

CHAPTER XI.

ANNUAL REPORTS TO SHAREHOLDERS AND PROXY STATEMENTS

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CHAPTER XI

ANNUAL REPORTS TO SHAREHOLDERS AND PROXY STATEMENTS

A. Introduction

In reviewing the disclosure documents produced under the federal securities laws, the Study gave special attention to those documents which are primarily directed at the existing shareholders of a corporation--annual reports to shareholders and proxy statements. These documents are often a fruitful and readily available source of information and are widely used in the process of investment analysis. The Study's recommendations are designed to make them more revealing and useful to those for whom they are intended in the first place, the shareholder whose vote or proxy is being sought.

B. Modest steps should be taken to improve the quality of annual reports to shareholders.1. Present regulation of annual reports to shareholders.

Commission rules require that an annual report to shareholders accompany or precede each proxy statement which solicits proxies on behalf of management for the election of directors (Rule 14a-3(b)). The report is not deemed "filed" with the

Commission (Rule 14a-3(c)). It must contain certain financial statements, and material differences between these statements and financial statements filed with the Commission which result from application of different accounting principles or practices must be reconciled or explained in the report. Apart from the foregoing, the form and content of an annual report are generally left to the discretion of management (Rule 14a-3(b)).^{1/}

There is something of a paradox in this situation. As former Commissioner Byron D. Woodside has expressed it:

The treatment of the annual report of the corporation under the proxy rules is an interesting example of administrative dexterity. I can think of nothing more likely to persuade stockholders that management should be retained in office than an annual report containing all the indicia of existing and continuing success. As so viewed, it would seem odd not to conclude that the report, sent with a request for a proxy, was not part of the soliciting material, if not in fact, the most effective inducement to mail a proxy to management. As so viewed, the report would be subject to the proxy rules and it would be “filed” with the Commission as proxy material.^{2/}

The Commission’s decision not to treat the annual report as soliciting material responded to an industry argument summarized as follows by Mr. Woodside:

^{1/} There are two minor exception: if no previous annual report has been sent to shareholders pursuant to the Commission’s proxy rules, the report must contain information which will, in the opinion of management, “indicate the general nature and scope of the business of the issuer and its subsidiaries” (Rule 14a-3(b)(5)). Also, if any portion of an annual report comments upon or refers to any opposition solicitation in an election contest, that portion of the report must be filed with the Commission along with other proxy material (Rule 14a-11(f)).

^{2/} Woodside, Development of S.E.C. Practices in Processing Registration and Proxy Statements, 24 Bus. Law 385-386 (1969).

. . . if the report was made subject to the rules, management would not communicate freely concerning corporate affairs for fear of risking liability under the Act or for fear of interference by government.^{3/}

2. An appraisal of annual reports to shareholders.

To assist in determining whether or not it would be in the public interest to recommend any change in the present regulatory status of the annual report to shareholders, the Study reviewed the annual reports of a random sample of 125 companies. In addition, a detailed, comparative study, covering a period of 3 or more years, was made of the annual reports, proxy statements, '33 Act registration statements (when filed), 10-K and 8-K reports of a selected group of 10 companies of varying character and size.

The conclusions reached were as follows:

(1) In almost every instance, a statutory prospectus reveals far more in the way of facts material to investment judgment than does an annual report. Often, the text of an annual report will convey a somewhat inflated picture of a company's business and prospects. Nevertheless, only in a small minority of cases can it be said that the disclosures in present-day annual reports are seriously misleading.

(2) As a result of the amendment to Rule 14a-3(b) adopted in 1964^{4/}, financial statements in annual reports now seldom differ in material respects from those contained in Form 10-K.

^{3/} Id. At 386.

^{4/} Securities Exchange Act Release No. 7324 (May 26, 1964).

(3) Where seriously misleading disclosures do occur, they are most frequently found in textual references made to, or condensed presentations of, the results of operations.

Set forth below are three examples of the kind of disclosures which the Study considered to be materially misleading:

The “financial highlights” section in one annual report for 1967 spoke of net earnings for the year of approximately \$4.9 million, or \$1.72 per share, and sales of approximately \$77 million. The highlights section then compared these figures with 1966 sales of only \$23.7 million and “profits” of only \$1.4 million, or \$.66 per share. In the certified financial statements, the 1966 results were adjusted to reflect a pooling of interest. On a pooled basis, 1966 sales were \$50.2 million, net income \$2.6 million, and earnings per share \$.88.

The president’s letter in another annual report stated that net income for 1966 was \$955,000 or \$.39 per share. It proudly contrasted these figures with a net loss in 1965 of \$175,000 or \$.07 per share. The certified financial statements appearing some 15 pages after the president’s letter reflected, for the year 1966, a net loss before extraordinary items (gain on the sale of certain property) of \$1,814,151. Interestingly, in that company’s next annual report to shareholders, the president’s letter took pains to point out an extraordinary item which accounted

for a \$9.3 million net loss for the year.

One company, engaged in the franchise business, stated in the text of its 1962 annual report that net income for the year was equal to 57 cents a share, based on the average number of outstanding shares that year. The 1963 annual report, however, announced that the per share earnings of 59 cents in that year represented an 18% increase over earnings of 50 cents per share in 1962. The 1964 annual report changed the 59 cents reported in 1963 to 56 cents and then compared it with 81 cents per share for 1964. In the 1965 report, the 81 cents of 1964 was changed to 76 cents. These results, which appeared calculated to enhance the picture of year-to-year growth of earnings per share, were achieved by dividing the preceding year's earnings by the number of outstanding shares in the current year rather than by the average number of shares outstanding in the prior year.

In one annual report to shareholders a "financial highlights" section on the inside cover page reflected net sales of \$242.3 million and net income per common share of \$1.43 for 1967, in contrast to net sales of \$90.6 million and net income per common share of \$1.15 in 1966. These contrasts were further emphasized in the president's letter on page 1 of the report by such statements as "In 1967, alone, total sales increased more than \$150 million over the \$90.6 million reported in 1966...", and "Earnings per share . . . increased from the \$1.15 reported in 1966 to \$1.43." The following

statement appeared at the bottom of the financial highlights section: “The data for . . . 1966 reflect amounts previously reported in the Company’s annual reports. Operations of companies acquired in pooling-of-interest transactions are reported from the beginning of the year in which the acquisition occurs.”

Quite a different picture was presented in the consolidated statements of income for the years ended December 31, 1966 and 1967 on pages 34 and 35 of the report. Those statements “restated to include accounts of companies acquired during 1967 in pooling of interest transactions” reflected the same figures for 1967, but net sales for 1966 of \$195.9 million and net income per common share for 1966 of \$1.75. In other words, with accounts appropriately restated net income per common share for 1967 actually represented a \$.32 per share decrease, rather than the \$.28 per share increase asserted in the “financial highlights” and the president’s letter, and the increase in net sales amounted to only \$46.4 million rather than \$150 million.

3. Recommendations relating to the quality of annual reports to shareholders.

Based on the conclusions outlined in the preceding section of this chapter, the Study is of the opinion that annual reports should remain non-filed documents under the proxy rules. A certain amount of experimentation in methods of communication between
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management and the company's shareholders ought to be permitted if consequences seriously adverse to the interests of investors do not ensue. However, steps should be taken to inhibit condensed presentations of financial information which lead the reader to believe that the financial results are more favorable than those shown in the company's certified financial statements. It is believed that such a rule would improve disclosures in annual reports without interfering with management's legitimate freedom of expression.

The reaction of the Commission to one example of a misleading condensed treatment of results of operations in an annual report was published in Securities Act Release No. 4910, issued on June 18, 1968. That release, however, dealt with the problem in the context of a request for acceleration of a pending registration statement. The subject surely deserves broader treatment. The Study considered the possibility of requiring by rule that all financial disclosures in an annual report to shareholders, wherever located in the report, be reviewed by the auditors for consistency with the certified financial statements and covered by their opinion. The opinion would be required to state that the auditor has reviewed such disclosures and that they are fairly based on the certified statements. An alternative approach would be to amend Rule 14a-3(b) to inhibit misleading condensations of financial information. A draft of the proposed amendment is submitted in Appendix XI-1.

In addition, the Study expects that the improvements in the scope and timeliness of Form 10-K recommended in Chapter X will exert a beneficial influence on the quality of the disclosures made in the annual report to shareholders. The revised Form 10-K would be required to be filed not later than 5 days after the mailing of the annual report to shareholders, and it would disclose significant aspects of the registrant's business. Such disclosures would therefore be available in timely fashion for comparison with those made in the annual report. This indirect way of influencing better disclosure in annual reports is preferable, in the Study's judgment, to the development of affirmative and specific Federal requirements for the text of annual reports.

4. Dissemination of annual reports to shareholders.^{5/}

When the report of the Study was in preparation, it included two recommendations designed to insure that an annual report is actually received by all beneficial owners of the shares of a reporting company at least once a year. The Study is happy to note that, as of the date of completion of its report, neither of these recommendations is needed.

^{5/} As noted in Chapter IX, annual reports to shareholders are now available on microfiche.

Many owners of securities cause such securities to be held in street name by their brokers. The New York and American Stock Exchanges have rules requiring their members to forward proxy material and annual reports to beneficial owners of all securities held by them in street name upon being reimbursed for their reasonable expenses. It seemed desirable to the Study that the NASD be asked to put into effect a similar rule and it has recently done so.

The laws of several states permit a corporation to dispense with an annual meeting if the consents of holders of a specified number of its shares are obtained.^{6/} This formerly meant that no annual report had to be furnished to shareholders, since Rule 14c-2 under Section 14, as formerly interpreted, required an information statement, which must be accompanied or preceded by an annual report, to be furnished only in connection with a meeting. It seemed desirable to the Study that steps be taken to require that an information statement (and annual report) be provided to shareholders if an annual meeting is dispensed with by a reporting company in accordance with state law on the basis of a consent procedure. Recently, the Commission adopted Rule 14c-2, which should accomplish this purpose.^{7/}

^{6/} See, for example, Delaware Corporation Law, Sec. 228.

^{7/} Securities Act Release 8521 (February 10, 1969).

C. The Study recommends no substantial change in present requirements for the annual proxy statement.^{8/}

Annual proxy statements relating to the election of directors play a unique part in the pattern of continuing disclosure. They are actually sent to shareholders, whereas reports designed to keep current the information filed with the Commission in dealing with non-management aspects of a company's affairs are not. This situation has led to suggestions that a description of the company's business be required to be set forth in each annual proxy statement. For reasons more fully stated in Chapter X, the Study did not adopt this suggestion.

Suggestions for changes in the rules governing the content of the annual proxy statement have been carefully considered and acted upon by the Commission at least twice in the last three years. While accumulated experience will doubtless indicate the desirability of additional changes in the future, at present the Study has only minor revisions to suggest. It is recommended (1) that Schedules 14A and 14C be revised to require disclosure of the aggregate amount of equity securities held by management, as now required in Form S-1, (2) the \$30,000 limitation as to directors' and officers' remuneration should be changed to \$40,000, in line

^{8/} The observations in this section of Chapter XI also relate to annual information statements required by Section 14 of the '34 Act and Schedule 14C.

with the similar recommendation pertaining to Form 10, and (3) the required data concerning new directors reflect the changes recommended in Form S-1 (see Chapter III).

D. To enhance its usefulness to the average investor, the merger proxy statement should be divided into two separately printed documents: (1) a concise statement of basic information, and (2) an appendix containing more detailed information and financial statements.

1. The usefulness of the typical merger proxy statement is impaired by its length and complexity.

The rapid increase in the number of mergers and corporate acquisitions in recent years has greatly increased the importance of the merger proxy statement^{9/} in the pattern of disclosure. In fiscal 1968, 634 definitive proxy statements were filed relating to mergers, consolidations, acquisitions of business, purchases (and sales) of property, and the dissolution of companies.^{10/} By contrast, it is estimated that only 170 such proxy statements were filed in fiscal 1960.^{11/}

In conferences with the Study, many security analysts stressed the value of merger proxy statements. No other single document, apart from the prospectus, was regarded as containing

^{9/} Hereafter, the phrase “merger proxy statement” is used to refer to a proxy statement relating to a vote of shareholders on a statutory merger or consolidation or a sale of assets incident to a business combination.

^{10/} 34 SEC Annual Rep. 41 (1968).

^{11/} 26 SEC Annual Rep. 87 (1960).

information of greater usefulness in evaluating the securities of publicly held corporations. However, the merger proxy statement has been criticized by those to whom it is primarily directed, the shareholders whose approval of the transaction is being sought. Several shareholder complaints came directly to the attention of the Study. In addition, representatives of the American Society of Corporate Secretaries informed the Study that they had received many complaints from shareholders concerning the length and complexity of merger proxy statements prepared in accordance with the Commission's rules.

The Study reviewed a number of merger proxy statements which ranged from approximately 60 to over 200 pages in length. The complaints of shareholders concerning these massive documents are understandable.

2. Several possible approaches to a solution.

First, the Study questions whether the mass of detailed financial statements provided in many merger proxy statements (and frequently constituting considerably more than half the bulk of the statement) are entirely necessary. A review of the requirements of Item 15 of Schedule 14A of the Proxy Rules should be made with a view to possible reduction of present requirements in the case of business combinations. In particular, if a large corporation

proposes to acquire a small corporation by merger and must therefore seek the approving vote of its own stockholders, a very short summary of the proposed transaction may be all that is needed adequately to inform such shareholders.^{12/} More complete information about both parties to the merger may well be needed by shareholders of the disappearing corporation.

Second, some means of summarizing the essential data for the benefit of the average shareholder should be found. This subject was discussed extensively with a special committee of the American Society of Corporate Secretaries. The following alternatives were considered:

(1) The Commission might develop standards for a summary merger proxy statement which would omit detailed descriptions of business and the bulk of the financial statements. Companies would either be permitted or required to send only the summary statement to shareholders. The full statement would be filed with the Commission.

(2) As a variant of (1), above, the summary statement would inform the shareholder that a copy of the full statement would be sent to him by the company at his request.

^{12/} Schneider, Acquisitions Under the Federal Securities Acts--A Program For Reform, 116 U. Pa. L. Rev. 1323, 1343 ff. (1968).

(3) A very short summary of essential information, together with comparative net income, dividend and per share book value data would be required to be printed separately as the merger proxy statement. Accompanying the merger proxy statement would be an appendix containing the detailed information and financial statements not provided in the shorter document.

The Study was unable to accept alternative (1). Under this alternative, shareholders who desired to be completely informed before casting their votes would have no alternative but to order the full proxy statement at their own expense from the Commission. Alternative (2) was unacceptable to the special committee of the ASCS for reasons which the Study considered valid. It was estimated that a significant number of shareholders would request the full proxy statement. However, the exact number of such requests would be impossible to determine in advance, and the corporation would therefore be unable to determine the number of statements it should print. Moreover, responding to individual requests is relatively expensive as opposed to arranging a mailing to all shareholders. Delays might occur in voting which would be protracted in situations where securities are held in street name and requests would have to pass through a broker.

A further problem with either of the first two alternatives arises from the concern over liability provisions in the securities laws expressed by members of the Committee on Securities Regulation of the Banking and Business Law Section of the American Bar Association, who consulted with the Study. There was strong reluctance to prepare entirely separate summaries of disclosure documents which, by hindsight, might be found to have omitted material information.

In the Study's opinion, alternative (3) offers a measure of relief sufficient to justify its adoption. This alternative does not differ greatly from the practice followed today by a few companies and their counsel who undertake to summarize the essential features of a merger proxy statement in its first few pages. Such a summary, separately printed, should average no more than 6 or 7 pages.^{13/} Its modest size, in comparison with a single, massive document would respond to the needs of the average shareholder. It should be written in clear and concise language and should be limited to:

- (a) General information as to the purposes of the solicitation, date and place of meeting, securities entitled to vote, record date, appraisal rights and a brief description of the securities being offered.

^{13/} The Study experimented with several large merger proxy statements, culling out the essential information in summary form. This experiment showed that a 6-7 page average length for the proxy statement could be expected.

- (b) A brief outline of the proposal to be voted upon.
- (c) A summary of the tax consequences.
- (d) A brief identification of the business of the parties to the merger.
- (e) Information as to the management of the surviving company.
- (f) Comparative stock prices for an appropriate period.
- (g) Comparative net income, dividends and book values per share on an historical and pro forma combined basis.

As to each item, reference should be made to the location of further details in the appendix and the last item in the proxy statement should be a table of contents of the appendix.

3. An analogous problem: the registration statement relating to a voluntary exchange of shares.

Many prospectuses filed with the Commission relating to offers of voluntary exchange which were examined by the Study presented problems similar to those of the merger proxy statement. There were 99 such prospectuses filed with the Commission from July 1, 1968, through December 31, 1968. A summarization of essential data, similar to that suggested for the merger proxy statement, should be required in the forepart of the prospectus used in an offer of exchange of securities.