Opportunity or Misfortune: Airline Management Faces an Integrated SEC Disclosure System

Hugh Tucker

Follow this and additional works at: https://scholar.smu.edu/jalc

Recommended Citation

This Comment is brought to you for free and open access by the Law Journals at SMU Scholar. It has been accepted for inclusion in Journal of Air Law and Commerce by an authorized administrator of SMU Scholar. For more information, please visit http://digitalrepository.smu.edu.
OPPORTUNITY OR MISFORTUNE: AIRLINE MANAGEMENT FACES AN INTEGRATED SEC DISCLOSURE SYSTEM

HUGH TUCKER

ON JANUARY 15, 1980, the Securities and Exchange Commission (SEC), in four separate but related releases,\(^1\) introduced a plan to redesign the registration and reporting systems under the Securities Act of 1933 (1933 Act)\(^2\) and the Securities Exchange Act of 1934 (1934 Act).\(^3\) The plan proposed substantial changes in the disclosure systems of the two acts and incorporated revisions designed to improve the overall disclosure made to investors and other users of financial information. The proposed changes were part of the SEC's ongoing effort to facilitate the integration of the two disclosure systems into a single disclosure system and to reduce current impediments to combining the various security holder communications.\(^4\) In particular, the rules sought to combine the annual reports to security holders (annual reports)\(^5\) with official SEC filings, such as Form 10-K\(^6\) under the 1934 Act and the registration statements\(^7\) under the 1933 Act.\(^8\)

This new disclosure plan, with modifications resulting from the

---


\(^6\) 17 C.F.R. § 249.310 (1980). The Form 10-K is the annual report form that is required to be filed with the SEC. It contains more detailed financial disclosure than the annual report to security holders. See text accompanying notes 223-64 infra.

\(^7\) 17 C.F.R. §§ 239.11 (Form S-1), 239.26 (Form S-7), and 239.18 (Form S-11). Registration statements are filed when securities are offered to the public and include information concerning the offering and the company. See text accompanying notes 299-322 infra, concerning new registration statement Form S-15.

comment process," was adopted at a public meeting of the SEC on August 21, 1980, was announced in a series of releases dated September 2, 1980, and was published in the Federal Register on September 25, 1980. The plan is effective with respect to fiscal years ending after December 15, 1980, and includes the following: 1) adoption of amendments to Form 10-K, Rule 14a-3, Rule 14c-3, and Regulation S-K to reduce certain regulatory burdens and facilitate the integration of the disclosure systems; 2) adoption of amendments to Regulation S-X to establish uniform financial statement instructions for certain forms and reports required to be filed pursuant to the 1933 Act and the 1934 Act; 3) adoption of amendments to Regulation S-X to eliminate, to the extent possible, the differences between the requirements of Regulation S-X and generally accepted accounting principles (GAAP); and 4) adoption of Form S-15 as a new simplified form for the registration of securities issued in certain types of business combination transactions.

This final rulemaking of the SEC constituted a major step toward the accomplishment of a coordinated disclosure system through integrated reporting under the 1933 and 1934 Acts. It bore directly on what the SEC considered to be the two major areas of concern in designing such a coordinated system:

---

9 45 Fed. Reg. 63,682 (1980). In accordance with the Administrative Procedure Act, the SEC was required to give general notice of its proposed rulemaking in the Federal Register and give any interested persons the opportunity to submit written comments on the proposals. 5 U.S.C. § 553 (1976).
13 Id. at 63,630.
15 17 C.F.R. § 240.14a-3 (1980). Rule 14a-3 sets out what information must be furnished to security holders on a periodic basis. Id.
16 17 C.F.R. § 240.14c-3 (1980). Rule 14c-3 sets out what information must be included in the annual report to security holders. See note 5 supra.
1) What information is material to investment decisions in the context of public offerings of securities?  
2) Under what circumstances and in what form should such material information be disseminated and made available by companies making public offerings to the various participants in the capital market system?

It represented a shift in emphasis from accommodating the preparers of the information and the SEC to an effort to meet the needs of users of financial statements. In addition the new rules represented a shift to disclosures that supplement and penetrate the financial statements and help the investor understand the significance of these statements.

The new rules will have a noticeable effect on the airline industry. With decreasing traffic levels, staggering jet fuel costs, employee layoffs, work schedule reductions, and the major airlines entering into new markets as a result of deregulation, management will find it difficult under the new disclosure rules to convey a bright picture. For example, Braniff International Airlines, which engaged in widespread route expansion pursuant to the route freedoms established by the Airline Deregulation Act of 1978, ran into severe financial difficulties in 1980. The cost of expanding into eighteen new United States cities and opening new Pacific and Atlantic routes, when traffic was softening and jet fuel costs exploding, resulted in a severe cash drain for the company during the first half of 1980. There was an operating loss of $54 million and

---


22 Id. The amendment relating to Form S-15 addressed this area of concern.


24 Id.


27 Industry Surveys, supra note 25, at A58.

28 Id.
a net loss of $69 million during the period.\(^9\) To improve finances a large scale cutback was initiated. Aircraft, including fifteen 727-200's and one 747SP, were sold, management and labor pay cuts were negotiated, capacity was decreased significantly,\(^{10}\) and $100 million in short-term credit was obtained.\(^{11}\) The company also granted security interests in its aircraft to holders of its long-term debt, effectively removing shareholder claims to the assets and curtailing its ability to sell the planes to raise more cash as it might be needed.\(^{12}\)

Braniff, however, was not the only airline that was hit hard in 1980. Most major airlines have cut back capacity in order to reduce overhead.\(^{13}\) In a further effort to reduce costs they have furloughed or laid off employees,\(^{14}\) and have slowed flying speeds to conserve jet fuel.\(^{15}\)

In sharp contrast to the majority of airlines in the industry, Delta Air Lines showed a net profit in 1980.\(^{16}\) This was primarily due to its cautiously planned expansion efforts under deregulation. Delta expanded into new routes only when the expansion fit into its existing route system and promised to be economical.\(^{17}\)

Deregulation thus provides management with the flexibility to make a difference in the performance of the airline, whether it be for good or ill. The airlines are no longer likely to move in the market as a group, as they invariably did in the past. They will move individually, each propelled by its own circumstances and prospects.\(^{18}\) It is these circumstances and prospects that the SEC now wants management to disclose to investors and the marketplace in a manner that indicates their significance for the past and future performance of the airline.

\(^{19}\) Id.  
\(^{20}\) Id. Capacity refers to the number of seats offered on each route. Id.  
\(^{21}\) Id.  
\(^{22}\) INVESTMENT SURVEYS, supra note 25, at 255.  
\(^{23}\) Id.  
\(^{24}\) Id. at 251. The employees included pilots, flight attendants, ticket agents, and mechanics. Id.  
\(^{25}\) Id.  
\(^{27}\) Id.  
\(^{28}\) Donlan, Airline Turbulence: But Deregulation Offers Hope by Year End, BARRONS, Feb. 25, 1980, at 9, 22.
The purpose of this comment is to point out the disparity that exists between the disclosure systems of the 1933 Act and the 1934 Act and to discuss the recent efforts of the SEC to coordinate the two. The analysis will initially focus on the legislative anomaly of the two act system. It will then evaluate the efforts of the SEC in defining the material information to be disclosed to investors and the market. Finally, it will discuss how the SEC will implement its new integrated system.

I. THE LEGISLATIVE ANOMALY:

The 1933 Act and the 1934 Act were enacted in response to different needs. The 1933 Act was enacted as a result of public sentiment aroused by the fact that worthless securities were being distributed to the public for billions of dollars. This situation was attributable to irresponsible investment bankers who overstimulated the appetites of investors with "alluring promises of easy wealth" and with "incomplete, careless or false representations" and not to the inability of investors to make rational investment decisions. Congress was, therefore, satisfied that provisions requiring full disclosure of all information necessary "to bring into the full glare of publicity those elements of real and unreal values which lie behind a security" could be structured to provide an appropriate regulatory solution to the problems inherent in the sale of new securities to the public. The 1934 Act was founded on the closely related theory that competing judgments of informed buyers and sellers as to the value of a security in a free and open securities market reflected fair value for that security. Since the 1933 Act only dealt with the issuance and distribution of new securities, additional

---

39 See text accompanying notes 42-115 infra.
40 See text accompanying notes 116-294 infra.
41 See text accompanying notes 295-322 infra.
43 Id. (quoting H.R. Rep. No. 85, 73d Cong., 1st Sess. 2 (1933)).
44 Id.
45 Id. (quoting H.R. Rep. No. 85, 73d Cong., 1st Sess. 4 (1933)).
46 Id.
47 Id. at 563.
current disclosure on a continuous basis was necessary with respect to outstanding securities that were traded among investors to assure an informed investment decision.48

The original statutory framework of the 1933 Act involved four interrelated elements that were designed to maximize the beneficial impact of "the full glare of publicity."50 First, issuers were required to file a registration statement with the SEC that disclosed information concerning the offering and the issuer's business and financial condition.50 Secondly, after the registration statement was filed a waiting period of twenty days was required before the statement could become effective.51 During this interim the investing public, state securities commissions, and independent securities services and advisors had an opportunity to scrutinize and digest the information before any securities were sold.52 Thirdly, a prospectus was required to be delivered to those persons who were contemplating purchasing securities during the distribution.53 Finally, civil liability for false and misleading information provided to investors in the course of the selling effort was imposed, jointly and severally, on the issuer,54 its directors,55 the accountants and other experts who authorized and furnished such information,56 the underwriter of the issue,57 and all persons who controlled any of the foregoing persons.58

48 Id.
49 Id. at 568.
50 15 U.S.C. § 77aa (1976) (Schedules A & B). The disclosures relating to the issuer's business and financial condition include information on business and property, controlling and controlled persons, compensation and other interests of management, material contracts, capital structure and options, the terms of outstanding securities, financial conditions, and results of operations. Id.
52 ADVISORY COMMITTEE REPORT, supra note 42, at 568-69.
53 15 U.S.C. § 77j (1976). The prospectus is the document that is to contain all material facts concerning a company and its operations so that a prospective investor may make an informed investment decision. Id. § 77b(10).
The 1933 Act disclosure obligations were potentially applicable to all issuers of non-exempt securities, but only when new securities were offered to the public. In addition, the obligation to update the information provided in connection with an offering terminated upon completion of the distribution. Thus, 1933 Act disclosure was designed specifically to confront the peculiar circumstances inherent in the distribution of securities to the public. In view of the occasional nature of such distributions, the 1933 Act did not assure a reliable source of information for investors who, in later years, purchased and sold those outstanding securities.

The 1934 Act was designed to address this problem of providing reliable information to subsequent purchasers and sellers. The 1934 Act had as its dominant purpose the regulation of securities being traded in the markets and thereby expanded the role of disclosure in the scheme of securities regulation in several important respects. The most important aspect, for purposes of this comment, was the requirement that information essentially similar to that provided under the 1933 Act be filed with the SEC on a continuous basis. In order to assure the general availability of accurate information in the marketplace, issuers with securities traded on the national stock exchanges were required to register outstanding securities. This was accomplished by filing a registration statement containing disclosures basically the same as those contained in a 1933 Act registration statement, omitting, however, special information about the offering, since none was involved.

---

58 15 U.S.C. § 77c (1976). Certain securities are exempt from registration under the 1933 Act, such as government and municipal bonds, bank stock, short term paper, insurance policies, annuities, building and loan association stock, railroad shares, bankruptcy trustee certificates, and intrastate offerings. Id.


61 ADVISORY COMMITTEE REPORT, supra note 42, at 572.

62 Id.

63 Id. at 573. These included the adoption of a continuous disclosure system (15 U.S.C. §§ 78l, 78m (1976)), amendments to the proxy rules to discourage insider trading (15 U.S.C. § 78n (1976)), and new regulations directed at the over the counter market (15 U.S.C. § 78o (1976)). Id. at 573-83.


65 15 U.S.C. § 78l(a) (1976). The registration statement must be filed prior to effecting any transaction in any security. Id.


67 Id.
The replacement of stale information with fresh data was accomplished through periodic and current reporting requirements. First in importance was the Form 10-K, an annual report filed within 120 days after the close of each fiscal year that contained certified financial statements for the fiscal year, together with a current restatement of certain data and an updating of other data previously required to be disclosed. Secondly, for most but not all registrants, there was a Form 9-K, a semiannual report containing some basic financial data on an uncertified basis. Thirdly, there was a Form 8-K, a current developments report required to be filed by the tenth of the month following that month in which the development occurred.

A major problem encountered under this two Act system was that each regime operated independently of the other. When registration under the 1933 Act was mandated, the full panoply of required information had to be disclosed, and it made no substantial difference whether the issuer was a continuous registrant under the 1934 Act. Thus, the company may have been filing for many years, including its latest fiscal year, financial statements meeting SEC accounting regulations; yet when 1933 Act registration was required, the same financial data for recent years again had to be included in the prospectus. This duplication raised the cost of making the public offering.

While the disclosure frameworks have remained basically the same and the disparate orientations of the two Acts still exist, the gap between the two frameworks has significantly narrowed since 1934. In 1936, Section 15(d) was added to the 1934 Act, making

---

69 Id. at 1356-57.
71 Cohen, supra note 68, at 1357.
72 17 C.F.R. § 249.308 (1980).
73 Cohen, supra note 68, at 1357.
74 Id. at 1345.
75 Id. at 1345. There were limited differences. Id. at 1378-79.
the continuous disclosure system applicable to all companies whose securities had once been offered to the public and registered under the 1933 Act, but were, nevertheless, unlisted." The disparity within the 1934 Act between disclosure requirements for unlisted and listed securities was not resolved until the passage of the Securities Acts Amendments of 1964, when Section 12(g) was added to the 1934 Act. Section 12(g) required issuers with total assets of more than $1 million and a class of equity security held of record by 500 or more persons, to comply with the 1934 Act continuous disclosure provisions, regardless of the company's listed or unlisted status. These amendments closed the gap that existed under the 1934 Act disclosure requirements and established a solid foundation upon which to develop a more meaningful disclosure system.

Shortly thereafter, in 1966, Milton Cohen, a principal advocate of the concept of integrating the disclosure frameworks under the two Acts, opined that the disclosure frameworks would have been quite different, and perhaps more congruent, if they "had been enacted as a single integrated statute—that is, if the starting point had been a statutory scheme of continuous disclosure covering issuers of actively traded securities and the question of special disclosures in connection with public offerings had been faced in [that] setting." It was his thesis that a new coordinated system should have as its basis the continuous disclosure system of the 1934 Act and that 1933 act disclosure should be treated as a special incident within this framework. The existing legislative anomaly and Cohen's thoughts provided the impetus for the SEC's

77 45 Fed. Reg. 63,693, 63,694 (1980). Unlisted refers to companies not listed on the national exchanges. Id.
80 Id. Held of record does not include all beneficial owners of the stock because of the practice of holding stock in "street names" (the name of the broker or financial institution). See generally W. CARY and M. EISENBERG, CORPORATIONS 290-91 (5th ed. 1979).
81 45 Fed. Reg. 63,693, 63,694 n.10 (1980). This afforded investors in publicly-held companies whose securities were traded over the counter the same fundamental disclosure protections as had been provided to investors in companies whose securities were listed on an exchange. See Securities Act Release No. 4725 (1964).
83 Cohen, supra note 68, at 1341-42.
84 Id. at 1342.
efforts at establishing an integrated disclosure system under the two Acts.\(^6\)

In November 1967 the SEC took initial steps toward a closer integration of the two Acts by adopting Form S-7.\(^7\) Form S-7 was a simplified form for registration of securities under the 1933 Act.\(^8\) Only issuers who were subject to the 1934 Act reporting requirements and who had a long record of earnings and stability in management and business could use the new form. It was designed to ease both the burden on the issuer of preparing the registration statement and the burden on the SEC staff of processing it.\(^9\)

At the same time the SEC formed an internal study group, the Disclosure Policy Study, to consider areas in which administrative action should be taken to improve the system of corporate disclosure. Its report, commonly referred to as the Wheat Report,\(^10\) recommended specific administrative reforms that would "enhance the degree of coordination between the disclosures required by the [19]33 and [19]34 Acts . . . .\(^{11}\)" The Study recommended that the SEC acknowledge the improved content and dissemination of 1934 Act reporting and more closely coordinate the disclosures under the 1934 Act with those made pursuant to the 1933 Act.\(^12\) It further recommended increased availability of shortened registration forms for certain quality companies and the development of one or two page prospectuses incorporating by reference significant information in a Company's 1934 Act file.\(^13\) The report concluded that 1933 and 1934 Act coordination was dependent on substantial improvement in 1934 Act reporting. More comprehensive reporting forms, better administration and enforcement of the regulations relating to the preparation and filing of such forms, and better dissemination of the information contained in such forms were also suggested by the Study as means to accomplish the goal of co-

\(^{7}\) 17 C.F.R. § 239.26 (1980).
\(^{9}\) Id.
\(^{10}\) SEC, Disclosure to Investors: A Reappraisal of Administrative Policies under the '33 and '34 Acts (1969) [hereinafter cited as Wheat Report].
\(^{11}\) Id. at 8.
\(^{12}\) Id.
\(^{13}\) Advisory Committee Report, supra note 42, at 615-16.
ordinating all SEC disclosure. In response to the recommendations of the \textit{Wheat Report}, the SEC expanded the availability of Form S-7 to include a larger class of registrants and adopted Form S-16 for secondary offerings of securities. Form S-16 contained minimal prospectus disclosure and placed more reliance on information previously reported under the 1934 Act. It incorporated by reference 1934 Act documents rather than reiterating and delivering such information to investors. In another vein the SEC moved to increase the use, availability, and quality of the annual report to security holders by amending Rules 14a-3 and 14c-3 to require that the annual report contain certain minimum financial information. These efforts tended to reduce the anomaly of two distinct disclosure frameworks, but did so only for the top tier of companies. Most registrants were still subject to the two separate systems.

Continuing its efforts toward integration of the two systems, the SEC appointed the Advisory Committee on Corporate Disclosure (Advisory Committee) in 1976 to review the SEC's disclosure policies and the premises upon which they were based. The Advisory Committee report concluded that the SEC's premise that mandated disclosure was necessary for informed investment decisions was basically sound. It then proceeded to outline several procedural and substantive recommendations concerning SEC disclosure requirements and standards. These recommendations included: 1) encouraging issuers to publish forward-looking informa-

\begin{thebibliography}{10}
\bibitem{} Id. at 616.
\bibitem{} Id. This larger class included companies which were not closely followed by the market. \textit{Id}.
\bibitem{} 17 C.F.R. § 239.27 (1980).
\bibitem{} \textit{Advisory Committee Report, supra note 42, at 616.}
\bibitem{} See notes 15-16 supra.
\bibitem{} \textit{Advisory Committee Report, supra note 42, at 617.}
\bibitem{} Id. The top tier refers to the seasoned, exchange-traded companies.
\bibitem{} Id.
\bibitem{} See note 42 supra.
\bibitem{} \textit{Advisory Committee Report, supra note 42, at II.}
\bibitem{} Id. at 305-555.
\end{thebibliography}
tion\textsuperscript{108} with the protection of a safe harbor rule;\textsuperscript{109} 2) adoption of a single integrated disclosure form;\textsuperscript{107} 3) classification of companies into three levels,\textsuperscript{108} 4) elimination of rules in Regulation S-X\textsuperscript{109} that duplicated generally accepted accounting principles (GAAP),\textsuperscript{110} and 5) revision of the existing Form 10-K.\textsuperscript{111}

In implementing the new integrated disclosure system announced in the September 2, 1980, release,\textsuperscript{112} the SEC drew upon many of the resources, ideas, and concepts of the Advisory Committee as well as those of the \textit{Wheat Report} and Milton Cohen. The SEC also incorporated ideas suggested by Professor Homer Kripke,\textsuperscript{113} who participated on the Advisory Committee but dissented from its report.\textsuperscript{114} Finally, the SEC incorporated some of its own conclusions in what it hoped would be a synthesis of concepts and ideas that represented a consensus of the users of SEC generated disclosure.\textsuperscript{115}

\section*{II. THE INTEGRATED SYSTEM}

In order to promote the integration of the 1933 Act and the 1934 Act disclosure systems, the SEC envisioned a system that would allow periodic and other reports filed under the 1934 Act to be used in connection with the registration of securities under

\begin{enumerate}
\item \textsuperscript{108} \textit{Id.} at D-34. Forward-looking information includes information involving financial projections, management plans and objectives for future operations, future economic performance, and the assumptions underlying such information. 17 C.F.R. \S\S 230.175, 240.3b-6 (1980).
\item \textsuperscript{109} \textit{Advisory Committee Report, supra} note 42, at D-34. A safe harbor rule protects management from liability for inaccurate forward-looking information when a disclosed assumption does not occur. 17 C.F.R. \S\S 230.175, 240.3b-6 (1980).
\item \textsuperscript{107} \textit{Advisory Committee Report, supra} note 42, at D-40. See text accompanying notes 119-120 infra.
\item \textsuperscript{108} \textit{Id.} The framework contemplated dividing issuers into three categories based on such factors as longevity of reporting, dissemination and professional analysis of information, and financial stability. The SEC has proposed for comment such a framework to be implemented in light of its new integrated disclosure system announced on September 2, 1980. \textit{See Securities Act Release No. 6235, 45 Fed. Reg.} 63,693 (Sept. 25, 1980).
\item \textsuperscript{109} 17 C.F.R. \S 210 (1980). See note 18 supra.
\item \textsuperscript{110} \textit{Advisory Committee Report, supra} note 42, at D-42—D-43.
\item \textsuperscript{111} \textit{Id.} at D-44—D-48.
\item \textsuperscript{112} See note 11 supra, and accompanying text.
\item \textsuperscript{113} See note 23 supra.
\item \textsuperscript{114} \textit{Advisory Committee Report, supra} note 42, at D-49.
\item \textsuperscript{115} \textit{Corporate Disclosure, supra} note 23, at 128-29.
\end{enumerate}
the 1933 Act. The SEC saw that one way to permit such use would be to incorporate a filed 1934 Act report by reference into a 1933 Act registration statement, as is permitted in the case of Form S-16. \textsuperscript{10} Such incorporation by reference had its limitations. There was no assurance that the mere reference to incorporated information would be meaningful to the recipient of a prospectus. Form S-16, which applied only to seasoned, exchange-traded companies, worked because the information in the incorporated filings was thoroughly analyzed by the market and was reflected in the price or rating of the securities being offered.\textsuperscript{11} This “incorporation by reference” technique, however, was not deemed suitable for companies that were not seasoned, exchange-traded companies because the analysis was less thorough and was not accurately reflected in the price or rating of the securities being offered.\textsuperscript{12}

The Advisory Committee took an initial step in attempting to design an effective “incorporation by reference” system that could be implemented with respect to all registered companies as opposed to just S-16 companies.\textsuperscript{13} It recommended a relatively unstructured document that would encourage registrants to combine informal annual and quarterly reports into a single document to be filed as a Form 10-K or Form 10-Q.\textsuperscript{14} This would assure that the annual report and the 10-K would contain the same information. Accordingly, when the prospectus would incorporate by reference to Form 10-K the security holders would have this information readily available to them in the annual report.

The SEC, however, had two principal reservations to the format proposed by the Advisory Committee.\textsuperscript{15} First, while the existing annual report was a readable document designed to be delivered to shareholders, the Form 10-K, because it was designed for analytical purposes, had a structure and technical quality that was not generally considered readable.\textsuperscript{16} Secondly, the SEC believed


\textsuperscript{11} Id.

\textsuperscript{12} Id.

\textsuperscript{13} See notes 95-97 supra, and accompanying text.

\textsuperscript{14} 45 Fed. Reg. 5972, 5973 (1980).

\textsuperscript{15} Id. at 5974.

\textsuperscript{16} Id.
that a mandate to combine totally the Form 10-K and annual report to security holders in order to produce a readable Form 10-K would be overly burdensome on some registrants and make SEC staff review more difficult. 133

In the search for a plan of integration, the SEC evaluated the disclosure policies and procedures underlying the 1933 Act and 1934 Act to identify what it thought was material information to investment and voting decisions. It premised its findings on the equivalence between reporting at the time of distribution of securities to the public under the 1933 Act and continuous periodic reporting under the 1934 Act. The SEC's position was that what was materially important for transactions involving offerings under the 1933 Act was equally important for an informed trading market. 134

The SEC, therefore, proposed a restructured Form 10-K. The principal feature of this change was the requirement that certain basic financial information must be set forth in the registrant's annual report and that this information, in turn, must be incorporated by reference into the Form 10-K. 135 In this manner the 10-K would still contain the detailed disclosures used primarily by institutional investors and professional analysts, but this information would not have to be disclosed in the annual report. The annual report would be required to contain only that information that the SEC believed should be given maximum public exposure. 136 More importantly, this information would then be available to supplement the prospectus describing the public offering without duplicating the information in the prospectus. Consequently, where the Advisory Committee envisioned the Form 10-K as the docu-

133 Id. The inability to assure in all cases that there would be a single document that would be available as a combination of the annual report to security holders and Form 10-K arose primarily because of the Business, Properties and Legal Proceedings disclosures called for under Items 1, 2 and 5 of Regulation S-K. and because of certain parent and subsidiary financial statements required by Regulation S-X. Although the SEC hoped that most registrants would have little trouble in presenting those items in a combined document, there was evidence that in some cases the sheer volume of the disclosure would adversely affect the readability of the annual report. Id. at 5974 n.5.

134 45 Fed. Reg. 63,693, 63,694 (1980). This excludes information that is merely descriptive of the offering. While material for 1933 Act purposes, such information is wholly inapposite to 1934 Act purposes. Id.


136 Id.
ment to be incorporated by reference, the proposal looked to the annual report as the critical integrating document.\textsuperscript{157}

The mandatory incorporation feature of the proposed Form 10-K was severely criticized by the commentators who responded to the proposed rules changes. Businessmen and their corporate counsel were concerned about the effect of such a mandate on the readability of the annual report, the 1933 Act liability of directors for the report, and what they saw as the beginning of a major incursion by the SEC into management's major security holder communication.\textsuperscript{158} As a result of this criticism, the mandatory feature was eliminated and the SEC adopted a compromise system that placed the emphasis on the "Basic Disclosure Package."\textsuperscript{159} This was accomplished by permitting registrants either to incorporate the information contained in this package from the annual report to the Form 10-K or to restate it completely.\textsuperscript{160} Accordingly, the SEC extensively revised and restructured the Form 10-K to facilitate incorporation by reference of the annual report and adopted several changes in Rules 14a-3 and 14c-3\textsuperscript{161} to require the annual report to contain the "Basic Disclosure Package."\textsuperscript{162}

A. Regulation S-K: Development of the "Basic Disclosure Package"

The principle of equivalence between reporting under the 1933 Act and reporting under the 1934 Act led to the development of Regulation S-K\textsuperscript{163} as a technical device designed to state in one place standard and integrated disclosure requirements that would be common to both 1933 Act and 1934 Act reporting. In December 1977 the SEC adopted Items 1 and 2 of Regulation S-K, dealing with business\textsuperscript{164} and properties,\textsuperscript{165} respectively, marking the

\textsuperscript{157} Id. at 5973-74.
\textsuperscript{158} 45 Fed. Reg. 63,630, 63,632 n.8 (1980).
\textsuperscript{159} See notes 144-217 infra.
\textsuperscript{160} 45 Fed. Reg. 63,630, 63,631 (1980).
\textsuperscript{161} See notes 15 & 16 supra.
\textsuperscript{162} See notes 147-217 infra.
\textsuperscript{163} 17 C.F.R. § 229.20 (1980). See note 17 supra.
\textsuperscript{164} Id. Item 1. This item requires disclosure relating to the general development of the business, its plan of operations, revenue and profit figures by industry segment, expenditures related to research and development, the product lines, number of employees, and a narrative description of the business. Id.
\textsuperscript{165} Id. Item 2. This item requires disclosure relating to the location and
first significant step toward achieving standard disclosure under both Acts. In July 1978 Items 3 through 6 were added, dealing with directors and executive officers, management remuneration, legal proceedings, and beneficial ownership, respectively. In August 1980 Item 7 was added, dealing with exhibits. The Regulation seeks to define what information is material to an investment or voting decision, whether under the purview of the 1933 Act or the 1934 Act. The refinement of disclosure items in Regulation S-K was therefore a recognized prerequisite to full integration of the registration and reporting requirements under the two Acts. Thus on September 2, 1980, the SEC revised and expanded Regulation S-K to include four new items that constitute the "Basic Disclosure Package." This package must be included

general character of the operation, plant, and other physical structures, designating any encumbrances on such property and categorizing them by industry segment. Id.


129 Id. Item 4. See text accompanying note 259 infra, for a discussion of required disclosure.

130 Id. Item 5. This item requires disclosure relating to any material legal action pending or contemplated by a government agency. The company must disclose the court or agency in which the action is pending, the date it was brought, the principal parties, the factual basis of the action, and the relief sought. Id.

131 Id. Item 6. This item requires disclosure in tabular form of the number of shares and the percentage of shares outstanding that are owned by beneficial owners of more than 5% of any class of voting security or by management. Id.


133 Id. 45 Fed. Reg. 58,825 (Sept. 5, 1980) (to be codified in 17 C.F.R. § 229.20 Item 7). This item provides a table showing which exhibits are required for certain forms. Some typical exhibits associated with the Form 10-K include the articles of incorporation, by-laws, instruments defining the rights of security holders, and material contracts. Id.


in both the company's annual report and its Form 10-K. As a result, this package will become the central disclosure mechanism in the integrated disclosure system and hence its contents deserve a detailed discussion.146

Item 9.147 Market for the Registrant's Common Stock and Related Security Holder Matters

Item 9 combines elements of paragraph 8 of Rule 14a-3,148 which required market price information to be included in the annual report, Guide 26,149 which required a statement of a registrant's dividend policy, and Item 9 of the old Form 10-K, which required information as to the approximate number of equity security holders. The only substantial change implemented by this new item is to move the item to Regulation S-K. Therefore, it will be easier for this information to be referenced into other reporting forms if such reference is advisable at a later date.150

Item 9(a) requires that the company identify principal markets on which its common stock is traded or furnish a statement that there is no market for the stock.151 For each quarter in the past

146 45 Fed. Reg. 63,630, 63,646 (1980). Rules 14a-3 and 14c-3 were amended to require that the annual report to security holders include the Basic Disclosure Package. Id.

147 Id. at 63,640 (to be codified in 17 C.F.R. § 249.310 Part II). See text accompanying notes 223-64 infra. The SEC has proposed to revise and expand Regulation S-K even further. The SEC proposes to subdivide Regulation S-K into seven categories: 1) Application; 2) Business; 3) Financial Information; 4) Management; 5) Securities of the Registrant; 6) Distribution of Securities; and 7) Other existing items of Regulation S-K, including those discussed in this comment, which would then be renumbered and relocated by subject matter. In addition the SEC took the first step in its "sunset review" program by proposing to withdraw or consolidate in Regulation S-K or Regulation C all but six of the sixty-five registration guides. Securities Act Release No. 6276 (Jan. 7, 1981).


151 45 Fed. Reg. 63,630, 63,643 (1980) (to be codified in 17 C.F.R. § 229.20). This item was revised from its proposed form, which would have required market information for all of the registrant's securities, to limit the market data only to that for common stock because it is the most relevant market information for investors and financial users. Id. at 63,635.
two years, the company must report either high and low sales prices if the market is an exchange or high and low bid quotations if the market is not an exchange.\textsuperscript{152} Item 9(b) requires that the company set forth the approximate number of holders of common stock.\textsuperscript{153} Item 9(c) requires that the company state the frequency and amount of dividends paid during the past two years with respect to common stock and describe any restrictions on its present or future ability to pay such dividends.\textsuperscript{154} Item 9(d) makes the disclosure of any further dividend policy completely optional\textsuperscript{155} because it appeared that dividend policy requirements had not elicited meaningful disclosure but had resulted in meaningless legalistic language.\textsuperscript{156}

In addition to the basic text of Item 9, the SEC has given special instructions to registrants who are foreign issuers. Under Instruction 2, in an effort to obtain data on these matters, a foreign issuer is required to include information regarding laws, decrees, or regulations of its country of origin that may impact dividend or interest payments to security holders,\textsuperscript{157} affect the right to hold or vote securities,\textsuperscript{158} or impose taxes on United States security holders.\textsuperscript{159}

\textit{Item 10. Selected Financial Data}

This item replaces the Summary of Operations that was previously called for under Item 2 of Form 10-K, reflecting the SEC's concern that operations summaries have duplicated information otherwise available in the financial statements, have not presented significant trend information, and may have unduly emphasized income over other enterprise performance measures.\textsuperscript{160} The com-

\textsuperscript{152} Id. at 63,643 (to be codified at 17 C.F.R. § 229.20 Item 9(a)).
\textsuperscript{153} Id. (to be codified in 17 C.F.R. § 229.20 Item 9(b)).
\textsuperscript{154} Id. (to be codified in 17 C.F.R. § 229.20 Item 9(c)).
\textsuperscript{155} Id. (to be codified in 17 C.F.R. § 229.20 Item 9(d)).
\textsuperscript{156} Id. at 63,635. Initially a discussion of dividend policy was "strongly encouraged," 45 Fed. Reg. 5972, 5982 (1980), but the SEC backed off in the final draft and merely "encouraged" discussion of dividend policy. 45 Fed. Reg. 63,630, 63,643 (1890).
\textsuperscript{157} Id. at 63,643 (to be codified in 17 C.F.R. § 229.20 Item 9, Instruction 2(a)).
\textsuperscript{158} Id. (to be codified in 17 C.F.R. § 229.20 Item 9, Instruction 2(b)).
\textsuperscript{159} Id. (to be codified in 17 C.F.R. § 229.20 Item 9, Instruction 2(c)).
\textsuperscript{160} 45 Fed. Reg. 5972, 5978, 63,630 (1980).
pany and its consolidated subsidiaries are required to provide in comparative columnar form significant five year data reflecting trends in its financial condition and results of operations. Allowing for some variation due to the nature of the enterprise's business, the data should include the following: net sales or operating revenues; income or loss from continuing operations; income or loss from continuing operations per common share; total assets; long term obligations and redeemable preferred stock; and cash dividends per common share. It is suggested that data reflecting the impact of inflation, such as that required by SFAS 33, segment data, such as that required by Item 1 of Regulation S-K, and any other data that will accurately indicate performance should be included in the Item 10 disclosure.

The SEC recognized that a detailed specification of the contents or format of a summary might not cure the perceived deficiencies in the replaced Summary of Operations. To avoid decreasing registrant flexibility the SEC did not increase disclosure requirements or their specificity as was originally proposed. Item 10 strikes a reasonable balance between specified content and flexibility that permits registrants to select data that best indicate performance.

---

161 45 Fed. Reg. 63,630, 63,643 (1980). When the word “enterprise” is used in this comment it refers to the company and its consolidated subsidiaries. Id. (to be codified in 17 C.F.R. § 229.20 Item 10, Instruction 4).

162 Id. (to be codified in 17 C.F.R. § 229.20 Item 10(a)). The enterprise may have to present data for more than five years if it is necessary to prevent the summary from being misleading. Id. (to be codified in 17 C.F.R. § 229.20 Item 10(b)).

163 Id. (to be codified in 17 C.F.R. § 229.20 Item 10, Instruction 2).

164 Id. (to be codified in 17 C.F.R. § 229.20 Item 10, Instruction 3). SFAS 33 specifies the minimum disclosures that are required to be presented as supplemental information in annual reports. The disclosure is to be made in two fundamentally different measurement approaches: (1) Historical cost/constant dollar accounting, which deals with general inflation (changes in the purchasing power of the dollar as represented by the Consumer Price Index); (2) Current cost accounting, which addresses the effect of specific price changes on a company's resources. FASB Statement No. 33, “Financial Reporting and Changing Prices” (Sept. 1979). See Accounting Series Release No. 271 (Oct. 23, 1979).

165 Id. at 63,635. See note 134 supra.

166 Id. at 63,643 (to be codified in 17 C.F.R. § 229.20 Item 10, Instruction 2).

167 Id. at 63,635. This revised format follows to a great extent that suggested by the Advisory Committee in Exchange Act Release No. 15,068 (Aug. 16, 1978) but provides for greater flexibility. 45 Fed. Reg. 5972, 5978 (1980).
Item 11. Management's Discussion and Analysis of Financial Condition and Results of Operations

Item 11 represents a restructuring and expansion of earlier requirements outlined in Guides 1 and 22. This was done because the SEC thought that the Guides were not fulfilling the objectives that had originally been contemplated. The purposes for the new item are to give the registrant the opportunity to articulate its objectives and financial policies, describe where it is headed and how it hopes to get there, and establish and maintain credibility.

The SEC has characterized this new item as a key component of the "Basic Disclosure Package" and has underscored its importance by stating that "management is in the best position to know what it is about its company that is important to the users of its reports, and management need not await the development of specific disclosure requirements by the SEC."

The SEC in proposing this new item was concerned basically with three problems. First, it was concerned that existing percentage tests found in the Guides were applied without regard to any concept of materiality or significance to the registrant's business. Accordingly, while some portions of the discussion would be meaningful, the meaningful discussion would be obscured by the inclusion of irrelevant material. Secondly, the SEC was concerned that the focus of the Guides was too narrow because the economic environment dictated the need to analyze an enterprise's liquidity and capital resources, as well as its revenues and income. Contrary to the objectives of the SEC, the Guides did not prompt disclosure regarding the financial condition of the enterprise as a

---
168 17 C.F.R. § 231.4936 (1980). These guides set out the specifics of what management is to discuss in this item. Id.
169 45 Fed. Reg. 63,630, 63,636 (1980). The original objective was to provide a framework whereby management could convey to its security holders an analysis of its financial condition in terms they would understand. Id.
173 Id.
174 Id. Most companies today are made up of numerous subsidiaries that all affect the financial condition of the parent company. Id.
175 See note 161 supra.
whole.\textsuperscript{177} Finally, the SEC was concerned about the adequacy of disclosures as to the impact of inflation and changing prices on individual registrants’ businesses.\textsuperscript{178}

The approach of Item 11 focuses disclosure on material that is relevant to the financial condition of the enterprise, with emphasis on liquidity,\textsuperscript{179} capital resources,\textsuperscript{180} and results of operations.\textsuperscript{181} The liquidity and capital resource discussions\textsuperscript{182} address an investor’s need for more information about a company’s ability to meet its need for cash, its commitments for capital expenditures, and the anticipated sources of funds to meet those needs.\textsuperscript{183} Trends or known changes that will materially affect both long-term and short-term liquidity\textsuperscript{184} must be disclosed, along with the mix and relative cost of capital resources.\textsuperscript{185} Any discussion of capital resources should consider changes among equity, debt, and off-balance sheet financing arrangements.\textsuperscript{186} The SEC suggests that disclosure of information concerning future cash outlays for income taxes that exceed current income tax expense is the type of information that should be provided, even though it is not explicitly required by Item 11.\textsuperscript{187} The purpose of these disclosures is to assist the investor in evaluating the amounts and certainty of cash flows, both from operations and outside sources.\textsuperscript{188} The discussion, therefore, has been expanded to focus on the full financial statements and other statistical data that the registrant believes will enhance a reader’s understanding of its financial condition, changes in financial condition, and results of operations for the three year period covered.

\textsuperscript{177} Id.
\textsuperscript{178} Id.
\textsuperscript{179} Id. at 63,643 (to be codified in 17 C.F.R. § 229.20 Item 11(a)).
\textsuperscript{180} Id. (to be codified in 17 C.F.R. § 229.20 Item 11(b)).
\textsuperscript{181} Id. (to be codified in 17 C.F.R. § 229.20 Item 11(c)).
\textsuperscript{182} Id. These two discussions may be combined whenever they are interrelated.
\textsuperscript{183} Id. See Items 11(a), (b)(1) and Instruction 5 at 45 Fed. Reg. 63,644 (1980).
\textsuperscript{184} Id. at 63,644 (to be codified at 17 C.F.R. § 229.20 Item 11, Instruction 5).
\textsuperscript{185} Id. at 63,643 (to be codified in 17 C.F.R. § 229.20 Item 11(b)(2)).
\textsuperscript{186} Id.
\textsuperscript{188} 45 Fed. Reg. 63,630, 63,644 (to be codified in 17 C.F.R. § 229.20 Item 11, Instruction 2).
Forward-looking information is encouraged but not required by Item 11. The company, however, is required to reveal data presently known that will have a predictable future effect, such as known future increases in the cost of labor or materials. The SEC is especially concerned that management might focus on financial data that may be misleading, either because it reflects past events that are unlikely to occur in the future or because it fails to reflect matters that will have a future impact but have not been significant in the past. If the company includes the optional forward-looking information it will be protected by the safe harbor rule for projections. While it is understandable for management to be gun-shy about projections, management forecasts are one of the most useful pieces of input a financial analyst has. Investors generally consider it useful to have management's projections since these statements reflect both management's vast amount of information and its own particular biases. The communicative format of Item 11 and the requirement that this information be in the annual report are beneficial to investors and consistent with the objectives of the integrated disclosure system.

Item 11(c) addresses the disclosure of results of operations.

---

188 Id. The information need only include that which is available to the registrant without undue effort or expense.

189 See note 105 supra.


191 Id.

192 Id. (to be codified in 17 C.F.R. § 229.20 Item 11, Instruction 3).

193 Id. See note 106 supra.


195 Id. Roberta Karmel, former SEC Commissioner, has expressed doubts about requiring forward-looking information. She thinks that such disclosures are questionable because in this inflationary age a great deal of hard information is getting soft. Further, she has said that it does not seem fair to put corporations at their peril, in terms of their potential liability under the securities laws or simply embarrassment in the eyes of the financial community, for making good faith predictions that prove false. Flax, Police Brutality?, FORBES, May 12, 1980, at 180.


197 45 Fed. Reg. 63,630, 63,643 (1980) (to be codified in 17 § C.F.R. 229.20 Item 11(c)).
It is aimed at identifying unusual, infrequent, or significant events, transactions or economic changes that materially affected the reported income of the company, and revealing the extent to which income was affected. In addition, the company must explain material increases in net sales or revenues, describe trends or uncertainties that may materially alter net sales, revenues or income, and disclose expected material changes in the relationship between costs and revenues.

Item 11(c)(4) stresses the disclosure of the impact of inflation and changing prices for fiscal years beginning after December 25, 1979. With inflation one of the most important topics in this country today, the investor is interested in the effect of inflation on the future cash flows of the company. Financial analysts assert that the impact of inflation cannot be revealed simply by the financial statements of past operations. Therefore, by providing management a forum and a framework for attacking this subject with more than mere statistical data, the SEC expects that the investor will be provided useful information.

Two final points concerning Item 11 deserve mention. First, where certain line items on consolidated financial statements reveal material changes, meaningful explanation is preferred over a line by line analysis that merely repeats numerical data easily computed from the financial statements. Secondly, foreign private registrants must include a discussion of pertinent governmental, economic, fiscal, monetary, or political factors that have materially affected or could materially affect, either directly or indirectly, company operations or investments by United States nationals.
Item 12. Supplementary Financial Information

Item 12 deals with the disclosure of selected quarterly financial data for those companies who have registered securities under the 1934 Act and have net income after taxes\(^{208}\) of at least $250,000 or total assets of at least $200 million.\(^{209}\) The disclosure includes net sales, gross profit, income before extraordinary items and the cumulative effect of a change in accounting, per share data based on net income, and net income for each full quarter within the two most recent fiscal years as well as for any subsequent interim period for which statements of income are presented.\(^{210}\) Discrepancies with previously filed reports such as Form 10-Q\(^{211}\) must be reconciled and explained.\(^{212}\) Furthermore, data as to the disposal of a segment of the business or other extraordinary events occurring in the last two fiscal years and in any subsequent interim period must be disclosed.\(^{213}\) The new rules merely relocate this item from Regulation S-X to Regulation S-K in recognition of the fact that this financial information is not required to be audited.\(^{214}\)

Item 12(b) deals with disagreements on accounting and disclosure of financial matters between registrants and their predecessor accountants that would have significantly affected the previous statements.\(^{215}\) This disclosure, according to Regulation S-X, was previously required to be placed in the notes to the financial statements. Several commentators, however, responding to the proposal that this requirement continue unchanged, argued that this disclosure was not of financial significance and should not be included in the notes to the financial statements.\(^{216}\) The SEC, while continuing to believe that this disclosure was necessary to put

\(^{208}\) 45 Fed. Reg. 63,660, 63,680 (1980). The net income after taxes figure is calculated without including extraordinary items or the cumulative effect of a change in accounting. Id.

\(^{209}\) Id. at 63,680-81 (to be codified in 17 C.F.R. § 229.20 Item 12(a)(1)(A) and (ii)). If the registrant is an insurance company it is exempted from this item, provided it does not meet the test set forth in Item 12(a)(1). Id.

\(^{210}\) Id. (to be codified in 17 C.F.R. § 229.20 Item 12(a)(2)).

\(^{211}\) 17 C.F.R. § 249.308a (1980). See note 70 supra.

\(^{212}\) 45 Fed. Reg. 63,660, 63,681 (1980) (to be codified in 17 C.F.R. § 229.20 Item 12(a)(3)).

\(^{213}\) Id. (to be codified in 17 C.F.R. § 229.20 Item 12(a)(4)).

\(^{214}\) Id. at 63,667.

\(^{215}\) Id. at 63,681 (to be codified in 17 C.F.R. § 229.20 Item 12(b)).

\(^{216}\) Id. at 63,664.
users of financial statements on notice of such disagreements, con-
cluded that the disclosure could be made outside of the financial
statements. Accordingly, it relocated this rule from Regulation S-X
to Regulation S-K.  

B. Annual Report to Security Holders

The increased burden of disclosure imposed on the annual report
by the new rules requiring the inclusion of the “Basic Disclosure
Package” is not designed to change the basic structure or quality
of the report. Instead, these changes are intended to provide
security holders with meaningful information regarding the busi-
ness, management operations, and financial position of the com-
pany through “the most effective means of communication between
management and security holders.” The recognition by the SEC
that the constituencies served by the annual report and Form 10-K
are different, both in need for information and the ability to utilize
it, led to the development of the “Basic Disclosure Package” as
an alternative to total integration. This package represents the
SEC’s view of what constitutes the minimum information necessary
to make an informed investment or voting decision and is therefore
deserving of maximum public exposure.  

C. Form 10-K

The restructured Form 10-K is specifically designed to segregate
the “Basic Disclosure Package” from proxy-related or supplemental
information. Accordingly, it is structured in four parts. Part I re-
tains the detailed disclosure requirements relating to business, prop-

\footnotesize

217 Id.
218 Id. at 63,646.
219 Id. at 63,632. The SEC is aware that the increased disclosure involves
a risk that readability may be impaired, but it encourages the company to con-
tinue to produce high quality, readable, and attractive annual reports in language
that the investor will understand. According to the SEC, the commonly stated
belief that disclosures made under the 1933 Act must be more legalistic and
less communicative is a misperception. Differences do not relate to form but
merely to the degree of care taken in making the disclosure. The SEC con-
siders the slight increased cost associated with a higher standard of care to be
more than offset by the general reduction in the volume of required disclosure.
221 Id. at 63,630.
erties, legal proceedings, and beneficial ownership. These disclosures have been placed in a supplemental role because they are not required to be included in the annual report. Part II consists of the "Basic Disclosure Package" that is common to both 1933 Act and 1934 Act disclosures and may be incorporated by reference to the annual report. Part III consists of traditional proxy disclosure information relating to directors and executive officers and management remuneration. This part may be completed by incorporation of a proxy or information statement. Finally, Part IV includes requirements for financial statement schedules that are not found in the annual report, exhibits required under Regulation S-K, and reports filed on Form 8-K. It is possible under

224 Id. The SEC, however, does encourage the inclusion of this information on a voluntary basis. If the information is included in the annual report, it may be incorporated by reference into the Form 10-K. 45 Fed. Reg. 5972, 5975 (1980). Since incorporation by reference only "files" the information contained in the "Basic Disclosure Package" (unless the company opts to make the more detailed disclosure of Part I of the Form 10-K in its annual report and incorporates it by reference), all other information in the annual report will be deemed not filed. 45 Fed. Reg. 63,630, 63,639 (1980).

225 Id. at 63,633. See notes 137-38 supra.

227 Id. at 63,632. See note 142 supra.

228 Id. at 63,637. See text accompanying note 72 supra. The outline of the new Form 10-K is as follows:

General Instructions
Cover Page

Part I
Item 1. Business (Item 1 in Regulation S-K)
Item 2. Properties (Item 2 in S-K)
Item 3. Legal Proceedings (Item 5 in S-K)
Item 4. Security Ownership of Certain Beneficial Owners and Management (Item 6 in S-K)

Part II
Item 5. Market for the Registrant's Common Stock and Related Security Holder Matters (Item 9 in S-K)
Item 6. Selected Financial Data (Item 10 in S-K)
Item 7. Management's Discussion and Analysis of Financial Condition and Results of Operations (Item 11 in S-K)
Item 8. Financial Statements and Supplementary Data (Item 12 in S-K)

Part III
Item 9. Directors and Executive Officers of the Registrant (Item 3 in S-K)
this new format that a Form 10-K could conceivably consist of nothing more than a cover page and a cross reference page setting forth that Parts I, II, and III are incorporated by reference. The company would then merely send its annual report and its proxy or information statement to the SEC, along with its 10-K.220

The new Form 10-K does not reflect any change in Items 2, 3, 4, 9, or 10,231 except to the extent that they were renumbered and reordered from the old Form 10-K.232 On the other hand, several items were eliminated from the old Form 10-K, the most significant of which was the Summary of Operations, which was replaced by new Item 6,233 Selected Financial Data.234 Other items were eliminated because the information was not generally useful or because the information is available elsewhere.235

There are a number of significant changes to the Form 10-K in addition to the inclusion of the “Basic Disclosure Package” in Items 5 through 8.236 One of these involves the signature requirements of General Instruction D, which has been expanded from requiring just one authorized signature to require directors’ signatures as well as more officers’ signatures. Form 10-K must now be signed on behalf of the company by the principal executive officer or

---

Item 10. Management Remuneration and Transactions (Item 4 in S-K)

Part IV

Item 11. Exhibits, Financial Statement Schedules, and Reports on Form 8-K (Item 7 in S-K)

Signatures

Supplemental Information

220 Folding 10-Ks into Annual Reports, BUSINESS WEEK, May 12, 1980, at 38 [hereinafter cited as Folding]. See 45 Fed. Reg. 63,630, 63,639 (General Instruction G(4)).

221 See note 229 supra.


223 Id. See note 229 supra.

234 Id.

235 Id. These items include the following: Parents and Subsidiaries (which was deleted in favor of a new exhibit that only requires the names of significant subsidiaries); Increases and Decreases in Outstanding Securities and Indebtedness; Changes in Securities and Changes in Security for Registered Securities; Default upon Senior Securities; Submission of Matter to a Vote of Security Holders; and Indemnification of Directors and Officers. These last five items have to be disclosed in the text or in the notes to the financial statements, if they are material, even if there is no specific requirement covering the particular event or transaction. Id.

236 See notes 144-217 supra, and accompanying text.
When this expanded signature requirement was proposed most of the commentators responding to the rule changes voiced their disapproval both on logistical and legal grounds.\(^\text{238}\) The logistical problem involved the expense and mechanics of obtaining the signatures of outside directors in a timely fashion.\(^\text{239}\) Many company officials agree with the assessment that the expanded signature requirement represents a "cosmetic change" and that the logistics involved would be an onerous, costly task.\(^\text{240}\) The SEC, while giving attention to the concerns of company officials, viewed the new signature requirement as necessary to increase director awareness of company affairs.\(^\text{241}\) Accordingly, it did not view the cost and logistical problems as undue obstacles to attaining that end.\(^\text{242}\)

The legal problems involve the extent to which the expanded signature requirement may increase director liability for information contained in the Form 10-K, especially in light of the incorporation by reference to the annual report.\(^\text{243}\) The SEC takes the position that the provision probably does not increase liability.\(^\text{244}\) It places reliance on the federal district courts' reasoning in \textit{SEC v. Kalvex, Inc.}\(^\text{245}\) and \textit{Blakely v. Lisac.}\(^\text{246}\) In those cases, the courts held that the directors are jointly and severally liable for any misrepresentations in the filed reports,\(^\text{247}\) and the annual report\(^\text{248}\) re-

\begin{flushleft}
\footnotesize
\textsuperscript{237} 45 Fed. Reg. 63,630, 63,638 (1980).
\textsuperscript{238} Id. at 63,634.
\textsuperscript{239} Id.
\textsuperscript{240} Folding, supra note 230, at 38.
\textsuperscript{241} 45 Fed. Reg. 63,630, 63,634 (1980).
\textsuperscript{242} Id.
\textsuperscript{243} Id. The legal arguments on both sides of this issue are too complex to be discussed adequately in the amount of space afforded by this comment; therefore, only brief comments will be made to give the reader a feel for the confusion.
\textsuperscript{244} Id.
\textsuperscript{245} 425 F. Supp. 310 (S.D.N.Y. 1975). In \textit{Kalvex} the director of a company was held liable for false and misleading statements in the 10-K under the 1934 Act, notwithstanding the fact that he had not signed the report. \textit{Id.} at 316.
\textsuperscript{246} 357 F. Supp. 255 (D. Ore. 1972). In \textit{Lisac} directors were held liable for misstatements made in an annual report under Rule 10b-5 of the 1934 Act. \textit{Id.}
\textsuperscript{247} Id. at 259.
\end{flushleft}
Regardless of whose signatures appear thereon. The position of many commentators, however, is that there are legitimate legal arguments that indicate that the SEC has indeed increased director liability. The existence of these legal arguments means that a number of companies will be hesitant to take advantage of the ability to incorporate the annual report by reference into the Form 10-K. The SEC acknowledges this potential impact on legal liability, but considers that the purpose of forcing directors to take a more active and responsible role in 1934 Act disclosure outweighs any potential impact on liability.

A few changes have been made in the cover page of Form 10-K. The number of common shares outstanding now must be disclosed as of the most recent practicable date rather than the end of the last fiscal year. The company must now reveal the market value of the voting stock held by non-affiliates. Finally, a listing of documents incorporated by reference must be included for microfiche purposes.

Item 1 reflects the revised Item 1 of Regulation S-K, with

---

249 Huffman, SEC Approves Rules to Reduce Disclosure Burdens, LEGAL TIMES OF WASHINGTON, Aug. 25, 1980, at 6 [hereinafter cited as Huffman]. Various arguments were raised by commentators to the proposed rule. The American Bar Association viewed the expanded signature requirement as increasing the director's liability under Section 18(a) of the 1934 Act. The Financial Executives Institute commented that the SEC's position was contrary to the simple fact that the new signature requirement would extend personal liability to a director who was not previously required to endorse a Form 10-K. Harvey Pitt, former SEC General Counsel, expressed concern that the signature requirement could alter existing civil liability under Section 15 of the 1934 Act and at a minimum presented a slight ambiguity because of the competing legal theories. See generally SEC. REG. & L. REP. (BNA) D-2-4 at 560 (July 2, 1980); Mann, New Proposal will Integrate Securities Disclosure Requirements, NAT'L L.J., March 3, 1980, at 26.

250 Huffman, supra note 250, at 6.

251 45 Fed. Reg. 63,630, 63,634 (1980). The 1934 Act disclosure referred to includes both the filed reports, such as Form 10-K, and the informal reports, such as the annual report to security holders. Id.

252 Id.

253 Id. "Non-affiliates" refers to companies that are not effectively controlled by the registrant. See 17 C.F.R. § 210.1-02(b) (1980). This change was made to obtain data to be evaluated in connection with possible future changes in the eligibility requirements for various 1933 Act registration forms. Id.

254 Id.

255 See note 229 supra.

256 45 Fed. Reg. 63,630, 63,634 (1980). The revised Item 1 has a three year
the exception that the discussion of development of business need only include developments arising since the beginning of the fiscal year as opposed to those arising over the last three fiscal years. Item 4 has been amended to correct significant distortions arising under prior rules. The amendments, while primarily technical in nature, relate specifically to pension, option, and stock appreciation rights plans, the definition of an executive officer, compensation relating to the termination of employment, indebtedness of management, and transactions with management. Item 11 reflects the SEC's new rule that revised Item 7 of Regulation S-K, which set out the general exhibit requirements applicable to a number of forms, including Form 10-K. Certain financial statements and schedules that are not part of the annual report to security holders are designated "financial statement schedules" rather than "exhibits." The purpose of this new designation is to ensure that security holders requesting a copy of the 10-K from the company will receive the financial statements at company expense, because the company is not required to provide copies of the exhibits to Form 10-K. In addition, an exhibit has been added to Item 7 of Regulation S-K, requiring a list of significant subsidiaries and the names under which such subsidiaries do business.

D. Regulation S-X: Uniformity in Timing, Form and Content of Financial Statements

Regulation S-X was adopted in 1940 for the purpose of codifying the existing instructions as to the form and content of financial statements of income as opposed to a five year requirement. 45 Fed. Reg. 63,682, 63,684 (1980).


45 Fed. Reg. 76,982 (Nov. 21, 1980). These amendments were made after the September 2, 1980 rulemaking that related to the other disclosure requirements.


Id.

Id. at 63,642. A subsidiary is considered significant if the parent's and other subsidiaries' investment exceeds 10% of 1) the total assets, 2) the total sales or revenues, or 3) the equity in income before taxes and extraordinary items—of the parent and its subsidiaries. 17 C.F.R. § 210.1-02(v) (1980).

statements included as part of each of the registration and reporting forms under the 1933 and 1934 Acts. The regulation did not prescribe accounting methods because there was little authoritative literature at that time. Instead, it stated requirements intended to elicit informative disclosures. Following the development of Regulation S-X, the private sector established and improved accounting and reporting standards. As a result, two separate sets of rules evolved with respect to financial statements, one for statements in filed reports prepared in accordance with Regulation S-X and the other for statements in the annual report to security holders that were prepared in accordance with generally accepted accounting principles (GAAP).

**Technical Revisions**

In order to accomplish the objective of integrating financial disclosure in the annual report with equivalent data prepared in accordance with Regulation S-X, the SEC made a number of technical revisions to Regulation S-X to achieve uniformity in the timing, form, and content of financial statements. According to the SEC, the revisions in the content of Regulation S-X are to "(i) eliminate rules which are presently duplicative of generally accepted accounting principles (GAAP), (ii) effect changes to recognize predominant current practice and changes in circumstances, (iii) clarify and modify requirements which are presently subject to differing interpretations, and (iv) expand certain re-

---

262 Id. at 63,660, 63,661.
266 Id.
267 Id.
268 Id.
269 Id.

270 Id. at 63,660. The chief accountant for the SEC, A. Clarence Sampson, explained that the changes will provide for several improvements: greater flexibility for the registrant to determine whether components of certain balance sheet accounts should be presented on the face of financial statements or in accompanying notes; management discretion in determining when note references are to be provided on the face of financial statements; relocation of information on short-term borrowing and supplementary income, required only on filings with the SEC; and elimination of the rule requiring presentation of valuation and qualifying accounts on the face of the balance sheet. He also explained that these requirements were not intended to be a slight to the FASB and that the SEC still looks to it for leadership in setting accounting standards. SEC REG. & L. REP. (BNA) D-3 at 568 (Aug. 27, 1980).
quirements to improve financial reporting.\textsuperscript{271}

The effects of the technical revisions to Regulation S-K are two-fold. First, the revised financial statements will add considerable volume and detail in most cases.\textsuperscript{272} Secondly, the prior distinction between GAAP and Regulation S-X compliance disclosures is eliminated.\textsuperscript{273} As a result, there is uneasiness among the financial community because annual reports to security holders are now subject to both the provisions of Regulation S-X and GAAP.\textsuperscript{274} The significance of this is that Regulation S-X contains rigid materiality concepts, an area with which GAAP has not been concerned.\textsuperscript{275} These revisions have the effect of requiring in all annual reports and Form 10-Ks those disclosures that are important to all users of financial statements, while requiring in all 10-Ks disclosures as supplemental schedules that are important to a more limited, sophisticated group of users.\textsuperscript{276}

Uniform Instructions

Under the previous rules, the periods for which financial statements were required to be filed with the SEC varied depending upon the particular registration form being filed.\textsuperscript{277} The SEC questioned the necessity for such differences.\textsuperscript{278} It concluded that whether a potential investor is considering investing in a security traded on the open market or in one being registered for the first time, his method of analysis and evaluation is very similar and his basic informational needs are the same.\textsuperscript{279}

Thus the SEC adopted a set of uniform instructions governing the periods to be covered by financial statements included in filings

\textsuperscript{271} Id.
\textsuperscript{272} Parker, supra note 171, at 17.
\textsuperscript{273} Id.
\textsuperscript{274} Id.
\textsuperscript{275} Id.
\textsuperscript{277} Id. at 63,682. See, e.g., Form S-1 (three year Statements of Income and Changes in Financial Position, with Balance Sheet of recent date); Form S-7 (five year Statements of Income and Changes in Financial Position, with Balance Sheet of recent date); Form S-8 and Form 10-K (two year Statements of Income and Changes in Financial Position, with Balance Sheets as of the end of the two most recent fiscal years). Id.
\textsuperscript{278} 45 Fed. Reg. 63,682, 63,683 (1980).
\textsuperscript{279} Id.
with the SEC under both Acts and in annual reports to security holders under the proxy rules. The amendments removed substantially all instructions regarding financial statements from the various registration and reporting forms and centralized the instructions in Regulation S-X. The principal focus of the uniform instructions was to provide uniform requirements for the “Basic Disclosure Package.” Uniform instructions regarding the age, form, and content of interim financial information included in registration statements were also adopted. These instructions require the company to provide in all filings audited statements of income and changes in financial position for the three most recent fiscal years and audited balance sheets as of the end of the two most recent fiscal years.

When filings, with the exceptions of Form 10-K or Form 10, are made within forty-five days after the end of the registrant’s fiscal year and audited financial statements for the most recent fiscal year are not yet available, balance sheets for the two previous years may be preserved with statements of income and changes in financial position for the three previous years. In such situations additional unaudited interim statements and balance sheets must be provided. This interim information must be at least as current as that compiled through the third quarter of the most recent fiscal year in order to update the most recent audited balance sheet and

---

280 Id. Under the proxy rules the annual report financial statements were prepared in accordance with GAAP. 17 C.F.R. § 240.14a-3 (1980).


283 Id. Commentators agree with the SEC that three year income statements are necessary to an understanding of changes in results of operations for two years and that the selected financial data for five years (see note 162 supra, and accompanying text) should be sufficient for an assessment of trends. Any incremental cost associated with the additional year’s statements of income and changes in financial position (see note 277 supra) would not be significant, nor would readability of the annual report be impaired because the change merely requires an additional column in the two statements. Id.
statements. An additional "forty-five day window" between the forty-fifth and ninetieth day after the end of the last fiscal year is provided within which registrants may continue to use unaudited statements to update the audited balance sheets and statements of prior years. New registrants and registrants with unprofitable operations are excluded from this "forty-five day window."

Registrants who are not required to file quarterly reports on Form 10-Q are allowed to utilize unaudited financial data up to 134 days from the end of the fiscal year. This amendment requires the financial statements in a registration statement to be at least as current as any financial statements previously required to be filed under the 1934 Act. This is a change from the previous requirements which allowed financial information less current than that already filed under the 1934 Act to be utilized in the registration process.

In addition, financial statements updating requirements now focus on the age of financial statements at the effective date of a registration statement or the proposed mailing date of a proxy statement. These requirements correspond with the requirements for quarterly data under the 1934 Act's Form 10-Q. This represents a significant relaxation of the previous requirements for such statements.

Finally, the form and content of the interim data under the 1933 Act are now consistent with the data required under the 1934 Act. The rules as adopted eliminate the requirements to in-

---

284 Id. at 63,684. The SEC recognizes that for a short period of time these companies may be prevented from going to the market; it has concluded, however, that it is reasonable to delay registration until such financial statements become available. Id. at 63,685.

285 Id. at 63,685.

286 Id.

287 Id.

288 Id. The 134 day figure represents the period after audited financial statements for the most recently completed year are required to be filed by most registrants on Form 10-K and the date on which most registrants are required to have filed interim financial statements for the first fiscal quarter. Id.

289 Id.

290 Id.

291 Id.

292 Id.

clude in registration statements complete financial statements and schedules for interim periods. They also eliminate requirements for separate financial statements for separate entities and require only condensed financial statements without schedules.394

III. DISSEMINATION AND AVAILABILITY OF DISCLOSURE

The SEC recognized that integration of the 1933 Act and 1934 Act could not be accomplished merely by standardizing the material information to be disclosed under the two Acts.395 Integration, the SEC realized, also hinged on the ability to determine under what circumstances and to whom this information should be made available.396 Otherwise, the system would be read to suggest that all the information contained in a Form 10-K would also need to be reiterated in every prospectus.397

In the past, information has been regularly furnished to the market through the periodic reports required by the 1934 Act. This information then has been evaluated by professional analysts and other sophisticated users, has been available to the financial press, and has been obtainable by any other person who seeks it at no or nominal cost. Therefore, the SEC has found little need to reiterate this information in a prospectus because, to the extent the market acts efficiently, this information is already adequately reflected in the price of the company's outstanding securities.398 Upon this premise, an experimental short form for the registration of certain business combinations has been adopted by the SEC as a mechanism to implement its newly designed integrated disclosure system.

New Form S-15: Optional Short Form for Certain Business Combinations

Form S-15399 is designed to reduce a company's costs399 in registering securities to be issued in certain types of business combi-

396 Id.
397 Id.
398 Id.
400 Id. at 63,649. The reduced costs are realized because of an abbreviated prospectus that does not have to reiterate what is already in the annual report.
nations. At the same time it is intended to provide investors with a simplified and more understandable disclosure document upon which to make decisions. These goals are accomplished through restricting the use of the form to those transactions in which the security holder's need for disclosure may be satisfied by delivery of an abbreviated prospectus accompanied by the issuer's latest annual report.

General Instruction A to Form S-15 provides that the form is available only for registration of securities issued: a) in Rule 145(a) transactions; b) in "short form mergers"; or c) in an exchange offer to acquire a majority of the securities held by the other person. In addition, five conditions are required to be met: 1) the effect of the transaction must not be a change of more than 10% in gross sales and operating revenues, net income, total assets, or total shareholders' equity for the issuer on a pro forma consolidated basis, giving effect to the transaction involved, and the total purchase price must not exceed 10% of the issuer's total assets; 2) the issuer must meet the requirements for the use of Form S-7 and have furnished to security holders its latest annual report pursuant to Rule 14a-3 or 14c-3, which contains audited financial statements as of a fiscal year not more than fifteen months prior to the effective date of the registration statement; 3) the transaction must have been approved or recommended by the boards of directors of both companies prior to the effective date of the registration statement; 4) the prospectus must be delivered to security holders at least twenty days prior to the meeting date, or the earlier of the date of the vote, consent or

302 Id.
304 45 Fed. Reg. 63,647, 63,649 (1980). A short form merger occurs where the applicable state law does not require a vote of the security holders of the company being acquired. Id.
305 Id. at 63,655.
306 Id.
307 See notes 15-16 supra.
309 Id. If a board of directors does not govern the company the governing body must approve the transaction. Id. (to be codified in 17 C.F.R. § 239.29 Instruction A(3)).
310 See text accompanying note 51 supra.
authorization, or the date the transaction is consumated, and 5) neither the issuer nor the company being acquired can be a registered investment company.

A Form S-15 prospectus may be in the form of and may serve as the proxy or information statement used in connection with the transaction. It is available for reoffers and resales of securities acquired pursuant to the S-15 registration statement by affiliates of the issuer or by any person who may be deemed an underwriter of securities, provided that: 1) the additional information called for by Item 8 of the form is included; 2) the selling security holders have an intent to make such offers and sales within sixteen months; and 3) the prospectus is updated through an amended prospectus in accordance with Section 10(a)(3) of the 1933 Act. The prospectus contains disclosure with respect to the transaction, disclosure regarding the company being acquired, and any additional information about the issuer necessary to update the annual report. This is because the annual report will be sent along with the prospectus to security holders, and the issuer's business description, financial statements, industry segment information, market information with respect to common stock, selected financial data, and management's discussion and analysis will be incorporated by reference from the annual report.

---

312 Id.
313 Id. (to be codified in 17 C.F.R. § 239.29 Instruction D).
314 See note 57 supra.
318 Id. at 63,651. The exact disclosure requirements are outlined in Part I of Form S-15 and comprise nine items: Item 1 requires summarized information about the two companies' businesses, the transaction at hand, and comparative share data; Item 2 requires a discussion of the terms of the transaction; Item 3 requires a description of the company being acquired; Item 4 requires proxy information; Item 5 requires information about the interest of affiliates in the transaction; Item 6 requires interim financial information of the issuer; Item 7 requires interim financial information of the company being acquired; Item 8 requires additional information if the registration is used for reoffer or resale; and Item 9 requires statements as to material incorporated by reference. Id. at 63,655-57.
It must be emphasized that the use of Form S-15 is optional. Forms S-1\(^{290}\) and S-14\(^{291}\) are still available should an issuer who qualifies to use S-15 prefer not to deliver its annual report. It is believed that Form S-15 will provide an experiment in the use of the annual reports in conjunction with shortened prospectuses to determine if this can satisfy the purposes of the 1933 Act. In the meantime the benefits of its savings are available to those who choose it.\(^{292}\)

IV. CONCLUSION

The SEC's new integrated disclosure system represents a dramatic change in securities act disclosure. The adoption of the "Basic Disclosure Package"\(^{293}\) is an imaginative piece of handiwork that should result in noticeable dividends. First, by requiring the "Basic Disclosure Package" to be included in the annual report\(^{294}\) and allowing for its incorporation by reference in the restructured Form 10-K\(^{295}\) and certain 1933 Act disclosures,\(^{296}\) companies can realize substantial cost savings in the preparation of their disclosure in association with public offerings of securities. The use of information previously disseminated in the annual report, which has been prepared in accordance with GAAP and a streamlined Regulation S-X,\(^{297}\) allows for abbreviated prospectuses that incorporate the annual report by reference. Likewise, the use of a previously filed "two-page" Form 10-K\(^{298}\) permits shortened registration statements\(^{299}\) that simply incorporate the Form 10-K by reference. Secondly, the centralization of the "Basic Disclosure Package" in Regulation S-K provides the SEC with the continuing ability to refine its view of what information is material to an investment or

\(^{290}\) 17 C.F.R. § 239.11 (1980).
\(^{291}\) 17 C.F.R. § 239.23 (1980).
\(^{293}\) See text accompanying notes 144-217 supra.
\(^{294}\) See text accompanying note 145 supra.
\(^{295}\) See text accompanying notes 223-64 supra.
\(^{297}\) See text accompanying notes 265-94 supra.
\(^{298}\) Folding, supra note 230, at 38.
\(^{299}\) See note 326 supra.
voting decision with a minimum of administrative effort. Businessmen and their corporate counsel can now focus their attention on amendments to Regulation S-K to achieve the desired changes in corporate disclosure in a predictable context rather than the whimsical context of amendments to the various disclosure documents on an ad hoc basis.

The expanded signature requirement of the Form 10-K,\(^3\) adopted seemingly without regard to the possible concomitant expansion of directors' liability,\(^4\) indicates that the SEC's new disclosure system is designed to encourage a higher degree of care and responsibility in the preparation of securities offerings. By bringing 1934 Act disclosure in line with 1933 Act disclosure the SEC has taken a major step in focusing the private sector's attention on the importance of making accurate investment information available on a current basis. Upon the acknowledgement of this fact by the private sector and its sincere compliance with the new disclosures, the SEC will be in a position to evaluate and synthesize the results of its new disclosure system.

A good yardstick for the SEC to utilize in evaluating the efficacy of its new disclosure system will be the disclosures made by the airlines in their annual reports for 1980. Particularly revealing will be the airline's disclosures under Item 11 of Regulation S-K, management's Discussion and Analysis,\(^5\) which affords management the opportunity, or misfortune, of discussing their operations in light of the particular circumstances and prospects of their own company, as opposed to the disclosure of specified information. The management of Delta Airlines, for example, will have the opportunity to discuss how its cautious and highly planned moves into economical new routes and exits from uneconomical routes under deregulation put it in the best financial position of any of the major airlines in 1980.\(^6\) The management of Braniff International Airlines and that of the other major airlines will have the misfortune of discussing why their rapid expansion into new routes under deregulation resulted in such a severe cash drain on their airlines that capacity was cut back, employees were laid off, work schedules

\(^3\) See text accompanying notes 243-52 supra.
\(^4\) See text accompanying notes 250-52 supra.
\(^5\) See text accompanying notes 168-207 supra.
\(^6\) See text accompanying note 36 supra.
were reduced, and, in the case of Braniff, fuel efficient aircraft were sold, management and labor unions negotiated pay cuts, and security interests in aircraft were granted to holders of its long-term debt. This latter group can take some solace in the fact that Item 11 provides for disclosure on the impact of inflation in a broader fashion than the provision of mere statistical data. Thus, the opportunity to attribute some of the financial difficulties to skyrocketing jet fuel prices will be afforded. This opportunity, however, is a two-edged sword because jet fuel prices are expected to rise 15% in 1981, and its effect on the liquidity of the airlines is a trend that must be disclosed. The salvation of this latter group will be its voluntary disclosure of forward-looking information. This provides an opportunity to show why a rapid expansion program, while disastrous in 1980 because of certain unusual events, will generate, in the long run, profits and stability in the competitive airline industry.

334 See text accompanying notes 25-35 supra.
335 See text accompanying notes 204-05 supra.
336 INVESTMENT SURVEY, supra note 25, at 251.
337 See text accompanying notes 198-202 supra.
338 See note 105 supra, and accompanying text.
339 See text accompanying note 193 supra.