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INTERPRETATIONS OF RULES AND REGULATIONS OF THE SECURITIES AND EXCHANGE COMMISSION BY DR. JAMES M. LANDIS, MEMBER, AT A MEETING OF THE NEW YORK STATE SOCIETY OF CERTIFIED PUBLIC ACCOUNTANTS HELD AT THE WALDORF-ASTORIA ON JANUARY 14th, 1935.

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A reason makes me particularly happy to have the opportunity tonight to address the New York State Society of Certified Public Accountants and its guests. It arises from the fact that I had the opportunity to address this Society somewhat more than a year ago, when federal securities legislation had only been just initiated and the regulation of stock exchanges was still a hope and not an accomplished fact. In talking to you then I tried to give you a sense both of the objectives and the mechanism of the Securities Act of 1933. But more than this, I appealed to you as representative of a financially vital and significant profession that, whatever our differences in detail might be, our objectives were the same and that government and the accounting profession should unite to make firm those objectives and iron out their differences as to the details. That appeal, I am happy to say, did not fall on deaf ears. We convinced you and you convinced us that we could work together earnestly, harmoniously and effectively.

Indeed, the subject of my talk tonight, the recent corporate reporting regulations promulgated by the Commission, are in large measure the product of that joint effort. I want to speak with some particularity to that theme because it seems to me illustrative of two things, the procedure that our Commission has towards approaching these new and difficult problems, and the attitude of professional and semi-professional groups towards the efforts of government in this and I hope many other fields. Words like “cooperation” have lost much of their meaning by their employment to describe situations that have only the pretense of joint effort and not its real content. But none of this pretense, none of these casual conferences, characterized the type of help that we received from a group of accountants representative of the American Institute of Accountants, the American Society of Certified Public Accountants and your Society. Instead, the story is one of long days, and long nights of work. On our side your reports and your memoranda were carefully considered; on your side, our series of tentative drafts were subjected to severe and weighty criticism. In many matters we were convinced by your arguments and in some matters we convinced you. It was an experience, which, I know, we enjoyed, but more, from which we learned to know and respect each other. I cannot pass this by without publicly expressing thanks for your generous efforts and your wise contributions. My subject, as it has been announced to you, is the recent regulations promulgated by the Securities and Exchange Commission dealing with the character of the reports that corporations shall file as a condition either to their issues being registered on a national securities exchange or as a condition

precedent to the issuance and distribution of new securities. As you know, the Securities Exchange Act of 1934 empowers the Commission to prescribe the type of listing requirements that shall govern on the various stock exchanges of this country. These listing requirements are to become effective on July first of this year, supplanting the temporary scheme for listing which was introduced last October. The first series of these requirements was promulgated a few days before Christmas and is known as Form 10, which is to be used for all corporations whose securities are now listed on an exchange with certain specified exceptions, such as railroads, banks, insurance companies, foreign corporate bonds and the like. The second series, promulgated last Saturday under the Securities Act, is known as Form A-2 and is the form to be filed by all corporations which have earnings' records for at least three years and have paid dividends on their common stock for two consecutive years during the past fifteen years.

First let me discuss Form 10, the form to be filed by corporations wishing to have the status of their securities now listed on the stock exchanges continued after July first of this year. Let me make clear at the outset that the mechanical regulations as to the manner of filing this form have not yet been promulgated. It seemed wise to the Commission not to defer the publication of this form until all these mechanical details could be thoroughly canvassed. So the form itself was promulgated in order that corporation executives and accountants could, before the end of the year, have an adequate conception of the nature of the information that would be required. Because of this fact--the absence of these mechanical requirements--it is impossible for me now definitely to answer certain questions that I find are commonly asked. Such questions, for example, as, what procedure will be required in the case of corporations whose fiscal year ended before December 31, 1934, and thus have already issued their statements in a different form than is now required? Or such a question, as to when deviations in substance from the Commission's requirements as are demanded by the very nature of the business, will be permitted? Or the question, as to what requirements the Commission will adopt with reference to quarterly statements or subsequent annual reports? Those questions are still to be determined; but I can assure you that they will be determined shortly in a sensible and practical manner.

Form 10 can be regarded as the basic form. The new form A-2 has been modeled upon it, deviating only where the need for providing different and additional information for new security issues has called for such change. The later forms will in all likelihood follow the same principle of basing themselves on Form 10. The problem raised by prescribing a form such as this is, of course, that of bringing to the investing public adequate information as to the nature and the record of securities now listed on the exchanges. The task was to accomplish this result and at the same time to make no demands either from a standpoint of difficulty or of expense to which any corporation which held itself out for public investment could reasonably object. Flexibility was, of course, essential. At the same time, definiteness was required so that corporations could clearly understand the obligations that they were asked to assume and to comfortably rely upon the requirements as phrased. I assure you that reaching the right balance between these considerations is no easy task. Though, of course, it is too much to hope that all these balances have been correctly struck, the help that we have had and the reception that our efforts have so far received, makes me believe that in the majority of instances, we have reached judgments that are sound, and possessed that quality of judiciality which has been aptly described as leaning neither to partiality on the one side nor to impartiality on the other.

Form 10 may appropriately be considered as consisting of two parts. The one consists of financial data that the registering corporation is called upon to furnish; the other consists of information of a non-financial nature bearing upon the security being registered and absolutely essential to any determination of its investment merit. A brief glance at these non-financial questions, thirty-three in number, will illustrate the character of the material called for. First, a number of simple questions go to the organization of the registering corporation and of the system of which it may be an integral part. Next follow a series of questions which outline the capital structure of the corporation, calling for its authorized and outstanding funded debt; the debt structure of its subsidiaries; the authorized, issued, and outstanding capital stock of the registering corporation; the amount of securities of other corporations that it may have guaranteed; and its position with reference to outstanding warrants and rights. Then follow a series of questions directed towards getting an adequate description of the actual securities being registered, so that there should be a succinct statement of those matters relating to these securities of which any investor should be aware, such as conversion and redemption rights, interest or dividend rates, underlying collateral, substitution rights and the like. An effort to keep these restrictions brief and confined to elemental facts relating to the issue being registered has been made in these questions. To afford those investors who seek more detailed and thorough knowledge of such matters, the Commission instead of calling for a more expanded description has instead merely requested the filing of certain exhibits, such as underlying indentures or other constituent instruments defining the rights of the security holder. This is a desirable procedure, for it relieves the corporation of the difficult burden of summarizing the provisions of complex instruments already presumably free from surplusage and unnecessary prolixity, but at the same time it affords the inquisitive investor such evidence as will best inform him as to the nature of his rights.

There follows a question seeking information as to the recent financing that the corporation may have undertaken which from the investing standpoint is one effective means of checking upon the general credit standing of the corporation. Finally, a series of questions relate to the control and management of the corporation. Large stock holding interests are asked to be stated. The general cost of executive management is required and, in order to bring the light of publicity to bear upon the larger salaries, those payable to directors and to the three highest executives are specifically required to be stated. At the same time, however, a decent respect for the confidential character of salaries is preserved by asking by name only for those which may generally be presumed to be above any question as to the need for non-disclosure from the purely managerial standpoint. Material management, engineering and supervisory contracts, which have been so unfortunately abused in recent years in some enterprises are also required to be disclosed. Finally, one question directs itself towards such stock options as may be outstanding and thus may materially affect the trading position of the securities on an exchange. The questions contained in the form are supplemented by instructions, which seek to amplify the nature of the question with the hope thereby of getting more exactitude in the answers. Throughout, the instructions insist upon brevity in the answers and by such devices as cross-referencing and permitting certain portions of the exhibit to be incorporated by reference, make brevity easy of achievement. We, as well as the investor, are weary of the voluminous answers that we have too often received. Neither fear of liability nor adequate investment description of the security demands this bulk and essentially confusing prolixity. We are now opening a means

for brief, simple, inexpensive descriptions and we shall use our powers to their full to the end of securing that ready intelligibility that the wide investing public rightly demands.

I turn now to the second portion of the form, that portion which calls for financial data. Here, as distinguished from the forms earlier promulgated, flexibility is the rule. Let me illustrate this specifically. We require the latest balance sheet and the latest profit and loss statement, but though we set forth an illustrative form, we specifically permit the furnishing of these financial statements in any other form that will be as comprehensive and as adequate. We set forth certain accounting terminology and accounting classifications, but we permit the use of other generally accepted terms and classifications. We call for consolidated balance sheets and consolidated profit and loss statements, but we do not insist that all subsidiaries shall be consolidated; instead we ask for the adoption of such a principle of inclusion and exclusion as will, in the opinion of the officers of the corporation, best exhibit the financial condition of the registrant, and in lieu of complete consolidation the submission of separate financial statements as to those subsidiaries that the registrant has chosen to exclude. We do not prescribe the form of the auditor's certificate; instead we ask for a certificate that shall be illuminating both as to the scope of the audit and the quality of the accounting principles employed by the registrant. Or again, in dealing with such a problem as the annual charges for maintenance and repairs, and depreciation and amortization, we do not disturb the integrity of such an item as the cost of goods sold, where these charges, under the accounting procedures practiced by a particular registrant, may be embraced within such an item. Those, and other examples, are illustrative of the principle of flexibility employed in this portion of the form.

The general requirement is for financial statements covering the fiscal year ending last December or any date subsequent thereto which may be the closing period of a registrant's fiscal year. Why, it may be asked, do we not go beyond this and demand either balance sheets or profit and loss statements for several years back, especially in view of the fact that our supporting schedules with reference to such accounts as the property account and the investment account permit the accountant to take as his opening balance the closing balance of the prior fiscal year? To this there are several answers. In the first place, it must always be remembered that we are dealing with companies whose securities are already listed on the exchanges, and who consequently have already met the listing requirements of the exchanges and have in accordance with these requirements been reporting more or less adequately to the exchanges and to their stockholders during the past years. Furthermore, for the same reason, the securities are themselves seasoned in the sense that they have been before the public for many years and have recently passed through a period which has generally tried them so as to make apparent these historical and congenital weaknesses. In the second place, the emphasis from the investment standpoint, as distinguished, for example, from the standpoint of rate regulation, is placed by the form primarily upon present earnings rather than past history. Thus, actual earnings as such and current position are stressed as contradistinguished from the ratio of earnings to actual investment. In the third place, with this same viewpoint dominating these regulations, there is the recognition that past accounting practices may effect the integrity of present reported earnings. With this in mind, the regulations require a survey of certain outstanding practices which may have occurred during the past decade and which in all probability are still reflected in present reported earnings. Thus, substantial revaluations that may have been made in such specific accounts as the investment account, the property account, and the intangible asset

account, are required to be stated together with the contra entries that will indicate the disposition of the amount added or deducted from the balance sheet by such write-ups or write-downs. Again, any amount that may have been released from the capital stock account either by the device of paid-in surplus or by restatement of capital stock is to be fully accounted for. Thirdly, a specific finger is put upon the too frequent and pernicious practice of writing off debt discount and expense rather than amortizing it over the period of the debt to which it relates, a practice which patently distorts the earnings statement and whose significance too often escapes even the vigilant investor. By this method, which avoids at the same time the difficult task of actually auditing surplus over this period, the great weaknesses which may exist in that account are disclosed. Now let me turn for a moment to the general balance sheet and profit and loss requirements. Examination of the various items will disclose in no instance, I believe, any case where there is demand for figures that the great majority of corporations do not already possess but may not have made generally available to their stockholders. To discuss these individual items at length is beyond the present scope of this talk, but a few general features deserve some comment. The first may be summed up in the phrase that current assets shall be truly current. No longer is it permissible to include among marketable securities, securities which do not truly meet that generally accepted criterion, and, at whatever figure these may be carried at in the balance sheets, their value on the basis of current market quotations must also be shown. Furthermore, a breakdown of this item is required when, as in a few corporations, it represents a substantial portion of the total assets of the company. Again, current assets if they consist of amounts due from subsidiaries or affiliates, are to be shown as such, and, in any event, are not to be treated as current assets unless the net current position of the subsidiary or affiliate justifies this treatment.

A second feature of the financial statements is the insistence in the profit and loss statement upon gross sales and cost of goods sold. The importance of these figures to the investor are self-evident. Indeed, no other figures in the financial statements, can perhaps, rank in equal importance with them. Obviously the Commission is justified in calling for them. At the same time, it is to be recognized that in unusual circumstances non-disclosure of these items may, perhaps, be justified, due to the extraordinary competitive nature of the enterprise in which the corporation may be engaged. Fortunately, from the standpoint of the investor, hesitancy on the part of corporations to the disclosure of these and other matters is not general. A recognition that the corporation, as a trustee of other peoples' money, owes a general duty of disclosure to its beneficiaries is not something that the Commission need exercise the power of government generally to enforce. Indeed, my observation and my contacts lead me to the conclusion that this is a doctrine whose acceptance is more general than otherwise, and whose further acceptance needs only the encouragement and protection of government rather than the exercise of its power.

A word as to the matter of confidential treatment of material that may be required to be furnished. In promulgating general requirements, it is inevitable that some individualization of treatment must find its place in the administration of these requirements. The Act itself recognizes this by providing means for confidential treatment of certain material whose disclosure in a particular instance may damage rather than benefit the investor. The mechanism provided gives the corporation not only the right to request such confidential treatment, but requires the Commission to give the protesting corporation the benefit of a hearing. What one

would hope as a matter of administration will take place is that such requests will not be made without an accompanying informal but adequate presentation of the reasons that underlie such a request, and that the hearing will be demanded only in the very significant cases.

Many questions have been asked of us as to the relationship of these reports and the annual report made by the corporation to its stockholders. To put the general question more concretely, must the annual stockholders' report for any reason be identical with such reports as may be required to be filed with the exchanges and with the Commission? To answer this question, let me first analyze it. Form 10 is the form which is to be filed as of the time that permanent registration is sought. It need only be filed once. But the Commission is required to call for annual reports which, in general, shall keep current the information filed in response to Form 10. The Commission may also, in its discretion, call for quarterly reports. But the Commission possesses these powers only with reference to the reports furnished to itself and to its exchanges; it possesses no express power as to the content or nature of the reports sent to stockholders. There is one way that the Commission might, however, affect the content of the stockholders' reports. This is by requiring that these reports should be filed with it, thus attaching to these reports, the general statutory liabilities created by the Act. This requirement has not, however, been imposed. Even if it were imposed, nothing would prevent reasonable and non-misleading condensation of the financial statements filed with the Commission. But with no such requirement in existence, the content and character of these reports from a legal standpoint is governed only by common law liabilities. As a practical matter, one knows that major differences between the reports filed with the Commission and those sent to stockholders will not occur; but again as a practical matter, one hopes that a reasonable degree of condensation will take place. The analytical stockholder will always still have easily available the degree of elaboration that can be found in the reports filed with the Commission and the exchanges, reports that under the law are accessible at all reasonable times to any inquirer.

Let me now leave Form 10 for the moment and turn to Form A-2, the recently promulgated form under the Securities Act governing new security issues. The experience of the Federal Trade Commission and our Commission had lead many months ago to the conclusion that revision of the early form, Form A-1, was demanded. However adequate its requirements may be to deal with the promotional venture -- the corporation with no history -- for the seasoned corporation its requirements, though occasionally illuminating, imposed burdens and difficulties incommensurate with the value of these facts to the investor. It is, of course, impossible to get every fact that may have investment merit before a prospective purchaser, and, however close one may come to such a goal in an individual case, to do it in a generalized fashion -- the way in which the law of necessity must operate -- is much more difficult. For example, the answer to one question may be of vital importance in the hundredth case, but have no significance in the ninety-nine cases where, nevertheless, the task of getting together the information involves both difficulty and expense. Thus again, one is faced with a problem of basing generalizations upon nice and experienced judgments.

Form A-2, as I said before, is modeled after Form 10. This very fact gives the corporation whose securities are listed a great advantage over the unlisted corporations, and rightly so, for the corporation that in the past has been dealing openly with its bondholders and stockholders should by that very fact be entitled to seek in the same open fashion new

bondholders and new stockholders. This synchronization of these two forms means in substance that the task of the listed corporation in filing a registration statement under the Securities Act is, in essence, simple. The task of the unlisted corporation, contrarywise, is proportionately more difficult as its practices vary from the listing requirements described under the Securities Exchange Act.

I can illustrate this thesis best by briefly comparing the two forms. In the non-financial data called upon to be furnished these are the chief additional features required to be stated:

1. A succinct statement of the franchise position of the registering corporation -- obviously, in those businesses where franchises are the legal foundation of their privilege to operate or of the monopoly they enjoy, a vital investment fact.

2. A more detailed description of the nature of the funded debt that ranks either prior to or upon an equality with the security being offered.

3. A more detailed description of the security being offered, requiring, besides such matters called for under Form 10 additional data such as, for example, a brief description of what obligations rest upon the trustee in event of default and what rights accrue to the bondholder upon the occurrence of the same contingency.

4. An analysis of the underwriting of the issue being offered, including a definite disclosure of the underwriting spread or commission, as well as a disclosure of all preferred lists.

5. A statement with a reasonable degree of itemization as to the use to which the corporation is planning to apply the proceeds to be derived from the issue.

6. A statement as to the business experience of the corporation’s chief executive officers, and of their major transactions with the corporation during the past few years.

7. A statement concerning pending litigation which may substantially threaten the financial position of the registrant.

8. A statement, carefully exact and limited, as to unexecuted and recent material contracts and as to material patents. A word as to this requirement, because from the standpoint of difficulty and expense to the corporation, the changes from the old form are of great consequence. As distinguished from the earlier requirement which called simply for material contracts not in the ordinary course of business, the new requirement delimits by definite and exact standards those contracts which for the purposes of registration are deemed to be material and are deemed not to have been made in the ordinary course of business. Similarly, the treatment of material patents is such that those patents only need be mentioned which from an investment standpoint are of particular significance, because the proceeds of the issue are to be used for their development. Furthermore, they are to be described in a general and not in a highly technical manner so that the relationship of these patent rights to the security being offered shall be succinctly set forth.

These are the prime differences in that portion of A-2 that does not comprehend the financial data. The other portion of A-2, that concerns itself with financial statement, differs primarily from Form 10 in only one respect, and that is the requirement for profit and loss statements covering three years rather than one. Of the absolute necessity for this requirement there can be no doubt, for to purchasers of new securities the earnings record over a period of years is, of course, essential. This change naturally brings some minor changes with it, such as slight adjustments in the supporting schedules, which will incorporate in these schedules such fact as the three-year audit of income readily brings out. Similarly, a survey of the dividend record over this period is required and other like matters. With regard to the historical financial information, for the reasons that I advanced earlier, the requirements are the same, that is, a survey of certain specified accounts and certain specified practices, going back, however, to 1922, rather than merely to 1925, avoiding as Form 10 does the necessity for actual auditing over these past years but at the same time bringing about the disclosure of those practices whose effect upon income is still present.

Form A-2 is, I believe, a distinct advance over the early Form A-1, not only does it very materially lighten the difficulties and expense that were entailed by meeting the earlier requirements, but it also furnishes the investor with more valuable and more current information. This, I feel sure, is bound to result both in a more informative and less cumbersome prospectus, and very much less hesitancy on the part of business executives and accountants in accepting the obligations of the Securities Act.

The work of getting out these two forms has been in preparation for many months. Indeed, some portion of that work even antedated the Securities and Exchange Commission. But those efforts from our standpoint will have, I believe, broken the back of the general problem though not, I trust, of our loyal staff and our hard-working accounting friends. Other forms to meet the special situations still unprovided for, are already on the way and will shortly be launched. In this final effort, I feel sure that we can count upon your continued earnest cooperation, so that you will then feel as you should now rightly feel, as participants in this truly democratic and joint process of government. You will still be more than welcomed at Washington for both your help, your criticisms and your inquiries.

I say advisedly more than welcomed. For here, in order to don the role of a true government executive, I must make my only little threat, which is that you must for your own good come when we need you. Indeed, we need you as you need us -- we to make government rightly respond to the desires to those who have the desire, the ability and the experience to help us in attaining the objectives of candor, honesty and integrity in corporate finances, objectives that are common to all of us. Correlatively you need us to help you buttress with our strength your constant efforts in the same direction for more adequate and informative corporate accounting, efforts which already have and will assuredly continue to make your profession capable of fulfilling the high position of trust that our modern corporate civilization demands that it assume.

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