dollars committed in it than in distributions.²⁵ Although there had been earlier efforts to attract attention to the shortcomings of disclosure in the trading market, the superb essay by Milton Cohen²⁶ sounded the tocsin most pointedly and urged a truly integrated system of disclosure that recognized the extent of the trading market and the somewhat hit-and-miss manner in which regulated information reached it.

THE ANNUAL REPORT

While the disclosure documents mandated by the 1934 Act remain for the most part in SEC files, and reach the public only indirectly through ambitious analysts and diligent researchers, one disclosure document has been increasingly recognized as communicating effectively with shareholders and the investment community in general: the annual report to shareholders.

The annual report has not always been viewed as a means of communicating significant information. In a 1902 annual report a publicly-held company candidly informed its shareholders that “[t]he settled plan of the directors has been to withhold all information from stockholders and others that is not called for by the stockholders in a body. So far no request for information has been made in the

23. See generally R. DEBEDTS, *THE NEW DEAL'S SEC: THE FORMATIVE YEARS* (1964). See also S. REP. NO. 1455, 73d Cong., 2d Sess. (1934).

24. See SEC, *DISCLOSURE TO INVESTORS*, *supra* note 22, at 392-95; Cohen, “*Truth in Securities*” *Revisited*, 79 HARV. L. REV. 1340, 1353-54 (1966).

25. See SEC, *DISCLOSURE TO INVESTORS*, *supra* note 22, app. II-1.

26. Cohen, *supra* note 24.

manner prescribed by the directors"²⁷ One wonders at the extent of our progress after nearly four decades of effort to improve corporate communications when a responsible writer comments, "[m]anagement seems to have forgotten that its first obligation to investors is to tell them what the company is, what it is trying to do, what it has accomplished, and where it has failed."²⁸

It is generally conceded that the issuer's annual report to shareholders is currently the most widely circulated and used disclosure document. Professor Loss has remarked in his Comment on section 601 of the proposed Federal Securities Code that the proposal therein giving direct authority to the SEC to regulate in some measure the contents of annual reports is based "on the theory that the annual report, more than the occasional prospectus or even the proxy statement, should be recognized as the central device for continuous disclosure."²⁹

To some extent this contention has been statistically confirmed in a study which surveyed analysts and nonprofessional shareholders.³⁰ The group of analysts who were surveyed indicated that the annual report was the written document that meant most to them.³¹ Further, the nonprofessional shareholders indicated that six out of ten spent more than five minutes with annual reports received and a third indicated that they spent fifteen minutes or more.³² The time spent by such persons on the disclosure documents under the 1934 Act would, of course, be very close to zero.

Indicative of the extent to which management uses the annual report to communicate to many audiences, not just to its shareholders, is the fact that typically companies print two or three times as many copies of annual reports as they have shareholders. Not only is the annual report used by companies for communicating with its shareholders and the investment community, but

the annual report is used regularly for such purposes as recruiting employees,

27. Jones, *Management Freedom in Annual Reports*, FINANCIAL EXECUTIVE, Aug., 1971, at 23.

28. Hobgood, *Segmented Disclosure in 1970 Annual Reports*, FINANCIAL EXECUTIVE, Aug., 1971, at 18, 22.

29. ALI FED. SEC. CODE § 601, Comment 2, at 119 (Tent. Draft No. 1, 1972).

30. See NEW TRENDS IN ANNUAL REPORT READERSHIP 23 (1971).

31. Not surprisingly, the analysts thought that form 10-K was the second most important written document and that both the annual report and form 10-K were markedly exceeded in value by management and analysts' meetings. *Id.*

32. *Id.* at 24.

selling products and services, attracting acquisitions, and, increasingly, as a "corporate calling card" when dealing with foreign businessmen.³³

The annual report is the darling of management since "they [management] have primary control over it (unlike prospectuses, often written by lawyers),"³⁴ and it is not unknown for a skillfully prepared annual report to raise a company's price-earnings ratio.³⁵ However, these benefits are not cheaply accomplished. American Telephone & Telegraph, for example, is reported to spend \$575,000 for simply printing and designing its annual report, plus additional expenses in mailing.³⁶

Typically, the annual report will contain the following:

1. The cover. Generally, this will be colorful and may or may not have some identifiable relationship to the company.

2. Financial highlights. Either in a very brief table or through bar charts and graphs, or both, the company's recent financial history will be summarized, similar to the method the SEC has mandated for the presentation of use of proceeds and dilution in prospectuses.³⁷

3. The president's letter to shareholders. This has been described as the last remaining opportunity for uncensored communication from the chief executive officer to his shareholders.

4. A description of the business of the company, often accompanied by arresting pictures related to the company's operations.

5. The financial statements. These include balance sheets, income statements, surplus statements, and source and application of funds statements, together with the auditor's certificate.

6. Usually the report will contain other useful information, such as the identity of officers and directors and the names of general counsel,³⁸ transfer agents and registrars.

Apart from whether the annual reports comply with technical legal requirements, many analysts have criticized them for a variety of reasons: "Many annual reports are creating serious credibility problems because they lack candor, are overtechnical or are just

33. GRAPHIS ANNUAL REPORTS 11 (1971).

34. *Id.*

35. *Id.* at 10.

36. *Id.*

37. See SEC Securities Act Release No. 5278 (July 26, 1972), reprinted in CCH 1972 FED. SEC. L. REP. ¶ 78,888.

38. Inclusion in the annual report of the name of general counsel may pose awkward problems, as for instance, exposure to liability. See *Black & Co. v. Nova-Tech, Inc.*, 333 F. Supp. 468 (D. Ore. 1971); Sommer, *The Role of General Counsel*, N.Y.L.J., June 15, 1972, at 1, cols. 3-4.

considered nothing more than promotional puffery."³⁹ Analysts have criticized the interpretations placed by management on events during the year, and they resent the frequency with which they receive "everything's all right" reports which shove the dirty problems of the company and its industry under the pretty pictures.⁴⁰ There is, in short, a broad band of dissatisfaction among analysts with respect to the contents of the annual report.

A HISTORY OF THE SEC AND THE ANNUAL REPORT

Despite the clear evidence of the importance of the annual report as the means by which information is communicated on a regular basis to a company's shareholders, to the investment community, and to the trading markets, the SEC has been remarkably circumspect and cautious in moving to improve the quality of the annual report. This hesitancy probably has its origin in two circumstances. First, nowhere in any of the securities statutes administered by the SEC, except in the cases of regulated issuers, is it given a clear mandate or power to control the content and uses of the annual report.⁴¹ It has clear and express authority to govern the contents and uses of prospectuses and other written communications used in connection with distributions;⁴² it has clear authority to regulate the contents of periodic reports filed with the SEC;⁴³ it has clear power to make rules with respect to the solicitation of proxies, including the contents of proxy statements.⁴⁴ But nowhere is the SEC accorded unimpeachable power to direct the contents and use of annual reports: "Apart from the Holding Company and Investment Company Acts, the SEC cannot directly regulate the reports sent to shareholders as distinct from those filed under the several statutes."⁴⁵

The second retarding circumstance is probably sensitivity to charges that too great an intrusion into the annual report may infringe upon the constitutional assurance of free speech. This concern was undoubtedly accentuated by the failure of Congress to give the SEC clear authority to regulate the contents of annual reports.

As discussed below, it was not until 1942 that the SEC took its

39. NEW TRENDS IN ANNUAL REPORT READERSHIP I (1971).

40. *See id.* at 9-11.

41. *See* 1 LOSS 348.

42. 15 U.S.C. §§ 77j, 77s (1970).

43. *Id.* §§ 78m, 78o(d).

44. *Id.* § 78n(a).

45. 1 LOSS 348.

first diffident step in the direction of regulating the annual report.⁴⁶ It was a relatively small step, especially when contrasted with the first step it had proposed to take.

SEC Proposals for Direct Regulation of Annual Reports

The Securities Exchange Act of 1934 gave the SEC broad power to make rules and regulations with respect to the solicitation of proxies, consents and authorizations pertaining to any security (other than an exempted security) registered on a national securities exchange. This enactment stemmed from an increased concern with "shareholders democracy," based upon evidence elicited in Congressional hearings that there had been a gross disregard of shareholders' rights.⁴⁷

The SEC first exercised its power under this section in 1937.⁴⁸ The rules adopted then, described by Professor Loss as "rudimentary in comparison with today's rules,"⁴⁹ required moderate disclosure of matters to be acted upon by shareholders and prohibited the making of any materially false or misleading statements in connection with the proxy solicitation. In 1938 the SEC amended its rules to require, for the first time, that shareholders receive a "proxy statement" with specified contents.⁵⁰

Sweeping changes in the proxy rules were proposed by the SEC in 1942.⁵¹ Among other changes, it proposed that the proxy statement contain information concerning the business activities of the issuer and its subsidiaries during the preceding fiscal year, including a description of changes in the character of the business; a description of changes in the issuer's charter; information concerning significant acquisitions and dispositions; actions taken with respect to compensation; information concerning changes in indentures and other instruments affecting the rights of security holders; and information concerning grants of options and the operation of bonus and other types of plans.

The SEC provided that this requirement could be satisfied through the medium of the annual report. Most importantly, the proposed amendments included the annual report within the defini-

46. See SEC Securities Exchange Act Release No. 3347 (Dec. 15, 1942).

47. 2 Loss 858-59; H.R. REP. NO. 1383, 73d Cong., 2d Sess. 13-14 (1934); S. REP. NO. 1455, 73d Cong., 2d Sess. 74-76 (1934); S. REP. NO. 792, 73d Cong., 2d Sess. 12 (1934).

48. SEC Securities Exchange Act Release No. 1350 (Aug. 13, 1937).

49. 2 Loss 869.

50. SEC Securities Exchange Act Release No. 1823 (Aug. 11, 1938).

51. SEC Securities Exchange Act Release No. 3347 (Dec. 15, 1942).

tion of "proxy soliciting material" which would have to be filed with the SEC at least ten days before such materials were mailed to shareholders. Thus, the contents of the annual report would have become subject to the potential liabilities flowing from section 18 of the 1934 Act⁵² and pre-use review by the SEC.

This proposal resulted in protest from issuers. Fifteen years later, the Chairman of the SEC, J. Sinclair Armstrong, described what occurred:

Many companies complained at that time [1942] that if the annual report to shareholders must be "filed" with the Commission and therefore subjected to civil liability provisions of section 18, the effect would be to place severe limitations upon the freedom of communication and comment to shareholders concerning corporate affairs. The Commission at that time believed that it would be in the public interest to encourage, rather than limit, the dissemination of information to security holders and that if fear of civil suits might have an adverse effect in this respect, it might be better to require delivery of the report but to free it from the provisions of section 18.⁵³

In response to these protests the SEC excluded the annual report from the scope of "proxy soliciting materials" and instead adopted the procedure which is preserved in substance today: an annual report had to precede or accompany the proxy statement sent to shareholders by management, and it had to contain such financial statements for the last fiscal year of the issuer as would, in the opinion of management, adequately reflect the position and operations of the issuer.⁵⁴ Copies of the report had to be sent to the SEC no later than the first date upon which they were mailed to shareholders.⁵⁵

Thus, there was to be no requirement of prior clearance with the SEC, as in the case of proxy statements, before the annual reports were sent to the shareholders; the reports were not to be deemed "filed" for purposes of section 18, a fact confirmed quite explicitly by the Director of the Corporation Finance Division of the SEC in 1943;⁵⁶ and annual reports remained essentially free of attack under the federal securities laws, for the implications of rule 10b-5,⁵⁷

52. 15 U.S.C. § 78r (1970). Section 18 has always been a "toothless tiger," for recoveries under this section have been few. E. GADSBY, *THE FEDERAL SECURITIES EXCHANGE ACT OF 1934* (pt. 1) § 5.02, at 5-4 (1971).

53. *Hearings on Stock Market Study Before the Senate Comm. on Banking & Currency*, 84th Cong., 1st Sess. 1556 (1955).

54. SEC Securities Exchange Act Release No. 3347 (Dec. 15, 1942).

55. *Id.*

56. SEC Securities Exchange Act Release No. 3380 (Feb. 5, 1943).

57. 17 C.F.R. § 240.10b-5 (1972).

adopted in 1942, had not yet been discerned by the most vigilant administrator or imaginative plaintiff's counsel.

During the course of hearings on the SEC's amended proxy rules,⁵⁸ the rule adopted by the SEC concerning the furnishing of annual reports to shareholders was discussed by Chairman Ganson Purcell before the House Committee on Interstate and Foreign Commerce. In response to the obvious confusion of the congressmen with respect to form 10-K (the annual report filed with the SEC and exchanges) and the annual report to shareholders, he said:

The principal difference, if there is a difference—and there usually is—between the annual report to stockholders and the report to the exchanges and to the Commission is that the annual report to stockholders is more discursive, chatty. It makes more interesting reading, as it should, to the stockholders than would ordinarily be the case of materials submitted on formal documents to the Commission.⁵⁹

It was evident from the dialogue with the members of the Committee that they were not bothered by the consequences under section 18 if the annual report were required to be "filed" with the SEC. They interrogated Chairman Purcell with respect to the SEC's power to require such filing, and he indicated a belief that the SEC had broad enough power to require such "filing."⁶⁰

The requirements adopted by the SEC in 1942, that annual reports be sent to each shareholder in connection with the solicitation of proxies, created only minimal additional obligations for issuers. The only issuers subject to the proxy rules in 1942 were those listed on exchanges, and as Mr. Purcell acknowledged to the House Committee on Interstate and Foreign Commerce, virtually all, if not all, exchanges required that annual reports with specified information be sent to shareholders.⁶¹ Chairman Purcell also acknowledged that the only purpose of the requirement that the reports be sent to the SEC was to permit monitoring of compliance with the requirement that they be mailed to shareholders.⁶²

Prior to the 1942 amendments to the proxy rules, the SEC, recognizing the apparent absence of direct power over annual reports,

58. See generally *Hearings on H.R. 1493, H.R. 1821, and H.R. 2019 (SEC Proxy Rules) Before the House Comm. on Interstate & Foreign Commerce, 78th Cong., 1st Sess., pt. 1* (1943).

59. *Id.* at 20.

60. *Id.* at 23.

61. *Id.* at 21.

62. *Id.* at 20.

sought such power from Congress. In 1941 it proposed that section 17 of the 1933 Act be amended to make it "unlawful for any issuer, by use of the mails or interstate commerce, to send to its stockholders a report containing any statement which is false or misleading with respect to a material fact."⁶³ According to Professor Loss, the securities industry would have gone along with this proposal provided that the defense essentially contained in section 18 of the 1934 Act—good faith and reasonable ground to believe—were incorporated in the provision.⁶⁴ It is interesting to note that at the time of this proposal the general belief was that section 17 of the 1933 Act provided the basis only for SEC administrative action and criminal action, and it was not contemplated that section 17 afforded anyone a private remedy; only in the following year did rule 10b-5 make its appearance,⁶⁵ and it was another four years before a court determined that rule 10b-5, with its similarity to section 17, afforded a private remedy;⁶⁶ and only many years later did a court conclude that section 17 also provided a private remedy.⁶⁷ As will be discussed below, to a large extent rule 10b-5, as extended in so remarkable a fashion by the courts, has provided a network of potential liabilities around the annual reports that goes further than the amendment proposed in 1941 would have gone.

Indirect Methods for Regulating Annual Reports

In 1954 still seeking to accomplish indirectly what it had recoiled from doing directly in 1942, the SEC amended form 10-K to require that if a registrant distributed an annual report to shareholders, a copy of the report should be furnished to the SEC not later than the date it was mailed to shareholders, and that if no such report was furnished to shareholders, then the SEC should be so told in the form.⁶⁸ Since issuers of listed securities were already required to furnish to shareholders and file with the SEC annual reports,⁶⁹ this new

63. STAFF OF HOUSE COMM. ON INTERSTATE & FOREIGN COMMERCE, 77TH CONG., 1ST SESS., REPORT ON PROPOSALS FOR AMENDMENTS TO THE SECURITIES ACT OF 1933 AND THE SECURITIES EXCHANGE ACT OF 1934 at 23 (Comm. Print. 1941).

64. 2 Loss 1029-30 n.652.

65. 3 Loss 1761.

66. *Kardon v. National Gypsum Co.*, 69 F. Supp. 512 (E.D. Pa. 1946). See also 3 Loss 1763 n.261.

67. *Pfeiffer v. Cressaty*, 223 F. Supp. 756, 757 (S.D.N.Y. 1963); *Osborne v. Mallory*, 86 F. Supp. 869, 878-79 (S.D.N.Y. 1949). See also 6 Loss 3813-14 (Supp. 1969).

68. SEC Release U-159 (1954). See also 1 Loss 349.

69. 15 U.S.C. § 78m (1970).

requirement affected only issuers required to file reports with the SEC as the consequence of section 15(d) of the 1934 Act⁷⁰—that is, companies which had a registration statement effective under the 1933 Act and which continued thereafter to meet certain requirements, but were not registered under the 1934 Act. Again, the annual reports were not to be considered as “filed” for purposes of section 18 liability. In 1965 with the extension of the proxy rules to unlisted companies covered by section 12(g) of the 1934 Act, form 10-K was amended to expressly limit this requirement to companies required to file reports with the SEC by section 15(d) of the 1934 Act.⁷¹

The hesitancy of the SEC to deal directly with the contents of the annual report has continued. In 1972 it proposed that issuers be required to identify in form 10-K those portions of the form not included in the annual report,⁷² presumably thereby enhancing the capacity of the SEC staff to determine the extent of an issuer’s candor with its shareholders, with possible administrative action as the consequence. This provision, in turn, would make issuers think twice before omitting significant information from the annual report, and would warn any person relying on the annual report that the whole story of the company may not be contained in the report. The Chairman of the SEC has made a parallel suggestion that the annual report contain identification of the portions of form 10-K not included, thereby presumably touching off curiosity on the part of the shareholders concerning the information denied them.

Role of Annual Reports in Federal Securities Regulations

The annual report to shareholders plays other roles in the scheme of federal securities regulation. First, in a number of instances financial statements in the annual report to shareholders may be incorporated by reference in official filings with the SEC; of course, when they are so incorporated, they become “filed” and potentially the subject of liability under section 18 of the 1934 Act. The general prerequisite for such use is that the information incorporated be in substantial conformance with the financial reporting requirements of the SEC.⁷³

70. The exchanges had for some time required that annual reports be furnished to shareholders. The Commission’s powers with respect to proxy statements prior to 1964 were confined to listed companies. *Id.* § 78o(d).

71. 4 Loss 2387 (Supp. 1969).

72. SEC Securities Exchange Act Release No. 9576 (Apr. 20, 1972), *reprinted in* [1971-1972 Transfer Binder] CCH FED. SEC. L. REP. ¶ 78,727.

73. 17 C.F.R. § 240.12b-23(c) (1972).

Schedule 14A details the required contents of proxy statements under section 14(a) of the 1934 Act and specifies that certain financial statements are material information and must be included in proxy statements soliciting proxies with respect to the authorization or issuance of a material amount of senior securities or the authorization or issuance of common stock in an exchange, merger, consolidation, acquisition or similar transaction.⁷⁴ These requirements can be satisfied with financial statements in the annual report to shareholders if it is "sent to security holders pursuant to § 240.14a-3 (Rule X-14A-3) with respect to the same meeting as that to which the proxy statement relates, provided such financial statements substantially meet the requirements of this item."⁷⁵

Rule 12b-23⁷⁶ under the 1934 Act provides a broad license for incorporation by reference of information in annual reports in filings with the SEC. It states that any information other than financial statements contained in an annual report "may be incorporated by reference in answer or partial answer to any item of a registration statement [under the 1934 Act] or report [principally forms 8-K, 10-Q and 10-K]." Financial statements contained in an annual report to shareholders may be incorporated by reference in a registration statement or report provided that "such financial statement substantially meets the requirements of the form on which the statement or report is filed."

Accounting Series Release No. 41⁷⁷ particularizes "substantial conformance" and indicates the variances from SEC financial statement requirements which would not preclude the use of statements in the annual report. In a number of instances—for example, the grouping of a number of items—the requirements of regulation S-X⁷⁸ are more exacting than those required by generally accepted auditing and accounting principles.

The SEC has relied heavily on the annual report with respect to form S-8. This form is available to issuers required to file reports with

74. *Id.* § 240.14a-101, item 15(c).

75. *Id.* § 240.14a-101, item 15(d).

76. *Id.* § 240.12b-23.

77. SEC Accounting Series Release No. 41 (Dec. 22, 1942), reprinted in 4 CCH FED. SEC. L. REP. ¶ 72,059 (1964).

78. The stringent standards of general regulation S-X, 17 C.F.R. § 210 (1972), as to the grouping of items on the balance sheets and income statements of "commercial and industrial companies" are set out in 17 C.F.R. §§ 210.5-02 to -03 (1972).

the SEC under either section 13⁷⁹ or section 15(d)⁸⁰ of the 1934 Act for securities to be offered to the issuer's employees, or employees of a subsidiary, pursuant to a stock purchase, savings or similar plan.

Item 25(a) of form S-8 requires the inclusion of certain financial statements in the registration statement. If the annual report of the issuer contains certified statements substantially conforming to those required in item 25(a), then they may be incorporated by reference in the registration statement. To insure that these incorporated-by-reference statements meet the eyes of the offerees, undertaking B(a) of this form requires the issuer to deliver with the prospectus a copy of its annual report for its most recent fiscal year unless the employee as a shareholder of the issuer otherwise receives such a report. Furthermore, undertaking B(b) requires that annual reports and other mailings to shareholders also be provided to participants under the plan with respect to which securities are registered unless they are shareholders and therefore otherwise receive reports.

THE ANNUAL REPORT IN COURT

The failure of the SEC to include the annual report among "filings" subject to section 18 or section 14 liability has not constituted a license to management to play fast and loose with truth in the annual report. As is the case in many areas of securities law, rule 10b-5 has filled the gap and, if anything, provided more serious danger of liability than would have been present had the express liability provisions of the statutory scheme been applicable.

In *SEC v. Texas Gulf Sulphur Co.*⁸¹ and *Heit v. Weitzen*⁸² the Second Circuit clearly established that for a rule 10b-5 violation to exist it was not necessary that the defendant have engaged in securities transactions; rather, the requirement that the misconduct be "in connection with the purchase or sale of any security" was satisfied if the purchaser or seller of securities was the victim of a stated wrong even though the wrongdoer was not in the market. In *Heit v. Weitzen* the application of rule 10b-5 to the annual report was expressly stated.⁸³ In that case the management of the issuer caused annual reports containing false information to be issued to its shareholders

79. 15 U.S.C. § 78m (1970).

80. *Id.* § 78o(d).

81. 401 F.2d 833 (2d Cir. 1968), *cert. denied*, 394 U.S. 976 (1969).

82. 402 F.2d 909 (2d Cir. 1968), *cert. denied*, 395 U.S. 903 (1969).

83. 402 F.2d at 913.

and circulated through the investment community. The purpose of circulating such false information was to conceal from the government information which might have adversely affected the issuer's defense contracting business. The Second Circuit held that a cause of action was stated by one who had allegedly purchased in the market on the basis of the information in the annual report.⁸⁴

A somewhat different basis of liability was found in *Butler Aviation International, Inc. v. Comprehensive Designers, Inc.*⁸⁵ The plaintiff in that case charged that the defendant corporation had engaged in various violations of federal securities laws in connection with a tender offer for the stock of the plaintiff. One of the charges was that the defendant's annual report constituted a part of the tender offer and that, in violation of section 14(e) of the 1934 Act, the report contained a material omission, namely, failure to disclose that the statement that the earnings during the final quarter of the fiscal year exceeded those of the preceding quarter was based solely on a change in accounting method. Section 14(e) prohibits in connection with tender offers substantially the same conduct forbidden by rule 10b-5 in connection with the purchase or sale of securities. The court held for the plaintiff on this and other grounds and stated that it did not have to reach the question of standing under rule 10b-5.⁸⁶

A case which posed an interesting question was *Dillon v. Berg*,⁸⁷ in which it was alleged that the defendants, who were officers and directors of a corporation, caused the corporation to mail annual reports to new shareholders without correcting information in the report which had become false. The court held that the failure to correct an annual report or update it could not give rise to liability under rule 14a-9,⁸⁸ which forbids the use of misleading statements or omissions in connection with proxy solicitations, but that if there were to be liability for any such failure it would have to be found within the terms of rule 14a-3.⁸⁹ Although the court concluded there was no basis for liability under rule 14a-3, it expressly recognized that annual reports were not "filed" for purposes of section 18 and based its conclusion with respect to possible liability deriving from the fals-

84. *Id.*

85. 425 F.2d 842 (2d Cir. 1970).

86. *Id.* at 843 n.1.

87. 326 F. Supp. 1214 (D. Del. 1971), *aff'd*, 453 F.2d 876 (3d Cir. 1972).

88. 17 C.F.R. § 240.14a-9 (1972).

89. *Id.* § 240.14a-3.

ity of the annual report on rule 10b-5.⁹⁰

The question of the extent to which monetary liability as distinguished from injunctive relief may flow from a misleading annual report is a confused and complex one. Judge Henry J. Friendly, apparently expressing the opinion of a majority of the Second Circuit sitting en banc in the *Texas Gulf Sulphur* case,⁹¹ expressed concern about awarding damages as the consequence of simple negligence in corporate reporting.⁹² In *Heit v. Weitzen*,⁹³ Judge Harold Medina stated that the question did not have to be resolved given the state of the pleadings in that case since the pleadings appeared to charge some degree of scienter. While this somewhat conservative view with respect to monetary liability appears to prevail in the Second Circuit, the Tenth Circuit in *Mitchell v. Texas Gulf Sulphur Co.*⁹⁴ stated that there may be such liability if a defendant fails to sustain the burden of proving that he did not know, and in the exercise of reasonable care could not have known, of the misrepresentation or omission. This opinion appears to be dictum since the lower court found for the plaintiffs on the basis that "the record here discloses that the press release issued by defendants was misleading, *intentionally* deceptive, inaccurate and *knowingly* deficient in material facts."⁹⁵ Monetary liability would extend to anyone who participated in the violation or who controlled the issuer.

Other cases have confirmed the applicability of rule 10b-5 to annual reports. In *Drake v. Thor Power Tool Co.*⁹⁶ the District Court for the Northern District of Illinois held that a cause of action was stated against accountants when it was alleged that they had negligently prepared financial statements appearing in an annual report. Similarly, in *Fischer v. Kletz*,⁹⁷ the District Court for the Southern District of New York determined that a cause of action was stated both under common law and rule 10b-5 when it was alleged that auditors who learned after their certification had been published in an issuer's annual report that the financial statements in the report which they had certified were false, failed to disclose in an appropri-

90. 326 F. Supp. at 1231 n.27.

91. 401 F.2d 833 (2d Cir. 1968).

92. *Id.* at 866 (concurring opinion).

93. 402 F.2d 909 (2d Cir. 1968).

94. 446 F.2d 90 (10th Cir.), *cert. denied*, 405 U.S. 918 (1972).

95. 309 F. Supp. 548, 563-64 (D. Utah 1970) (emphasis added).

96. 282 F. Supp. 94 (N.D. Ill. 1967).

97. 266 F. Supp. 180 (S.D.N.Y. 1967).

ate manner such subsequently acquired knowledge.

THE PRESENT SEC RULES

Rule 14a-3⁹⁸ as it presently stands requires that if a solicitation is made on behalf of management and relates to the annual meeting at which directors are to be elected, each proxy statement furnished, if the issuer is subject to the proxy rules, must be accompanied or preceded by an annual report. This annual report must contain the following and have the following characteristics:

1. It must include in comparative columnar form such financial statements for the last two fiscal years, prepared on a consistent basis, as will in the opinion of management adequately reflect the financial position of the issuer at the end of each year and the results of operations for each such year. Consolidated financial statements of the issuer and its subsidiaries must be included in the report if they are necessary to reflect adequately the financial position and results of operations of the issuer and its subsidiaries, but in such case, the individual statements of the issuer may be omitted even though they are required to be included in reports to the SEC. The SEC may permit the omission of the statement for the earlier of the two years when good cause is shown.

2. Any difference reflected in the financial statements included in the annual report from the principles of consolidation or other accounting principles or practices, or methods of applying accounting principles or practices, applicable to the financial statements of the issuer filed or proposed to be filed with the SEC (form 10-K) which would have a material effect upon the financial position or results of operations of the issuer must be noted in the annual report and the effect reconciled or explained. However, the financial statements and the report may omit details and employ condensation to the extent deemed suitable by management, with the caveat that "such statements, considered as a whole in the light of other information contained in the report, shall not by such procedure omit any material information necessary to a fair presentation or to make the financial statements not misleading under the circumstances."⁹⁹

3. The financial statements for at least the most recent fiscal year must be certified unless those statements in form 10-K are not re-

98. 17 C.F.R. § 240.14a-3 (1972).

99. *Id.* § 240.14a-3(b)(2).

quired to be certified or the SEC finds that certification would be impracticable or involve undue effort or expense.

4. The rule then states that “[s]ubject to the foregoing requirements with respect to financial statements, the annual report to security holders may be in any form deemed suitable by the management.”¹⁰⁰

5. If the issuer has not previously submitted to the security holders an annual report pursuant to the rule, then the report must contain such information concerning the business done by the issuer and its subsidiaries during the fiscal year as will, in the opinion of management, indicate the general nature and scope of the business of the issuer and of subsidiaries. When it was first proposed in 1964 that a description be included in the annual report, it was urged that it be in *each* annual report.¹⁰¹ The final rule required such a description only for one year.

6. An annual report need not precede or accompany a proxy solicitation by management if a solicitation is being made in opposition to management and management’s proxy statement includes an undertaking to furnish the annual report to all persons being solicited at least twenty days before the meeting. This provision was obviously intended to avoid disadvantaging issuers against whom proxy contests were mounted by precluding their responding to some extent because the annual report was not available.

7. Seven copies of the annual report must be sent to the SEC “solely for its information” not later than the date on which the report is first sent or given to security holders or the date on which preliminary copies of solicitation material are filed with the SEC, whichever date is later. The rule specifically states that

[t]he annual report is not deemed to be ‘soliciting material’ or to be ‘filed’ with the Commission or subject to this regulation otherwise than as provided in this rule, or to the liabilities of Section 18 of the Act, except to the extent that the issuer specifically requests that it be treated as a part of the proxy soliciting material or incorporates it in the proxy statement by reference.¹⁰²

Apparently, the annual report is rarely incorporated into the proxy statement by reference.¹⁰³

100. *Id.* § 240.14a-3(b)(4).

101. SEC Securities Act Release No. 7447 (Oct. 21, 1964), *reprinted in* [1964-1966 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,142. Under the original 1942 proposal both the annual report and a proxy statement would have had to be “filed” and a description of the business had to be included. See notes 51-52 *supra* and accompanying text.

102. 17 C.F.R. § 240.14a-3(c) (1972).

103. 2 Loss 887.

In 1964 Congress amended the Securities Exchange Act of 1934, *inter alia*, to provide in section 14(c)¹⁰⁴ that if an issuer subject to the SEC proxy rules did not solicit proxies, it had to furnish to its shareholders, in accordance with such rules and regulations as the SEC might adopt, information "substantially equivalent" to that which would be furnished in a proxy statement. The SEC has adopted rules under this section¹⁰⁵ which virtually parrot the proxy rules, including rule 14a-3.¹⁰⁶ Thus, even if a corporation does not solicit proxies, it has the obligation to furnish annual reports to shareholders and to the SEC to the same extent as if it did solicit proxies.

The development of rule 14a-3¹⁰⁷ since its first appearance in 1942 has almost entirely been the consequence of the emergence of specific abuses, rather than the consequence of an effort to develop a coordinated system of disclosure. Specifically, the requirement of consolidated financial statements had its origin in the *Atlantic Research Corp.* case.¹⁰⁸ Atlantic Research had a subsidiary which had incurred substantial research and development costs resulting in a large loss, a loss which, if reflected in consolidated financial statements, wiped out the profits of the parent and other affiliated companies. The rule applicable to form 10-K required that in these circumstances consolidated financial statements be incorporated in the filing with the SEC. These consolidated financial statements indicated that the enterprise as a whole had lost money during the most recent fiscal year. However, in the financial statements included in the annual report to shareholders, *only* the parent's income statement, which showed a substantial profit, was included. As a result of this case, subparagraph (2) of rule 14a-3 was inserted, requiring that variations between financial statements in annual reports and filings with the SEC be noted and reconciled or explained.¹⁰⁹ Again, it should be noted how cautiously the SEC dealt with the problem. Rather than mandating that the financial statements contained in the annual report should be prepared consistently with those contained in form 10-K with

104. 15 U.S.C. § 78n(c) (1970).

105. 17 C.F.R. §§ 240.14c-3 to -7 (1972).

106. See notes 98-102 *supra* and accompanying text.

107. Whenever reference is made to rule 14a-3, the remarks are equally applicable to rule 14c-3.

108. SEC Securities Act Release No. 4657 (Dec. 6, 1963), *reprinted in* [1961-1964 Transfer Binder] CCH FED. SEC. L. REP. ¶ 76,949.

109. SEC Securities Exchange Act Release No. 7324 (May 26, 1964), *reprinted in* [1961-1964 Transfer Binder] CCH FED. SEC. L. REP. ¶ 76,999.

specified exceptions, the SEC simply required that variations had to be disclosed and reconciled.

Generally, since the adoption of this requirement, the financial statements in annual reports have been virtually identical with those filed with the SEC. However, as noted by commentators, there are a number of variations that are permissible:

These may include some relatively small degree of condensation . . . They may also include certain cost and expense classification differences on the part of a few companies which, because of Rules 14a-3 and 14c-3, disclose the differences and reconcile the two reports [with respect to variations in stating cost of goods sold, depreciation, depletion and amortization, etc.]. Further, the SEC does not object to the omission of certain technical or compliance disclosures required by S-X that are usually omitted in the financial statements contained in stockholders' reports on the grounds that they are not essential to a fair presentation of the statements. Generally these technical or compliance disclosures are considered to include [certain items] most of which concern footnotes . . .¹¹⁰

In one area to which the requirements of rule 14a-3(a)(2) do not extend, disparities between reports filed with the SEC and the information contained in annual reports has been noted. In 1969, after extensive discussion, the SEC adopted amendments to forms S-1, S-7 and 10,¹¹¹ which were extended to form 10-K in 1970.¹¹² These amendments required that any registrant having more than one line of business include as a part of its "description of business," and not as a part of its financial statements, information concerning the sales and profits of each "line of business" which met certain size tests. The determination of what constituted a "line of business" was left largely to management's judgment guided by certain very broad tests.¹¹³

A recent study¹¹⁴ compared the "line of business" reporting practices of 84 multi-line companies in forms 10-K and in the correspond-

110. H. KELLOGG & M. POLOWAY, ACCOUNTANT'S SEC PRACTICE MANUAL 721 (1971).

111. SEC Securities Exchange Act Release No. 8650 (July 14, 1969), *reprinted in* [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,729.

112. SEC Securities Exchange Act Release No. 9000 (Oct. 21, 1970), *reprinted in* [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,919.

113. See form 10-K, item 1(c)(1), *reprinted in* CCH 1972 FED. SEC. L. REP. ¶ 31,103, at 22,053. See also Sommer, *Experience in Line of Business Reporting*, in *THIRD ANNUAL INSTITUTE ON SECURITIES REGULATION* 163, 164-65 (Mundheim & Fleischer eds. 1972); SEC Securities Act Release No. 4988 (July 14, 1969), *reprinted in* [1969-1970 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,729.

114. 10-K and the Annual Report: How One Hundred Leading Corporations Report Sales and Earnings to the SEC and to Shareholders, Oct. 1971 (Selvage, Lee & Howard Research Study).

ing annual reports. Of these companies, 36 gave identical breakdowns of sales and earnings; two gave breakdowns in the annual report which were not the same as those in form 10-K; 18 gave sales, but no earnings, breakdowns. Of these companies, 10 were identical with the form 10-K breakdowns and eight were substantially different. Twenty-eight gave no breakdowns whatsoever in the annual report. Among 16 single-line companies, required in form 10-K to set forth sales of classes of products or services if they reached certain levels of importance, which had reported sales broken down by classes of product or service in their forms 10-K, three gave the same breakdowns in the annual report, two gave different breakdowns, and 11 gave no breakdown whatsoever.

If such "line of business" and product or service class information were part of the financial statements covered by rule 14a-3, regulation S-X, and the financial statement requirements of form 10-K, a reconciliation and explanation would be required in the annual report with no doubt more and better information going to shareholders. There is presently discussion among accountants concerning the feasibility of including such information in the audited financial statements.¹¹⁵ It should be noted that although there remain serious discrepancies in this area of reporting, the situation has been steadily improving.¹¹⁶

Another way in which the SEC has sought to regulate annual reports indirectly is the requirement that a prospectus disclose whether or not annual reports will be furnished to security holders and whether they will contain certified statements.¹¹⁷ The manner in which the SEC has sought to upgrade annual reports indirectly is seen even more clearly in its release discussing a registrant which issued its annual report for 1967 while a registration statement under the 1933 Act was pending with the SEC.¹¹⁸ In the statistical information in the front of the annual report, the company compared 1967 sales and earnings, which included a significant acquisition made in a "pooling" during the year, with 1966 results "as reported," rather

115. See AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, DISCLOSURES OF SUPPLEMENTAL FINANCIAL INFORMATION (1967); AMERICAN INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS, OUTLINE OF POSSIBLE OPINION (1967).

116. Hobgood, *supra* note 28, at 28.

117. SEC Securities Act Release No. 4936 (Dec. 9, 1968), reprinted in [1967-1969 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,636.

118. See SEC Securities Exchange Act Release No. 9010 (Nov. 19, 1970), reprinted in [1970-1971 Transfer Binder] CCH FED. SEC. L. REP. ¶ 77,929.

than as restated to reflect the pooling in 1967 (the certified income statement for 1966 was restated). The SEC concluded that this reporting was misleading.¹¹⁹

As a result of its determination, the SEC did not bring an injunctive action under rule 10b-5 or section 17(a). Rather, it resorted to a device which has often been criticized:¹²⁰ it refused to accelerate the effectiveness of the 1933 Act registration statement. Although this is not reflected in the release, it also pressured the registrant to send an amended annual report to its shareholders.

Although an SEC sponsored study¹²¹ concludes that "only in a small minority of cases can it be said that the disclosures in present-day annual reports are seriously misleading, . . ." ¹²² it nonetheless recited instances in which disclosure in annual reports departed markedly from reasonable standards of fair presentation.¹²³ The study considered requiring by rule that all financial disclosures in the annual report to shareholders, wherever located in the report, be reviewed by the issuer's auditors for consistency with the certified financial statements and covered by their opinion.¹²⁴ However, the study appeared to opt for a somewhat different approach, namely, a rule that would prohibit any chart, schedule, highlights section, and so on, in the annual report from presenting the results of operations or other material information in a light more or less favorable than the financial statements included in the annual report or any prior reports.¹²⁵ The study's recommendation has not been implemented.

THE ANNUAL REPORT AND CODIFICATION

Because of the hesitancy of the SEC to assert direct control over the contents of annual reports, the granting of this power in unmistakable terms has been for Professor Loss one of the major *desiderata* of the American Law Institute Codification Project which he heads.

119. It also faulted the company for setting forth two earnings per share figures, one based on common shares and "residual securities" and the other on average common outstanding during the year. The SEC stated that when a company had residual securities outstanding, it should not include in its report an earnings figure based only on common shares actually outstanding.

120. See Mulford, "Acceleration" Under the Securities Act of 1933—A Reply to the Securities and Exchange Commission, 14 BUS. LAW. 156 (1958).

121. SEC, DISCLOSURE TO INVESTORS, *supra* note 22.

122. *Id.* at 368.

123. *Id.* at 368-71.

124. *Id.* at 372.

125. *Id.* app. XI-1.

In his first report to the membership of the American Law Institute on the project, Professor Loss said:

Another basic idea which might be developed is to give the Commission direct jurisdiction over the annual report to stockholders. That, after all, is the document that gets to people, much more so than the occasional prospectus. We know that today it's the proxy statement that has become the really valuable disclosure device, not the prospectus. The Commission has backed into the stockholders' report by having it submitted to the Commission, although it's not technically filed, more or less as an appendage to the proxy statement. But why not make the stockholders' report central? Why should we have a system in which the Commission regulates what goes into an occasional prospectus but cannot say what goes into the stockholders' report, so that, subject to the fraud provisions, companies can say what they like in the stockholders' report even though it's perhaps different from what they have just said in an annual report filed with the SEC?

In short, while diminishing the impact of the prospectus, we might maximize the impact of more effective devices—the proxy statement, the report to stockholders.¹²⁶

In Tentative Draft No. 1 of the proposed code,¹²⁷ which was approved by the membership of ALI in May, 1972, Professor Loss and his counsellors and advisors have implemented this intent. Section 601 of this draft of the code would provide:

- (a) [Commission's authority] A registrant shall
 - (1) file,
 - (2) send to every record holder of its securities other than commercial paper,
 - (3) keep for whatever periods the Commission prescribes by rule, and
 - (4) publish (through press releases or otherwise) whatever annual reports (with financial statements), quarterly reports, and other reports the Commission requires by rule to keep reasonably current the information and documents contained in the registration statement or to keep investors reasonably informed with respect to the registrant.
- (b) [Optional material] A report may contain material that is not required.
- (c) [Time of filing] A report required to be filed shall be filed at whatever time the Commission specifies by rule, except that it may not require that optional material sent to security holders or published be filed before it is sent or published.

In comparison, the draft originally submitted to the Council of the ALI simply provided that a registrant would file "at whatever

126. Loss, *The American Law Institute's Federal Securities Code Project*, 25 BUS. LAW. 27, 33-34 (1969).

127. ALI FED. SEC. CODE (Tent. Draft No. 1, 1972), contains the portions of the proposed code pertaining to definitions, exemptions, issuer registration, distributions and post registration.

time (which may be in advance of use) the Commission requires by rule, whatever annual reports" and other reports the Commission would require by rule "to keep reasonably current the information . . . in the registration statement or to disclose material changes with respect to the registrant."¹²⁸ This earlier version, which would have permitted the SEC to control the entire contents of the annual report and require the filing of the entire report before use, met with objections from some members of the Council because, as Professor Loss stated in the Comment in Tentative Draft No. 1, they were apprehensive that it "might be both impracticable, because of the mass of reports that the staff would have to examine in the early months of each calendar year, and self-defeating, because of the danger that reports to stockholders would become as lengthy and complex as many prospectuses."¹²⁹ Perhaps there was also the concern that the president's last chance at uncensored communication with shareholders might be lost.

Professor Loss, however, in his Comment in Tentative Draft No. 1, reiterates the importance of the annual report:

However, it is central to the philosophy that has marked the planning and discussion of the Code thus far that the concept of the annual report to stockholders as *the central device for continual disclosure* should be adopted unequivocally. It is that assumption more than anything else that justifies needed relaxation in what is now the Securities Act registration area.¹³⁰

Section 601 in the version approved by the membership of the ALI seeks to preserve the centrality of the annual report and quiet the fears of the Council and others. The SEC under the approved section could prescribe information which must be included in all reports to shareholders, including the annual report, and compel the filing before use of those portions prescribed with the SEC. Nevertheless, the right of management to speak without prior clearance in whatever manner it wished, subject only to anti-fraud considerations, is preserved by permitting the inclusion of non-required information and material which does not have to be filed in advance with the SEC. Professor Loss remarks that perhaps cautious managements will want to file in advance even the optional portions and that whether this will be feasible will depend upon the willingness and resources of the SEC.¹³¹

128. ALI FED. SEC. CODE § 601-I (Council Draft No. 1, 1972).

129. ALI FED. SEC. CODE § 601, Comment 2(d), at 120 (Tent. Draft No. 1, 1972).

130. *Id.*

131. *Id.* at 121.

When the proposed code will be adopted has been the subject of varying estimates. Professor Loss is hopeful that it will be finally approved by the American Law Institute in 1975;¹³² how long from this date to legislative enactment is anyone's guess, and the time thereafter for implementation by the SEC is equally uncertain. Thus, it appears to be at least half a decade before the new approaches to securities regulation embodied in the code become an operative reality.

THE ANNUAL REPORT AND RULE-MAKING

Since it will be several years before the code will be enacted, what should be done in the meantime? In a number of instances, goals of the codification effort are being achieved in substantial measure through rule-making and other means available to the SEC. For example, as a consequence of the SEC's Disclosure Study¹³³ much progress has been made in integrating the disclosure requirements of the 1933 and the 1934 Acts. Pending enactment of the code, should, or can, steps be taken to make the annual report a more reliable document?

As discussed above, the SEC has moved cautiously in the annual report area. It has been suggested, however, that perhaps the SEC has more power than it acknowledges. One commentator has said:

The way to do a real job for disclosure to the investing public is the improvement of the information in the annual report. I don't have a doubt that the Commission would have the power to force that improvement. It has already gone a long way in that direction through Rule 14a-3.¹³⁴

Further, as noted earlier, the SEC itself believes that it has the power to compel the pre-use filing of the annual report with consequent liability under section 18 of the 1934 Act, and it would appear that this belief, at least in 1943, would extend to the power to control the contents of the annual report.

Two of the principal tools available to the SEC would be further rule-making under the 1934 Act and a step-up of enforcement proceedings when confronted with misleading annual reports, accompanied perhaps by greater scrutiny of annual reports when they are submitted to the SEC.

132. *Id.* at xvii.

133. SEC, DISCLOSURE TO INVESTORS, *supra* note 22.

134. Address by Professor Homer Kripke, Securities Regulation—The Myth of the Informed Layman, New York State Bar Association, Jan. 27, 1972.

The SEC is given extremely broad rule-making power in connection with proxy solicitations, power which is broad enough to require the pre-use filing of materials proposed to be used in such solicitations. Under section 14(c) that power is broadened to require the communication of previously cleared information to shareholders even when no proxies are solicited. Under this power, the SEC has established its present regulation of the annual report. Is there any reason why the SEC could not go much further than it has? Surely, it is no exaggeration to suggest that *any* report to shareholders, no matter when sent to them, is a proxy solicitation, even if it does not occur within the formal period of four or six weeks prior to the shareholders' meeting. Former SEC Commissioner Byron D. Woodside has stated the argument in this manner:

The treatment of the annual report of the corporation under the proxy rules is an interesting example of administrative dexterity. I can think of nothing more likely to persuade stockholders that management should be retained in office than an annual report containing all the indicia of existing and continuing success. As so viewed, it would seem odd not to conclude that the report, sent with a request for a proxy, was not part of the soliciting material, if not in fact, the most effective inducement to mail a proxy to management. As so viewed, the report would be subject to the proxy rules and it would be "filed" with the Commission as proxy material.¹³⁵

Some precedent for this notion is afforded by *Butler Aviation International, Inc. v. Comprehensive Designers, Inc.*,¹³⁶ in which the court found that communications well in advance of the formal commencement of a tender offer were in fact a part of the tender offer and hence subject to the regulation under the 1934 Act.

Once it is determined that the annual report is part of the proxy solicitation materials, it would seem that the codification goal of a two-part annual report, one pre-use part cleared with the SEC, the other "free writing," could be readily accomplished. The SEC could make mandatory certain contents—financial statements, description of important changes in the business during the past year, information concerning conflicts of interest and the like. After all, the SEC has taken significant leaps in requiring use of annual reports and to some extent prescribing the contents of financial statements therein, and it could require, as it once proposed to do, that portions be filed

135. Woodside, *Development of S.E.C. Practices in Processing Registration Statements and Proxy Statements*, 24 BUS. LAW. 375, 385-86 (1969).

136. 425 F.2d 842 (2d Cir. 1970).

in advance with the SEC and be deemed "filed" for the purposes of section 14 and section 18 of the 1934 Act.

There is little doubt that the SEC could require in proxy soliciting materials financial statements and the kind of information found in annual reports—bar charts, graphs, discussion of recent developments, and description of the business done during the past year. If this is true, and if the annual report to shareholders may properly be considered as a part of the soliciting process, where is the block to the accomplishment of more reliable disclosure in the annual report to shareholders?

It may be that the mandatory upgrading of a portion of the report would have salutary effects on the remainder. With one portion of the annual report containing "hard" information (and perhaps, given the new approach of the SEC, "soft" information—projections, budgets, appraisals—as well)¹³⁷ cleared with the SEC, the report would probably inhibit somewhat the free-wheeling and often misleading propensities of some presidents' letters and highlights sections.

Another disclosure approach would be reliance upon rule 10b-5. Given the broad construction of the language "in connection with the purchase or sale of any security" by the Second Circuit,¹³⁸ the possibility of promulgating rules under section 10(b) of the 1934 Act governing the annual report should not be overlooked. This section gives broad power to the SEC to adopt rules "necessary or appropriate in the public interest or the protection of investors" to bar manipulative or deceptive devices or contrivances. While the SEC has, with the exception of rule 10b-5, used its power under this rule rather conservatively and only with respect to fairly particular types of deception or manipulation, the willingness of the courts evidenced in rule 10b-5 cases to give the SEC's power a broad reading would suggest that an effort to control the contents of annual reports under this section would not be ill-favored by the courts.

A somewhat different approach which could be taken is greater enforcement activity under rule 10b-5. In an injunctive proceeding by the SEC under rule 10b-5, there is little or no requirement of scienter;¹³⁹ thus the SEC would have to prove only the fact of violation,

137. See, e.g., SEC Securities Act Release No. 5276 (July 26, 1972), reprinted in CCH FED. SEC. L. REP., special ed. no. 434 (1972).

138. See *Heit v. Weitzen*, 402 F.2d 909 (2d Cir.), cert. denied, 395 U.S. 903 (1968). See also *SEC v. Capital Gains Research Bureau, Inc.*, 375 U.S. 180 (1963).

139. I A. BROMBERG, SECURITIES LAW § 8.4, at 203 (1971).

and not the state of mind of the perpetrators. Such SEC actions almost invariably breed class actions by those allegedly harmed by the misconduct; hence a few well-chosen SEC actions directed toward faulty annual reports, followed by the inevitable private litigation, would go far to inhibit looseness with truth in annual reports.

Assuming that the SEC could under its present powers compel the pre-use review of portions of the annual report by the SEC staff, and assuming that the SEC could require that annual reports contain specified information, what would be accomplished? As mentioned before, the annual report has wide circulation in the investment community; generally the proxy statement has little circulation beyond the family of shareholders, and the filings with the SEC have virtually none. If information presently contained in the proxy statement—for example, officers' compensation and transactions with insiders—were required to be included in the annual report, the information would be more broadly circulated, and hence, would have the potential of affecting management conduct more significantly than is true today. Furthermore, a requirement with respect to the description of the business akin to that suggested in 1943, coupled with an opportunity for the SEC to review the material in advance of use, could significantly reduce the complaint of analysts and others about the “pollyanna” aspects of annual reports.

If the SEC has power to require pre-use filing and review of the entire annual report, then surely it would have power to require this with respect to only part of it. Given the limits of manpower and finances, this is the course the SEC would probably prefer. Thus, as provided in the proposed code, the opportunity would remain for presidential free writing, but obviously, this opportunity would be disciplined by the awareness that other parts of the report had been processed through the SEC staff.

Is a requirement that certain information be included in the annual report and that such information be reviewed by the SEC staff before use too heavy or exacting a burden for corporations? Does making such information “filed” for purposes of sections 14(a) and 18 of the 1934 Act create excessive risks of liability? In 1942 industry protested the proposal for pre-use filing and the potential of liability under section 18. Thirty years have passed. While in many contexts concern for liability is, if anything, more real than ever, there is perhaps less concern about this notion, as evidenced by the relatively limited objection of the ALI Council to some pre-use review of annual reports by the SEC and the acceptance of the two-part annual report by the membership of the ALI.

There has been a growth in the integrity of annual reports and in the convictions of corporate executives that the ultimate good of their corporations is best served by meaningful and accurate disclosure to the financial market place. Thus, the adoption of a proposal for pre-use review by the SEC and mandatory incorporation of certain information in the annual report would result in a far less dramatic upgrading of annual reports than would have occurred had the SEC's proposal in 1942 been adopted. Finally, section 18, with its elaborate defenses, is recognized as less a danger than it was earlier.¹⁴⁰ However, since *Mills v. Electric Auto-Lite Co.*,¹⁴¹ section 14(a) has been recognized as a significant potential source of liability. Notwithstanding these fears, good reason exists to believe that, given the concern with meaningful and reliable corporate disclosure, the sensitivity of the securities markets, and the vastly increased participation, directly and indirectly, of the public in the markets, the annual report, the principal medium of disclosure, should be made a more reliable document, and the most immediate means of accomplishing this is through greater regulation of its contents.

Would a requirement that portions of the annual report be filed in advance for clearance by the SEC place upon an already overworked staff additional demands that would prove unbearable? This would depend largely upon the extent to which the SEC carries through its avowed intent of reallocating resources in the direction of more careful scrutiny of continuous disclosure documents, with corresponding de-emphasis upon sometimes excessive scrutiny of filings under the 1933 Act. If this intent is followed, the burden would be tolerable, particularly if Congress recognizes the constructive import of such a procedure with adequate appropriations.

Obviously, making the annual report read like a prospectus should be avoided; consequently, any rules adopted to accomplish the suggestions in this article should preserve clearly the opportunity of the management to speak in a "discursive, chatty" fashion to its shareholders. A skillfully drafted rule should not interfere with that opportunity, while affording to investors an assurance of improved annual report quality.

140. See *Heit v. Weitzen*, 402 F.2d 909, 915 (2d Cir.), *cert. denied*, 395 U.S. 903 (1968); *Hoover v. Allen*, 241 F. Supp. 213, 220-25 (S.D.N.Y. 1965); E. GADSBY (pt. 1), *supra* note 52, § 5.02, at 5-4; Comment, *The Prospects for Rule X-10b-5: An Emerging Remedy for Defrauded Investors*, 59 YALE L.J. 1120, 1129 (1950); *cf.* *Fischman v. Raytheon Mfg. Co.*, 188 F.2d 783, 788 (2d Cir. 1951).

141. 396 U.S. 375 (1970).

CONCLUSION

It is axiomatic that the annual report is the most effective instrument presently available for continuous disclosure. It is likewise axiomatic that the quality of disclosure in the annual report falls far short of that customary in 1933 Act registration statements and prospectuses and in the 1934 Act filings with the SEC, which are generally believed to be inferior to 1933 Act filings. The SEC has used its rule-making power under sections 14(a) and 14(c) with hesitancy and circumspection to eliminate or hamper gross abuses in the use of annual reports when they appear, but it has been hesitant to assert the power to make the annual report a consistently credible document. It is suggested in this article that greater enforcement effort directed to annual reports under rule 10b-5, and a greater willingness by the SEC to push to the limits of the power given it by sections 10(b), 14(a), and 14(c), would go far to achieve the degree of control sought through the codification proposal of the ALI, giving direct power over annual reports to the SEC.

