Timely Disclosure - The View from 11 Wall Street

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by

*Phillip L. West**

THE ACTIVITY of a company's stock in the market is often the best gauge of how well the company has translated timely disclosure policy into timely disclosure practice. More importantly, the marketplace can often give the corporation a good indication of whether confidential information has leaked out and of the existence of potentially actionable insider trading.

For instance, just before the opening of trading here at the New York Stock Exchange one day recently, a specialist noticed an unusually heavy influx of buy orders in one of his stocks but no readily apparent news to account for this influx. The specialist was willing to sell stock from his own account to meet a large portion of the demand, but this was still insufficient. After a brief consultation with a floor governor, it was decided to delay the opening of the stock. The Department of Stock List was notified of the delay and immediately made a routine check with the company. The company said it had just been unofficially informed that it was being awarded a large contract for components. The contract was expected to have a major impact on its earnings. However, the company pointed out, it still had no official confirmation and could make no announcement. The long delay in getting official confirmation on the contract and in distributing an announcement held up the opening of the company's stock until the following morning.

This situation, although somewhat unusual, contains all of the elements of a typical problem in timely disclosure. Just as typically, it could and should have been avoided. This is the goal of the Exchange's timely disclosure policy: the avoidance of any disruption of the orderly market process because of inadequate—or unfair or improper—disclosure practices.

Determining Materiality. The Exchange's disclosure policy is more of a common-sense guideline to ethical behavior than a legal document, since it was designed to aid listed companies in selecting the correct solution to situations that often have no one pat answer. The heart of our policy is contained in the first sentence of the disclosure section of the *Company Manual*: "A corporation whose stock is listed on the New York Stock Exchange is expected to release quickly to the public any news or information which might reasonably be expected to materially affect the market for securities."[1] Although designed specifically for NYSE-listed companies, this policy could be followed by any publicly owned corporation seeking effective disclosure.

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[1] N.Y. STOCK EXCHANGE, COMPANY MANUAL A-18 (1968).

Of course, the first step in achieving this goal is accurately to determine what constitutes material information. There are many items which are obviously material, such as quarterly and annual reports, dividend announcements, mergers, acquisitions, tender offers, and major management changes. But materiality is not always so easily determined. One gauge of materiality is the "reasonable man" principle described in Judge Friendly's decision in *Texas Gulf Sulphur*—information is material if it would prompt a reasonable man to make an investment decision.[2] This still leaves the problem of selecting a "reasonable man" out of an investing population which includes every degree of investor sophistication from rank amateur to professional.

We have developed our own gauge of materiality to avoid this complication. We think it is better for the individual executive responsible to ask himself this question: "Would this information prompt me to risk my own funds?" If the answer is yes, then immediate disclosure should be made. Even with this guideline it is possible to be doubtful on rare occasions. In this case, we suggest an even simpler rule of thumb: "When in doubt—disclose."

Disclosure Security. Usually, it is far better to make disclosure than to risk the possibility of violating Exchange or the Securities and Exchange Commission rules, but there are times when a corporation may, for one reason or another, wish to defer disclosure until an appropriate time. In these cases, disclosure can be properly avoided, but only if the information can be kept confidential. The corporation should be extremely conscious of the fact that information leaks, particularly when accompanied by insider trading, not only damage management's reputation for integrity but also put the company in danger of a stockholder suit.

The Exchange strongly urges that a corporation exercise extreme care in guarding confidential information until ready for broad publication. Where possible, any discussions of material information should be limited to a small group of the top management of the company or companies involved, and their individual confidential advisors, where adequate security can be maintained. This security must at times be extreme. When one major listed company was considering a stock split a few years ago the discussions were kept so secret that only three of the company's top executives knew about it. No memos or written notes were kept of their discussions. There was not even a hint of the proposal to directors until they were asked to vote on it.

Contrast this with a situation that occurred with another listed company. The company's stock suddenly attracted unusually heavy demands with no apparent reason. Our investigation revealed that that company was a takeover candidate but, the company said, only a very few people knew about it. Further investigation showed most of the buy orders were from the company's home town. We later learned that the townspeople had quite logically deduced what was going on when four accountants from a major

[2] SEC v. Texas Gulf Sulphur Co., 401 F.2d 833, 849 (2d Cir. 1968).

New York firm checked into a motel for several days and traveled by cab to the company's office.

Generally, security can be easily maintained within the corporation, but at some point during merger and acquisition negotiations it becomes necessary for the corporation to involve outsiders to conduct preliminary studies or assist in other preparations such as business appraisals, tentative financing arrangements, engineering studies, and so forth. Our experience has shown that at this point it becomes impossible for the corporation to maintain security, and in all fairness a press release should be issued. The extent of disclosures at this point will depend on the state of negotiations, discussions, and studies, but should, so far as possible, be definite as to price ratio, timing, and/or any other pertinent information necessary to permit a reasonable evaluation of the matter. As a minimum, these disclosures should include all disclosures made to outsiders.

If the initial announcement cannot be specific, it should be supplemented as more definitive terms, or different terms, are discussed or determined. During merger and acquisition negotiations, the corporation should watch closely the activity of its stock and, if unusual market activity should arise, be prepared to make immediate public announcement. In addition, the company should regularly remind employees as well as directors and officers, that they must not disclose confidential information learned in the course of business nor attempt to take advantage of such information themselves.

Situations will also arise in which a corporation may rightly avoid or defer a public announcement. This type of situation often occurs in the area of product development. A few years ago when the shares of water desalinization companies were the glamour stocks of the market, one of our listed companies came to us with a problem. They had developed a process for desalting water but were not yet sure if the process was commercially feasible. They had kept the process secret until this time. Although they felt an announcement should be made, they were reluctant to inflate unduly the price of their stock. Under ordinary circumstances the process should have been disclosed, but, since its commercial feasibility was still unknown, there was justification in delaying the announcement, provided secrecy could be maintained. A few months and several hundred thousand dollars later, the process was abandoned. The company had saved itself and the investing public many headaches by withholding its press release until it was more definite about the potential of its process.

Press Releases. Publishing a press release fulfills only part of a corporation's disclosure obligation. The corporation is also responsible for insuring that news will be handled in the proper perspective by exercising appropriate restraint, good judgment, and careful adherence to the facts. Premature announcements of new products whose commercial application cannot yet be realistically evaluated should be avoided. So too should overly optimistic forecasts, exaggerated claims, and unwarranted promises. If subsequent developments indicate that performance will not match earlier projections, this too should be reported and explained. Financial projections fall into the same category and can, should expectations go awry, cause problems. Any projection of financial data should be soundly based, appropriately qualified, conservative, and factual. Likewise, excessive or misleading conservatism should also be avoided. Repetitive release of essentially the same information is similarly inappropriate.

Security Analysts. Not all disclosures are made in press releases. Occasionally major announcements are made inadvertently at meetings with security analysts. Analysts have become increasingly important in evaluating and interpreting the financial affairs of listed companies. The analyst working for financial institutions, such as mutual funds, trust funds, insurance companies, banks, or pension funds, plays a particularly important role since the sizable investments of these institutions can have substantial impact on trading in a company's stock.

The Exchange recommends that corporations observe an "open door" policy in their relations with security analysts as well as financial writers, shareholders, and others who have a legitimate investment interest in the company's affairs. However, a company should not give information to one inquirer that it would not give to another nor should it reveal information it would not willingly give to the press for publication. A corporation should never give advance earnings, dividend, stock splits, merger, or tender information to analysts whether they represent an institution, a brokerage house, an investment advisor, a large stockholder, or anyone else. At the same time, the corporation should not withhold any information in which the inquirer has warrantable interest. We realize, of course, that occasionally discussions with analysts may inadvertently lead to the revelation of material information. However, if material information is discussed, the information should be simultaneously released to the public.

Many corporations appear regularly before various analysts' groups. The majority of these groups open their meetings to members of the press; however, a few do not, or occasionally an invitation to the press may be inadvertently overlooked. The corporation should, whenever possible, attempt to have the press in attendance when substantive material is going to be discussed. If the press cannot attend, a press release should be issued, covering the substantive material to be reported. It is only fair to point out that the competent security analyst depends on his professional skills and his broad industry knowledge in making his evaluations and does not need to depend on inside information which would provide him with an unfair advantage.

Insider Trading. During the past few years several stockholder suits have been filed, charging officers or directors with trading in their own stock on the basis of "inside" information. Our experience has shown that many stockholders feel that their directors and officers should have a meaningful investment in the companies they manage. Naturally their investments should not be made at the advantage of stockholders or the investing public.

As shareholders themselves, directors are more likely to represent the viewpoint of other shareholders, whose interests they are charged with protecting. Similarly, officers—the executive management group—may well perform more effectively with the incentive of stock options. However, the widespread endorsement of director and officer shareownership brings with it questions that concern the timing of their stock transactions. For instance, when may a director or officer properly buy or sell shares of his company's stock? When is it appropriate to award stock options to key executives? There are no simple uniform answers to these questions, but they do underscore the importance of a policy of adequate timely disclosure both for the benefit of the investing public and for the protection of management.

NYSE Suggested Policy. Because of the sensitive position of officers and directors in regard to their intimate knowledge in the corporation's affairs, a company should consider establishing a policy which would place the stock transaction of officers and directors above suspicion. The Exchange suggests that corporations consider adopting one or more of the following policies:

1. Establishing a regular investment program where the officer makes periodic purchases and where the timing of purchases is not controlled by the individual.
2. Requesting officials not to buy or sell stock for a thirty-day period commencing one week after the annual report has been mailed to stockholders or otherwise broadly circulated.
3. Requesting officials to avoid transactions unless the officer or director contacts the chief executive officer of the company to find out if there are any important developments pending which need to be made public before an insider could properly participate in the market.
4. Requesting officials to delay any purchases or sales until at least twenty-four hours after the release of material information. This will insure that adequate dissemination of the news has taken place.
5. Requesting officials to avoid transactions when developments of major importance are expected to reach the appropriate time for announcement within the next few months.

In granting stock options to key officers and directors, the same philosophy that relates to purchases and sales may well apply. Where an established pattern or formula is part of a plan specifically approved by shareholders, a question of timing may not arise. When taking up an option, the timing of the purchase is not usually critical since the price is set at the time the option is granted. This reasoning might also apply to stock purchase plans in which officers and directors may be entitled to participate.

The same consideration applies to the families or close associates of officers and directors who are presumed to have preferential access to information. As far as the public is concerned these individuals are also insiders. And while this assumption may be unjustified in many cases, it is a fact of life which those in positions of leadership and responsibility cannot ignore.

Conclusion. The corporate directors and officers have a special responsibility in the area of timely disclosure. As officials of publicly owned corporations they invited the public to become part owners of the corporation and its assets. Surely these assets include the information possessed by the company. The value of this data is often reflected in the price movement of the company's stock. When a corporate official violates or abrogates this fiduciary obligation, he is doing so at the expense of the owners of the corporation.

The Exchange's disclosure policy, or any disclosure policy for that matter, seeks to avoid any disruption of an orderly market process by assuring that all investors have equal access to material information. If a corporation strives towards this goal, it cannot possibly violate either the letter or the spirit of disclosure practices.